



UK GAAP 2026

Application of FRS 100-104
in the UK

May 2026



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UK GAAP 2026

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About this book

UK GAAP 2026 is the fourth edition of the EY publication on UK GAAP following the issuance of new UK GAAP accounting standards, FRSs 100-104, which have applied for accounting periods beginning on or after 1 January 2015. The original publication, New UK GAAP 2015, was published in 2015 and revised editions, UK GAAP 2017 and UK GAAP 2019, were published in 2017 and 2019, respectively. This publication has been fully revised and updated in order to:

- Incorporate the September 2024 editions of FRSs 100-104 and amendments thereon issued as at March 2026 including the Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs - Periodic review 2024* (published in March 2024) (Periodic Review 2024). The changes made by the Periodic review 2024 are discussed in each relevant chapter.
 - Include changes to legal requirements for UK companies and LLPs introduced since the previous edition.
- And
- Provide further insight on the many issues relating to the practical application of the new UK accounting standards which have arisen since the publication of UK GAAP 2019, based on the extensive experience of the book's authors in dealing with recent day-to-day issues.

This book comprises 39 chapters. Each chapter includes a detailed list of contents and a comparison of UK GAAP to IFRS. The book also contains an index of references to standards and interpretations.

FRS 101 *Reduced Disclosure Framework - Disclosure exemptions from EU-adopted IFRS for qualifying entities* uses the recognition and measurement principles of International Financial Reporting Accounting Standards (IFRS Accounting Standards). In certain circumstances, FRS 102 also refers entities to IFRS Accounting Standards. Detailed guidance on applying IFRS can be found in the latest edition of the EY publication, International GAAP®.

Preface

The Financial Reporting Standards (FRSs 100-105) have applied from accounting periods beginning on or after 1 January 2015 (or, for small entities that choose to apply the small entities regime and micro entities that choose to apply the micro entities regime, accounting periods beginning on or after 1 January 2016), along with the associated accounting requirements of the Companies Act 2006 (CA 2006). FRS 105 is outside of the scope of this publication.

New standards

Since the publication of UK GAAP 2019, further amendments have been made to FRSs 100-104. The most significant of these were as a result of the second periodic review of the standards. When FRS 102 was issued originally in March 2013, the FRC indicated that it would be reviewed every three years. The first periodic review was completed in December 2017 and its requirements were mandatory for accounting periods beginning on or after 1 January 2019.

The second periodic review was issued in 2024 (the Periodic Review 2024) and its requirements, with minor exceptions, are applicable for accounting periods beginning on or after 1 January 2026. In developing the amendments made by the Periodic Review 2024, the FRC considered both major and minor changes to IFRS Accounting Standards, the IASB's proposed changes in developing the third edition of the IFRS for SMEs Accounting Standard, stakeholder feedback in response to the FRC's 2021 request for views and FREDs 82 and 84, along with other developments in corporate reporting. The FRC's intention is that FRS 102 reflects up-to-date IFRS-based solutions, providing high-quality understandable financial reporting to users in line with the FRC's overriding objective to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. The FRC believes that the amendments have been designed to be proportionate to the size and complexity of the entities applying the FRSs.

In our view, the principal changes to FRS 102 which are likely to have the most impact relate to:

- New accounting requirements for revenue in Section 23 of FRS 102, based on the five-step model for revenue recognition from IFRS 15 *Revenue from Contracts with Customers*, with some simplifications. The extent to which this will change an entity's revenue recognition in practice will depend on the nature of its contracts. For some entities, this will result in a material change in revenue recognised.
- New lease accounting requirements in Section 20 of FRS 102 for lessees, based on the on-balance-sheet model from IFRS 16 *Leases*, with some simplifications. This is expected to result in an impact on the financial statements of most entities that are lessees with one or more operating lease.
- Increased disclosure for small entities in the UK applying Section 1A *Small Entities* that the FRC considers are necessary in order to give a true and fair view.
- A revised Section 2 *Concepts and Pervasive Principles*, updated to reflect the IASB's *Conceptual Framework for Financial Reporting*, issued in 2018.
- A new Section 2A *Fair Value Measurement*, replacing the *Appendix: Fair value measurement* to Section 2 and updated to reflect the principles of IFRS 13 *Fair Value Measurement*.
- Amendments made to Section 29 *Income Taxes* to explain how to account for uncertain tax treatments based on the requirements in IFRIC 23 *Uncertainty over Income Tax Treatments*.
- Disclosure requirements introduced in Section 7 *Statement of cash flows* based on the IASB's May 2023 *Supplier Finance Arrangements (Amendments to IAS 7 and IFRS 7)*. Qualifying entities not preparing a cash flow statement are exempt from the supplier finance arrangements disclosure requirements only if equivalent disclosures are included in the consolidated financial statements.

And

- Removal of the option to adopt for the first time the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* under paragraphs 11.2(b) and 12.2(b) of FRS 102 (unless needed to achieve consistency with group accounting policies), in preparation for the eventual removal of this option. Entities already applying the IAS 39 option are permitted to continue to apply it.

Following consultation, the FRC did not introduce elements of the expected credit loss model of IFRS 9 *Financial Instruments* or the requirements of IFRS 17 *Insurance contracts* into FRS 102 or FRS 103 *Insurance contracts* in the Periodic review 2024. The FRC intends to reconsider the expected credit loss model in due course, taking into account the IASB's third edition of the *IFRS for SMEs Accounting Standard* which was finalised in February 2025. New disclosure requirements were inserted in Section 11 of FRS 102 for entities applying IFRS 9 and therefore applying the expected credit loss model.

It is expected that the FRC is likely to wait for several years' implementation experience before considering alignment of FRS 103 *Insurance contracts* with IFRS 17. As noted in the Basis for Conclusions to FRS 101, conflicts between IFRS 17 and company law have led the FRC to conclude previously that it is not currently possible to apply IFRS 17 in Companies Act accounts (i.e., accounts prepared in accordance with the FRC's FRSs) whilst continuing to maintain compliance with company law.

Since the Periodic Review 2024, in February 2026, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime - Adapted formats*. These amendments, which apply only to entities using the adapted formats, amend the requirements for classifying assets and liabilities as current or non-current and amend the balance sheet and profit and loss account formats to align with IFRS 18 *Presentation and Disclosure in Financial Statements* albeit without the underlying application guidance. These amendments are mandatory for accounting periods beginning on or after 1 January 2027 with early application permitted.

FRS 102 will be subject to the next periodic review in five years (i.e., 2029). However, the FRC will continue to assess emerging issues as they arise and therefore it is possible that there may be amendments issued outside the regular periodic review cycle.

Since the publication of UK GAAP 2019, the FRC has also issued amendments to FRS 101 with the main purpose of accommodating the forthcoming replacement of IAS 1 *Presentation of Financial Statements* with IFRS 18. In addition to retaining the existing disclosure exemptions within IAS 1, now contained in IFRS 18, qualifying entities will be exempt from disclosures in respect of management-defined performance measures and the additional expense disaggregation disclosures. Separately, insurance companies have been prohibited from applying FRS 101 due to the conflict between IFRS 17 and Companies Act accounts mentioned above. Insurance companies must apply either FRS 102 or IFRS accounting standards.

This publication includes our views on the judgemental areas we believe are likely to be most common in practice based on our experience of applying UK GAAP and similar issues encountered in applying IFRS accounting standards. As experience of applying the Periodic Review 2024 amendments evolves, we expect our views will continue to evolve. It is not possible for this publication to cover every aspect of company reporting. For some of the more complicated or less common areas which are not covered by FRS 102 and for which IFRS accounting standards provide relevant guidance, further explanations can be found in the latest edition of the EY publication, *International GAAP®*.

Contributors

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Our thanks go particularly to those who reviewed and edited the drafts, most notably:

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References and abbreviations

The following references and abbreviations are used in this book:

References in index of standards:

Foreword.19	Paragraph 19 of the Foreword to Accounting Standards issued by the FRC
FRS 100 Summary (i)	Paragraph i of the Summary of FRS 100
FRS 100.4	Paragraph 4 of FRS 100
FRS 100 Appendix I	Appendix I: Glossary to FRS 100
FRS 100.AG7	Paragraph 7 of the Application Guidance to FRS 100
FRS 101.10	Paragraph 10 of FRS 101
FRS 101 Appendix I Table 1	Table 1 of Appendix I to FRS 101
FRS 101 A3.2	Paragraph 2 of Appendix III to FRS 101
FRS 101.BC15	Paragraph 15 of the Basis for Conclusions to FRS 101
FRS 102.1A.7	Paragraph 7 of Section 1A of FRS 102
FRS 102.23.9	Paragraph 9 of Section 23 of FRS 102
FRS 102.PBE34.89	Paragraph PBE34.89 of Section 34 of FRS 102
FRS 102 Appendix I	Appendix I of FRS 102: Glossary
FRS 102 Appendix II	Appendix II of FRS 102: Table of equivalence for company law terminology
FRS 102.A3.5	Paragraph 5 of Appendix III of FRS 102: Note on legal requirements
FRS 102.A4.1	Paragraph 1 of Appendix IV to FRS 102: Republic of Ireland legal references
FRS 102.BC.B2.1	Paragraph B2.1 of the Basis for Conclusions to FRS 102
FRS 102(2022).23.10	Paragraph 10 of Section 23 of FRS 102 applicable in the UK and Republic of Ireland (January 2022)
FRS 103.1	Paragraph 1 of FRS 103
FRS 103.IG2.15	Paragraph 15 of Section 2 of the Implementation Guidance to accompany FRS 103
FRS 103.A2.5	Paragraph 5 of Appendix II to FRS 103: Definition of an insurance contract
FRS 103.BC18	Paragraph 18 of the Basis for Conclusions to FRS 103
FRS 104.1	Paragraph 1 of FRS 104
FRS 105.1	Paragraph 1 of FRS 105
FRS 11.9	Paragraph 9 of FRS 11
SSAP 19.11	Paragraph 11 of SSAP 19

FRSSE 6.51	Paragraph 6.51 of the Financial Reporting Standard for Smaller Entities
IFRS 1 Appendix A	Appendix A of IFRS 1
IFRS 3.29	Paragraph 29 of IFRS 3
IFRS 4.IG70	Paragraph 70 of the Implementation Guidance to IFRS 4
IFRS 10.B98	Paragraph 98 of Appendix B to IFRS 10
IAS 1.12	Paragraph 12 of IAS 1
IAS 27.15 (2012)	Paragraph 15 of the version of IAS 27 effective in 2012
IFRIC 18.BC22	Paragraph 22 of the Basis for Conclusions to IFRIC 18
s395(2)	Section 395 subsection (2) of the Companies Act 2006
s408 (LLP)	Section 408 of The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911)
Regulations 6(2)	Paragraph 6(2) of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/1910)
1 Sch 53	Paragraph 53 of Schedule 1 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/1910)
Regulations (SC) 8	Paragraph 8 of the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)
1 Sch 1C (SC)	Paragraph 1C of Schedule 1 to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)
LLP Regulations 3	Paragraph 3 of The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913)
1 Sch 1 (LLP)	Paragraph 1 of Schedule 1 to The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913)
LLP SC Regulations 6	Paragraph 6 of The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912)
1 Sch 10(2) (LLP SC)	Paragraph 10(2) of Schedule 1 to the Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912)
TECH 02/17BL	Technical Release 02/17BL: <i>Guidance on Realised and Distributable Profits under the Companies Act 2006</i> issued by the ICAEW and ICAS (April 2017)
DTR 7.2	Paragraph 7.2 of the Disclosure and Transparency Rules
LR 11	Paragraph 11 to the LSE Listing Rules
LLP SORP Appendix 4	Appendix 4 to the Statement on Recommended Practice - Accounting by Limited Liability Partnerships - issued by the CCAB

Professional and regulatory bodies:

CCAB	Consultative Committee of Accountancy Bodies
EEA	European Economic Area
EU	European Union
FRC	Financial Reporting Council
IASB	International Accounting Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IFRS IC	International Financial Reporting Standards Interpretations Committee
PRA	Prudential Regulation Authority
TAG	UK GAAP Technical Advisory Group

Accounting related terms:

AIM	Alternative Investment Market
CA 2006	Companies Act 2006
CA 2014	Companies Act 2014 (Republic of Ireland)
CBDC	Central Bank Digital Currency
CGU	Cash-generating unit
Code	The UK Corporate Governance Code (2024)
DAS	Digital Apprenticeship System
ECL	Expected Credit Loss
E&E	Exploration and evaluation
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, tax, depreciation and amortisation
EBT	Employee benefit trust
EIR	Effective interest rate
EPS	Earnings per share
FC	Foreign currency
FIFO	First-in, first-out basis of valuation
FRED	Financial Reporting Exposure Draft (issued by the FRC)
FRS	Financial Reporting Standard (issued by the FRC)
FRSSE	Financial Reporting Standard for Smaller Entities
FTA	First-time adoption
FVLCD	Fair value less costs of disposal
FVLCS	Fair value less costs to sell
GAAP	Generally Accepted Accounting Practice
IAS	International Accounting Standard (issued by the former board of the IASC)
IBOR	Interbank offer rate
IBNR	Incurred But Not Reported

IBR	Incremental borrowing rate
IFRS	International Financial Reporting Standard (issued by the IASB)
IFRS for SMEs	International Financial Reporting Standard for Small and Medium-sized Entities
IIR	Implicit interest rate (in a lease)
IRIL	Interest rate implicit in a lease
IRR	Internal rate of return
JA	Joint arrangement
JANE	Joint arrangement that is not an entity
JCA	Jointly controlled asset
JCE	Jointly controlled entity
JCO	Jointly controlled operation
JV	Joint venture
LIBOR	London Inter Bank Offered Rate
LIFO	Last-in, first-out basis of valuation
LLP	Limited liability partnership
LLP Regulations	The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913)
MMF	Money Market Fund
NCI	Non-controlling interest
NBV	Net book value
NPV	Net present value
NRV	Net realisable value
OBR	Obtainable borrowing rate
OCI	Other comprehensive income
OEIC	Open-ended investment company
PAYE	Pay As You Earn
PBE	Public benefit entity
Periodic Review 2024	Amendments to FRS 102 <i>The Financial Reporting Standard applicable in the UK and Republic of Ireland</i> and other FRSS
PP&E / PPE	Property, plant and equipment
R&D	Research and development
Regulations	The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)
ROU / ROUA	Right-of-use / Right-of-use asset
SCA	Service concession arrangement
SE	Structured entity
SI 2015/980	The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (SI 2015/980)
SI 2016/575	The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (SI 2016/575)

Small Companies Regulations	The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)
Small LLP Regulations	The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912)
SME	Small or medium-sized entity
SORP	Statement of Recommended Practice
SPE	Special purpose entity
SSAP	Statement of Standard Accounting Practice
SV	Separate vehicle
TSR	Total shareholder return
Triennial review 2017	<i>Amendments to FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland - Triennial review 2017 and Incremental improvements and clarifications</i> - issued in December 2017
2016 FRC Guidance	Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks - Guidance for directors of companies that do not apply the UK Corporate Governance Code (April 2016) - issued by the FRC
UITF	Urgent Issues Task Force
UK	United Kingdom
VAT	Value Added Tax
VIU	Value in use
WACC	Weighted average cost of capital
WE&EE	Waste Electrical and Electronic Equipment

Authoritative literature

The content of this book takes into account all UK accounting standards extant as at May 2026.

References to the main text of each chapter to the pronouncements below for FRSs 100-105 are generally based on the version of the standard issued in September 2024.

Accounting Standards

Foreword to Accounting Standards (January 2022)

Overview of the financial reporting framework (March 2025)

FRS 100 - Application of Financial Reporting Requirements (September 2024)

FRS 101 - Reduced Disclosure Framework - Disclosure exemptions from adopted IFRS for qualifying entities (September 2024)

Amendments to FRS 101 - Reduced Disclosure Framework - 2024/25 cycle (May 2025)

FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland (September 2024)

Amendments to FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to micro-entities regime - UK company size thresholds (March 2025)

Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-entities regime* (February 2026)

FRS 103 - Insurance Contracts - Consolidated accounting and reporting requirements for entities in the UK and Republic of Ireland issuing insurance contracts (September 2024)

FRS 104 - Interim Financial Reporting (September 2024)

FRS 105 - The Financial Reporting Standard applicable to the Micro-entities Regime (September 2024)

Chapter 1

FRS 100 – Application of financial reporting requirements

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Overview

This chapter deals with the application of FRS 100 *Application of Financial Reporting Requirements*. The standard applies to entities preparing financial statements in accordance with legislation, regulations or accounting standards applicable in the UK and the Republic of Ireland (i.e., FRSs 101 to 105). [FRS 100.1]. The chapter primarily deals with the September 2024 version of FRS 100, which incorporates the changes made by *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review 2024*.

What you need to know

- FRS 100 sets out the financial reporting requirements for UK and Republic of Ireland entities. The purpose of this FRS is to establish the financial reporting framework for entities when preparing their financial statements in accordance with the laws and accounting standards that apply in the United Kingdom and the Republic of Ireland.
- FRS 100 sets out the applicability of Statements of Recommended Practice (SORPs).
- FRS 100 includes application guidance on the interpretation of 'equivalence' for the purposes of:
 - The exemption from preparation of consolidated financial statements in section 401 of the Companies Act 2006.
 - The reduced disclosure framework discussed in Chapter 2 for FRS 101 and in Chapter 3 for FRS 102.

1 Introduction

'UK and Irish GAAP' incorporates the following Financial Reporting Standards:

- FRS 100 *Application of Financial Reporting Requirements*
- FRS 101 *Reduced Disclosure Framework: Disclosure exemptions from adopted IFRS for qualifying entities* (see Chapter 2)
- FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*
- FRS 103 *Insurance Contracts - Consolidated accounting and reporting requirements for entities in the UK and Republic of Ireland issuing insurance contracts* (see Chapter 38)
- FRS 104 *Interim Financial Reporting* (see Chapter 39)

And

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

The objective of FRS 100 is to set out the applicable financial reporting framework for entities preparing financial statements in accordance with legislation, regulations or accounting standards applicable in the United Kingdom and Republic of Ireland. [FRS 100.1].

The Companies Act 2006 recognises two broad categories of financial reporting frameworks for the preparation of financial statements; UK-adopted international accounting standards or UK and Irish GAAP. UK companies with transferable securities admitted to trading on a regulated market (at the financial year-end) are required by section 403(1) of the Act to prepare their consolidated financial statements using UK-adopted international accounting standards. A list of regulated markets is available online.¹

Entities that are not required by UK company law to prepare financial statements using UK-adopted international accounting standards may be required to do so by other regulatory requirements, such as the AIM Rules or by other agreements (e.g., shareholders' or partnership agreements).

However, other UK companies are permitted to prepare their consolidated and/or individual financial statements as IAS accounts (using UK-adopted international accounting standards) or Companies Act accounts (using 'applicable accounting standards' – see 3.5.1 below), subject to company law restrictions concerning the 'consistency of financial reporting framework' used in the individual accounts of group undertakings and over changes in financial reporting framework from IAS accounts to Companies Act accounts (see 5.1.2 and 5.1.3 below).

The requirements for preparation of financial statements under the Act are addressed at 5 below. Except where otherwise stated, the rest of this chapter will refer to the requirements for UK companies. UK LLPs and other entities preparing financial statements in accordance with Part 15 of the Act are subject to similar requirements, modified as necessary by the regulations that govern the content of their financial statements.

¹ [The Financial Services Register](#)

2 Summary of FRS 100

The following is a summary of FRS 100:

- FRS 100 sets out the application of the financial reporting framework for UK and Republic of Ireland entities (see 3 below). The detailed accounting requirements are included in UK-adopted international accounting standards, FRS 101, FRS 102 and FRS 105, depending on the choice of GAAP made by the entity. FRS 103 applies to financial statements prepared in accordance with FRS 102. FRS 104 applies to interim financial statements and can be applied by entities preparing annual financial statements under FRS 101 or FRS 102. FRS 100 sets out the applicability of SORPs (see 3.6 below).
- FRS 100 sets out the transition arrangements to FRS 101, FRS 102, and FRS 105 (see 4 below).
- FRS 100 includes application guidance on the interpretation of 'equivalence' for the purposes of:
 - The exemption from preparation of consolidated financial statements in section 401 of the Act. This is discussed in Chapter 2 at 2.3 (for FRS 101) and Chapter 8 at 3.1.1 (for FRS 102) but the same requirements apply to IAS accounts.
 - And
 - The reduced disclosure framework discussed in Chapter 2 (for FRS 101) and in Chapter 3 at 3 (for FRS 102) respectively.

3 FRS 100 – Application of financial reporting requirements

The publication of the original versions of FRS 100 to FRS 105 followed a lengthy period of consultation (from 2002 to 2012) on changes to financial reporting in the UK and Republic of Ireland (the 'Future of UK and Irish GAAP').

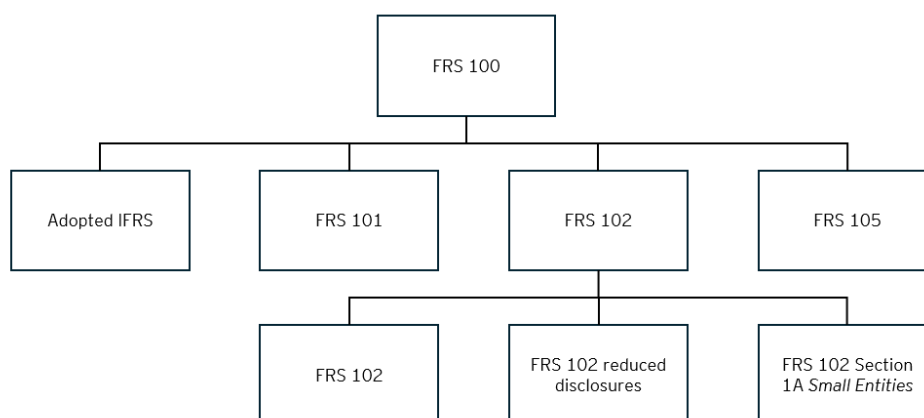
In developing the standards, the FRC set out an overriding objective to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. [FRS 100.BC.1].

In meeting this objective, the FRC stated that it aims to provide succinct financial reporting standards that: [FRS 100.BC.2]

- Have consistency with global accounting standards through application of an IFRS-based solution unless an alternative clearly better meets the overriding objective.
 - Balance improvement, through reflecting up-to-date thinking and developments in the way businesses operate and the transactions they undertake, with stability.
 - Balance consistent principles for accounting by all UK and Republic of Ireland entities with proportionate and practical solutions based on size, complexity, public interest and users' information needs.
 - Promote efficiency within groups.
- And
- Are cost-effective to apply.

The financial reporting framework set out in FRS 100 is summarised in the diagram below:

Figure 3-1: The UK Financial Reporting Framework



3.1 Scope of FRS 100

The objective of FRS 100 is to set out the applicable financial reporting framework for entities preparing financial statements in accordance with legislation, regulations or accounting standards applicable in the UK and Republic of Ireland. [FRS 100.1].

FRS 100 applies to financial statements intended to give a true and fair view of assets, liabilities, financial position and profit or loss for a period. [FRS 100.2].

FRS 100 to FRS 105 can be applied by an entity that is not a UK or Irish company which is preparing financial statements that are intended to give a true and fair view. However, paragraph A2.20 of Appendix II to FRS 100 states that the FRC sets accounting standards within the framework of the Act and therefore it is the company law requirements that the FRC primarily considered when developing FRS 102, therefore entities preparing financial statements within other legal frameworks will need to satisfy themselves that FRS 102 does not conflict with any relevant legal obligations. See 3.3 below.

3.2 Effective date of Periodic Review 2024

In March 2024 amendments were made to FRS 100 as a result of the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS – Periodic Review 2024*. The amendments, which are included in the September 2024 version of the standard, are effective for accounting periods beginning on or after 1 January 2026. Early application is permitted, provided that all the amendments are applied at the same time. If an entity applies these amendments before 1 January 2026, it should disclose that fact. [FRS 100.10E].

3.3 Basis of preparation of financial statements

FRS 100 does not address which entities must prepare financial statements but sets out the applicable financial reporting framework for entities presenting financial statements in accordance with legislation, regulations or accounting standards applicable in the UK and Republic of Ireland. [FRS 100.1].

The individual or consolidated financial statements of any entity within the scope of FRS 100 (that is not required by the Act or other legislation or regulations to be prepared in accordance with UK-adopted international accounting standards) must be prepared in accordance with either: [FRS 100.4]

- FRS 105, if the entity is a micro entity eligible to apply that standard and chooses to do so – see 3.3.5 and 5.4 below.
- One of the following if the financial statements are those of an entity that is either not eligible or chooses not to apply FRS 105:
 - Adopted IFRS (see 3.3.2 below)
 - FRS 102 (see 3.3.3 below) and, where applicable, FRS 103 (see Chapter 33)
 - FRS 101 (if the financial statements are individual financial statements of a qualifying entity) (see 3.3.4 below)

The above choices are also available for the individual financial statements of an entity that is required to prepare consolidated financial statements in accordance with UK-adopted international accounting standards. [FRS 100.4, FRS 102.1.3].

An entity's choice of financial reporting framework must be permitted by the legal framework or other regulations or requirements that govern the preparation of the entity's financial statements. Other agreements or arrangements (such as shareholders' agreements, banking agreements) may also restrict the choice of financial reporting framework.

3.3.1 Company law and regulatory requirements governing financial reporting framework

A UK parent company with transferable securities admitted to trading on a UK regulated market at its financial year end must prepare its consolidated financial statements in accordance with UK-adopted international accounting standards. [s403(1)]. The individual financial statements of such a parent company may be either Companies Act individual accounts or IAS individual accounts. [s395(1)].

Although AIM is not a regulated market, the AIM Rules require consolidated accounts for an 'AIM company' (i.e., a company with a class of security admitted to AIM) incorporated in the UK, to be prepared under UK-adopted international accounting standards. However, a UK AIM company that is not a parent company at the end of the relevant financial period may prepare and present its annual accounts either in accordance with UK-adopted international accounting standards or in accordance with the accounting and company legislation and regulations that are applicable to that company due to its country of incorporation which in the UK would include FRS 101 – if a qualifying entity – and FRS 102. While the AIM Rules do not specifically differentiate between consolidated and individual financial statements, many AIM companies incorporated in the UK use UK-adopted international accounting standards in their consolidated financial statements but UK GAAP in their individual financial statements. However, a parent company that only prepares individual financial statements, e.g., it is exempt from preparing consolidated financial statements, must prepare these in accordance with UK-adopted international accounting standards.²

For a UK company, the choice of framework, is subject to the requirements in the Act on a change in financial reporting framework (from IAS accounts to Companies Act accounts) (see 5.1.2 below) and consistency of financial reporting framework in individual accounts of group undertakings (see 5.1.3 below).

² [Aim Rules for Companies - 1 January 2021](#)

For the purposes of the Act, only statutory accounts prepared in accordance with UK-adopted international accounting standards are IAS accounts, whereas statutory accounts prepared in accordance with FRS 102, FRS 101, or FRS 105 are Companies Act accounts. [s395(1), s403(2)].

UK charitable companies are not permitted to prepare IAS accounts under the Act, [s395(2), s403(3)], and charities are not permitted to apply FRS 101 (as they are excluded from its definition of a qualifying entity). [FRS 100 Appendix I, FRS 101 Appendix IJ]. UK charitable companies preparing financial statements under the Act must, therefore, apply FRS 102. Other charities in the UK preparing financial statements under charities legislation must also apply FRS 102.³

FRS 101, FRS 102 and FRS 105 may also be used by entities preparing financial statements intended to give a true and fair view, but which are not subject to the Act. Entities preparing such financial statements intended to give a true and fair view within other legal frameworks will need to satisfy themselves that the standard being applied does not conflict with any relevant legal obligations. [FRS 100.A2.20, FRS 102.A3.41]. Where an entity is subject to a SORP, the relevant SORP will provide more details on the relevant legislation. [FRS 100.A2.2, FRS 102.A3.I.2].

3.3.2 Adopted IFRS

Adopted IFRS - IFRSs that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. [s474].

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

FRS 102 is a single financial reporting standard that applies to the financial statements of entities that are not applying UK-adopted international accounting standards, FRS 101 or FRS 105, adoption of which was first mandated for periods beginning on or after 1 January 2016,

In March 2024 amendments were made to FRS 102 as a result of the Periodic Review 2024. An entity shall apply the amendments, as set out in *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs - Periodic Review 2024*, for accounting periods beginning on or after 1 January 2026.

FRS 102 is arranged into the following sections:

- Section 1 addresses scope
 - Section 1A addresses small entities
 - Sections 2 to 33 each address a separate accounting topic
 - Section 34 addresses specialised activities
- And
- Section 35 addresses transition

There is a reduced disclosure framework available for qualifying entities (see 3.4 below) in their individual financial statements and also a separate disclosure framework for small entities (see Chapter 5).

Small entities can apply Section 1A of FRS 102, which requires small entities to apply the recognition and measurement requirements of FRS 102 in full. However, the presentation and disclosure requirements of Section 1A are based on those of the Act and the Small Companies Regulations for companies that are subject to the small companies regime.

The application of the small entities regime in Section 1A is not mandatory and an entity can instead apply FRS 102 in full. The small entities regime of FRS 102 is discussed in Chapter 5.

Any amendments to FRS 102 to reflect major changes in IFRS will be considered by the FRC on a case-by-case basis, including the appropriate timing. In addition, FRS 102 will be subject to periodic reviews reflecting stakeholder feedback, minor changes in IFRS and the IFRS for SMEs and other issues. These periodic reviews are likely to take place every four to five years, to allow time for experience of the most recent edition of FRS 102 to develop before seeking stakeholder feedback. However, the FRC will continue to assess emerging issues as they arise to determine whether action needs to be taken. When necessary this will include issuing amendments to standards outside regular review cycles. [FRS 102.BC.A.44, FRS 102.BC.A.45].

³ [Charities SORP 2026 - October 2025](#)

3.3.4 FRS 101 - Reduced Disclosure Framework

FRS 101 sets out a framework which addresses the financial reporting requirements and disclosure exemptions for the individual financial statements of qualifying entities (see 3.4 below) that otherwise apply the recognition, measurement and disclosure requirements of standards and interpretations issued by the International Accounting Standards Board (IASB) that have been adopted in the UK (IFRS accounting standards as adopted by the UK).

An entity reporting under FRS 101 complies with UK-adopted international accounting standards except as modified by the standard. FRS 101 contains various recognition and measurement modifications to UK-adopted international accounting standards, primarily to ensure compliance with UK company law.

The FRC reviews FRS 101 annually to ensure that the reduced disclosure framework continues to be effective in providing disclosure reductions for qualifying entities when compared with UK-adopted international accounting standards. [FRS 101.BC10].

See Chapter 2 for further guidance on FRS 101.

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

An entity that chooses to prepare its financial statements in accordance with the micro-entities regime as set out in *The Small Companies (Micro-entities' Accounts) Regulations 2013 (SI 2013/3008)* is required to apply FRS 105.

The recognition and measurement requirements of FRS 105 are based on those in FRS 102 (but with significant simplifications) and its presentation and disclosure requirements are consistent with the micro-entity provisions (in UK company and LLP law).

FRS 105 is outside the scope of this publication.

3.3.6 Considerations on choice of financial reporting framework

Entities will need to carefully consider their choice of financial reporting framework, based on their individual circumstances.

Factors influencing the choice of financial reporting framework might include:

- Whether the entity is a member of a group, and if so, what GAAP is used for group reporting. In particular, subsidiaries of groups reporting under IFRS or in multinational groups may prefer to apply IFRS, FRS 101 or *IFRS 19 Subsidiaries without Public Accountability* (effective for annual periods beginning on or after 1 January 2027) rather than FRS 102.
- The level of disclosures required in the financial statements:
 - FRS 101 and FRS 102 financial statements prepared by a UK company are Companies Act accounts and therefore must comply with the requirements of the Act and all applicable schedules of the Regulations (as well as accounting standards) - see 5.7 below. Financial statements prepared under UK-adopted international accounting standards do not need to comply with Schedules 1, 2 or 3 to the Regulations but must comply with the extensive disclosure requirements in IFRS.
 - The level of disclosure also depends on whether the entity is a qualifying entity and can make use of a reduced disclosure framework (under FRS 101 or FRS 102) in its individual financial statements (see 3.4 below). While FRS 102 has fewer disclosures than IFRS, the level of disclosure required may sometimes not be significantly different from FRS 101, but this will depend on the entity's individual circumstances.
- Stability of the financial reporting framework (in general, there are more frequent changes to IFRS than to FRS 102).
 - The implications of new IFRSs; including IFRS 18 *Presentation and Disclosure in Financial Statements* which will replace IAS 1 *Presentation of financial statements* for annual periods beginning on or after 1 January 2027, and other expected changes that will be implemented or expected to be finalised in future periods.
- IFRS provides detailed and sometimes complex guidance, whereas the requirements in FRS 102 are much shorter (but lack the same level of application guidance as in IFRS, and are likely to involve increased application of management judgement in applying the standard).

And

- The implications of different GAAPs for distributable profits (see 4.5 below) and taxation, in particular cash tax. This will also depend on the interaction with tax legislation, and whether tax elections are made.

3.4 Reduced disclosure framework

Both FRS 101 and FRS 102 provide for a reduced disclosure framework for qualifying entities in individual financial statements.

A 'qualifying entity' is a member of a group (i.e., a parent or subsidiary) where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation. [FRS 100 Appendix I, FRS 101 Appendix I, FRS 102 Appendix I]. The term 'included in the consolidation' has the meaning set out in section 474(1) of the Act, i.e., that the qualifying entity is consolidated in the financial statements by full (and not proportional) consolidation. Note that under FRS 101, a charity cannot be a qualifying entity. [FRS 101 Appendix I].

The disclosure exemptions available in FRS 102 are more limited than in FRS 101, which provides a reduced disclosure framework for qualifying entities under UK-adopted international accounting standards. This reflects the fact that FRS 102 (as a starting point) has much simpler disclosures than UK-adopted international accounting standards. Under the reduced disclosure framework in both standards, there are fewer disclosure exemptions available for the individual financial statements of financial institutions.

Certain disclosures require 'equivalent' disclosures to be included in the publicly available consolidated financial statements of the parent in which the qualifying entity is consolidated (i.e., of the parent referred to in the definition of qualifying entity). FRS 100 provides guidance on the concept of 'equivalence' for these purposes. [FRS 100.AG5, FRS 100.AG6].

Chapter 2 includes further discussion of the reduced disclosure framework under FRS 101 and Chapter 3 discusses further the reduced disclosure framework under FRS 102, including the detailed requirements for its use, the definitions of 'qualifying entity' and 'financial institution', the disclosure exemptions available, and guidance on 'equivalence' for the purpose of the reduced disclosure framework.

IFRS 19 is effective for annual periods beginning on or after 1 January 2027 with earlier adoption permitted. The standard allows eligible entities that prepare IAS accounts to elect to apply reduced disclosure requirements while still applying the recognition, measurement and presentation requirements in other IFRS accounting standards. (See Chapter 2 at 1.2.2).

3.5 Statement of compliance

FRS 100 requires that an entity preparing its financial statements in accordance with FRS 101 or FRS 102 (and where applicable, FRS 103) includes a statement of compliance in the notes to the financial statements in accordance with the requirements of the relevant standard. [FRS 100.9, FRS 101.10, FRS 102.3.3, FRS 103.1.12]. See Chapter 2 at 1.3 (for FRS 101 financial statements), Chapter 6 at 3.8 (for FRS 102 financial statements), and Chapter 5 at 11.2.5 and 11.3 (for small entities under FRS 102) for further details.

Financial statements should not be described as complying with FRS 101 or FRS 102, unless they comply with all of the requirements of the relevant standard. Indeed, FRS 102 includes an explicit requirement to this effect. [FRS 102.3.3].

3.5.1 Related Companies Act 2006 requirements

Where the directors of a large or medium-sized company (i.e., a company not subject to the micro-entity provisions or the small companies regime – see 5.4 and 5.5 below) prepare Companies Act individual or group accounts (such as those prepared under FRS 101 and FRS 102), the notes to the accounts must include a statement including the particulars of any material departure from those standards and the reasons for the departure. Large companies must also provide a statement as to whether the accounts have been prepared in accordance with applicable accounting standards. [Regulations 4(2)(a), 1 Sch 45].

'Applicable accounting standards' means statements of standard accounting practice issued by the FRC (and SSAPs, FRSs issued by the Accounting Standard Board and UITF Abstracts, until withdrawn).⁴ Therefore, FRS 100 to FRS 103 (and FRS 105 for companies applying the micro-entity provisions only) are 'applicable accounting standards'.⁵

Where the directors of a company prepare IAS individual or IAS group accounts (see 5.1 below), the notes to the accounts must include a statement that the accounts have been prepared in accordance with UK-adopted international accounting standards. [s397, s406, s474].

3.6 Statements of Recommended Practice (SORPs)

References to a SORP are to an extant Statement of Recommended Practice developed in accordance with the FRC's *Policy on Developing Statements of Recommended Practice (SORPs)*. SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector. [FRS 100 Appendix I].

The overview sections of the FRC's Policy on Developing Statements of Recommended Practice (SORPs) explains SORPs may only be developed and issued by 'SORP-making bodies', being bodies recognised by the FRC for the purpose of producing the SORP for a particular industry or sector. SORP-making bodies have a responsibility to act in the public interest when developing, maintaining and issuing SORPs. To be recognised as a SORP-making body, a particular industry or sectoral body must meet criteria set by the FRC and must agree to develop SORPs in accordance with the FRC's Policy on Developing Statements of Recommended Practice (SORPs).

SORPs recommend particular accounting treatments and disclosures with the aim of narrowing areas of difference and variety between comparable entities. Compliance with a SORP that has been generally accepted by an industry or sector leads to enhanced comparability between the financial statements of entities in that industry or sector. Comparability is further enhanced if users are made aware of the extent to which an entity complies with a SORP, and the reasons for any departures. [FRS 100.7].

FRS 100 states that if an entity's financial statements are prepared in accordance with FRS 102, SORPs apply in the circumstances set out in those SORPs. [FRS 100.5].

The application of SORPs under FRS 102 is discussed in Chapter 3 at 2.3.

When a SORP applies, an entity, other than a small entity in the Republic of Ireland applying the small entities regime in FRS 102 (i.e., Section 1A of FRS 102), must state in the financial statements the title of the SORP and whether the financial statements have been prepared in accordance with the SORP's provisions currently in effect. The provisions of a SORP cease to have effect, for example, to the extent they conflict with a more recent financial reporting standard. [FRS 100.6].

Paragraph 12 of the FRC's Policy on Developing Statements of Recommended Practice (SORPs) explains that SORPs should be developed in line with current accounting standards and best practice. A SORP's provisions cannot override provisions of the law, regulatory requirements or accounting standards. When a more recently issued accounting standard or change in legislation leads to conflict with the provisions of an existing SORP, the relevant provisions of the SORP cease to have effect. The SORP-making body is responsible for updating the relevant provisions of the SORP on a timely basis to bring them in line with new legislation or accounting standards, or to withdraw them, as appropriate.

Where an entity departs from the SORP's provisions, it must give a brief description of how the financial statements depart from the recommended practice set out in the SORP, which must include: [FRS 100.6]

- For any treatment that is not in accordance with the SORP, the reasons why the treatment adopted is judged more appropriate to the entity's particular circumstances.
- And

4 s464, The Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc.) Order 2012 (SI 2012/1741).

5 The Accounting Standards (Prescribed Bodies) (United States of America and Japan) Regulations 2015 (SI 2015/1675) permits companies with securities registered with the SEC or publicly traded on specified Japanese exchanges (but that do not have securities admitted to trading on an (EEA) regulated market) to prepare consolidated financial statements (but not individual financial statements) using US GAAP or JGAAP. Therefore, in these circumstances, US GAAP and JGAAP are applicable accounting standards. Such consolidated financial statements would also be Companies Act accounts. These Regulations, which replace a similar Statutory Instrument, come into force on 1 October 2015 and apply for financial years beginning on or after 1 January 2015. However, the dispensation applies only in respect of the group financial statements of a parent company for the first 4 financial years following incorporation of that company. It ceases to have effect on 30 September 2022.

- Brief details of any disclosures recommended by the SORP that have not been provided, together with the reasons why not.

The effect of a departure from a SORP need not be quantified, except in those rare cases where such quantification is necessary for the entity's financial statements to give a true and fair view. [FRS 100.7].

Entities whose financial statements do not fall within the scope of a SORP may, if the SORP is otherwise relevant to them, nevertheless choose to comply with the SORP's recommendations when preparing financial statements, providing that the SORP does not conflict with the requirements of the framework adopted. Where this is the case, entities are encouraged to disclose this fact. [FRS 100.8]. FRS 100, therefore, does not require an entity preparing its financial statements in accordance with FRS 101, or UK-adopted international accounting standards, to disclose whether it has applied the relevant SORP.

3.6.1 Status of SORPs

Certain SORPs were withdrawn on implementation of the new UK and Irish GAAP framework. Other SORPs have been updated to conform with FRS 102.

The following SORPs have been updated to conform with FRS 102:

- *Authorised funds (October 2025)*
- *Charities (October 2025)*
- *Further and higher education (November 2025)*
- Financial reports of pension funds (2018, with updated edition expected in 2026)
- Investment trust companies and venture capital trusts (July 2022, with updated edition expected in 2026)
- *Limited Liability Partnerships (November 2025)*
- *Registered Social Housing Providers* (September 2014, with updated edition expected in 2026)

See Chapter 3 at 2.3 for further details on the application of SORPs.

4 Transition

FRS 100 sets out the requirements for transition to FRS 101, FRS 102 and FRS 105.

On first-time application of FRS 100 or when an entity changes its basis of preparation of its financial statements within the requirements of FRS 100, it should apply the transitional arrangements relevant to its circumstances as explained at 4.2 to 4.4 below.

There is no requirement to change the GAAP applied by a UK parent and its UK subsidiaries at the same time. However, the Act sets out restrictions over changes in financial reporting framework (in both individual and group accounts) and over consistency of financial reporting framework in individual accounts of group undertakings (see 5.1.2 and 5.1.3 below).

4.1 Transition to UK-adopted international accounting standards

An entity transitioning to UK-adopted international accounting standards must apply the transitional requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, as adopted by the UK. [FRS 100.11(a)].

An entity's first IFRS financial statements (to which IFRS 1 must be applied) are the first annual financial statements in which the entity applies UK-adopted international accounting standards, by an explicit and unreserved statement in those financial statements of compliance with UK-adopted international accounting standards. [IFRS 1.2, IFRS 1.3]

An entity that has applied UK-adopted international accounting standards in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with UK-adopted international accounting standards must either apply IFRS 1 or else apply UK-adopted international accounting standards retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as if the entity had never stopped applying IFRSs. [IFRS 1.4A].

The requirements of IFRS 1 are discussed in the EY publication, International GAAP®.

4.2 Transition to FRS 101

A qualifying entity can transition to FRS 101 from either UK-adopted international accounting standards or another form of UK or Irish GAAP. In this context, another form of UK or Irish GAAP means FRS 102 or FRS 105. The transition requirements differ depending on whether or not the qualifying entity is applying UK-adopted international accounting standards prior to the date of transition. [FRS 100.11(b), FRS 100.12, FRS 100.13]. The transition requirements to FRS 101 are explained in Chapter 2 at 3.

4.3 Transition to FRS 102

A first-time adopter of FRS 102 is an entity that presents its first annual financial statements that conform to FRS 102, regardless of whether its previous financial reporting framework was UK-adopted international accounting standards, FRS 101, FRS 105, another set of GAAP such as its national accounting standards, or another framework such as the local income tax basis. [FRS 102.35.1, FRS 102 Appendix I]. An entity transitioning to FRS 102 must apply the transitional arrangements set out in Section 35 of that standard. [FRS 100.11(c), FRS 102.35.1].

FRS 102 also addresses the situation where an entity has previously applied FRS 102 and then applies a different GAAP for a period before re-applying FRS 102. An entity that adopted FRS 102 in a previous reporting period but whose most recent annual financial statements did not contain an explicit and unreserved statement of compliance with FRS 102 must either apply Section 35 or else apply FRS 102 retrospectively in accordance with Section 10 *Accounting Policies, Changes in Estimates and Errors*, as if the entity had never stopped applying the standard. [FRS 102.35.2].

An entity applying FRS 102 is required to apply FRS 103 to insurance contracts (including reinsurance contracts) that the entity issues and reinsurance contracts that the entity holds, and to financial instruments with a discretionary participation feature) that the entity issues. See Chapter 33 for a discussion of the requirements of paragraph 5.4 of FRS 103.

4.4 Transition to FRS 105

A first-time adopter of FRS 105 is an entity that presents its first annual financial statements that conform to FRS 105, regardless of its previous financial reporting framework. [FRS 105 Appendix I]. In practice, most first-time adopters of FRS 105 are likely to have previously applied Section 1A of FRS 102. An entity transitioning to FRS 105 must apply the transitional arrangements set out in Section 28 *Transition to this FRS* of FRS 105. [FRS 100.11(d), FRS 105.28.3].

As noted in 3.3.5 above, the application of FRS 105 is outside the scope of this publication.

4.5 Impact of transition on distributable profits

There may be circumstances where a conversion to FRS 101, FRS 102, FRS 105 or UK-adopted international accounting standards eliminates an entity's realised profits or even turns those realised profits into a realised loss. TECH 02/17BL - *Guidance on realised and distributable profits under the Companies Act 2006*, issued by the ICAEW and ICAS, states that the change in the treatment of a retained profit or loss as realised (or unrealised) as a result of a change in the law or in accounting standards or interpretations would not render unlawful a distribution already made out of realised profits determined by reference to 'relevant accounts' which had been prepared in accordance with principles accepted at the time that the accounts are prepared (subject to the considerations below). This is because the Act defines realised profits and realised losses for determining the lawfulness of a distribution as "such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses". [s853(4), TECH 02/17BL.3.283.29].

The effects of the introduction of a new accounting standard or of the adoption of IFRSs (or FRS 101, FRS 102 or FRS 105) become relevant to the application of the common law capital maintenance rule only in relation to distributions accounted for in periods in which the change will first be recognised in the accounts. This means that a change in accounting policy known to be adopted in a financial year needs to be taken into account in determining the dividend to be approved by shareholders in that year. Therefore, for example, an entity converting to a new financial reporting framework (FRS 101, FRS 102, FRS 105, or UK-adopted international accounting standards) in 2026 must have regard to the effect of adoption of the new financial reporting framework in respect of all dividends payable in 2026, including any final dividends in respect of 2025, even though the 'relevant accounts' may still be those for 2025 prepared under another GAAP. These considerations apply to all dividends whether in respect of shares classified as equity or as debt (or partly equity or debt). [TECH 02/17BL.3.30, TECH 02/17BL.3.31, TECH 02/17BL.3.32, TECH 02/17BL.3.33]

There is no requirement to prepare statutory 'interim accounts' under sections 836(2) and 838 of the Act (and delivered to the Registrar if the company is a public company) if a proposed distribution can be justified by reference to the relevant accounts. However, under common law, a company cannot lawfully make a distribution out of capital and the directors may therefore consider preparing non-statutory 'interim accounts' using the new financial framework to ascertain that there are sufficient distributable profits and, if the company is a public company, that the net asset restriction in section 831 of the Act is not breached. [TECH 02/17BL.3.35]. In some cases, however, the directors may be satisfied that no material adjustments arise from transition to the new financial framework (and therefore that there are sufficient distributable profits) without preparing such 'interim accounts'. Statutory 'interim accounts' would be required if transition to a new financial reporting framework increases distributable profits and the directors wish to make a distribution not justified by reference to the relevant accounts. [TECH 02/17BL.3.3435, 37].

TECH 02/17BL states that if the directors have not yet decided whether to adopt UK-adopted international accounting standards, say, for the current financial year, the company's accounting policies are those that it has previously applied until a decision is made to change them. Therefore, in applying the above, it is not necessary to have regard to possible changes of policy that are being considered but have not yet been agreed. [TECH 02/17BL.3.36].

Distributable profits are discussed more generally at 5.8 below.

5 Companies Act 2006

5.1 Basis of preparation of financial statements

The directors of almost every company must prepare individual accounts for the company for each financial year (see 5.2 below), the only exception is for certain dormant subsidiary undertakings, the criteria for which are set out in sections 394A to C. [s394]. The directors of a parent company must prepare group accounts, unless there is an exemption available from preparation of group accounts (see 5.3 below). Directors must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and in the case of group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company. [s393].

5.1.1 Choice of IAS accounts and Companies Act accounts under the Act

A company's individual accounts may be prepared:

- In accordance with the Act using FRS 101, FRS 102 or FRS 105 - these are called Companies Act accounts.
- Or
- In accordance with UK-adopted international accounting standards - these are called IAS accounts. [s395(1)].

See 5.2 below for the requirements for IAS accounts and Companies Act accounts.

There are constraints on a company's ability to choose which of these two frameworks to use. In particular, there are restrictions on a company changing its financial reporting framework and requirements for consistency of financial reporting framework within the individual accounts of group undertakings (see 5.1.2 and 5.1.3 below respectively).

The group accounts of a parent company whose securities are, on its balance sheet date, admitted to trading on a UK regulated market are required to be prepared in accordance with UK-adopted international accounting standards. [s403(1)].

The group accounts of other companies may be prepared:

- In accordance with section 404 (Companies Act group accounts).
- Or
- In accordance with UK-adopted international accounting standards (IAS group accounts). [s403(2)].

Group accounts are also subject to the restrictions on changes of financial reporting framework (see 5.1.2 below).

The individual and any group accounts of a company that is a charity must be Companies Act accounts. [s395(2), s403(3)].

5.1.2 Restrictions on changes of financial reporting framework

Under the Act, a company which wishes to change from preparing IAS individual accounts to preparing Companies Act individual accounts (such as financial statements prepared under FRS 101, FRS 102 or FRS 105) may do so only:

- If there is a relevant change of circumstance (see below).
- Or
- If the company has not changed to Companies Act individual accounts in the period of five years preceding the first day of that financial year. In calculating the five-year period, no account is taken of a change made due to a relevant change of circumstance. [s395(3), s395(4), s395(5)].

The same requirements apply where a company wishes to change from preparing IAS group accounts to preparing Companies Act group accounts, except that the references to individual accounts above are to group accounts. [s403(4), s403(5), s403(6)].

These requirements enable the members of a group where the parent and subsidiary undertakings prepare IAS individual accounts to instead prepare FRS 101 financial statements or even FRS 102 financial statements (as these are both Companies Act individual accounts) where the above criteria are met.

A relevant change of circumstance in respect of individual accounts occurs if, at any time during or after the first financial year in which the directors of a company prepare IAS individual accounts:

- The company becomes a subsidiary undertaking of another undertaking that does not prepare IAS individual accounts.
 - The company ceases to be a subsidiary undertaking.
 - The company ceases to be a company with securities admitted to trading on a UK regulated market.
- Or

- A parent undertaking of the company ceases to be an undertaking with securities admitted to trading on a UK regulated market. [s395(4)].

A relevant change of circumstance for the purposes of group accounts occurs if, at any time during or after the first financial year in which the directors of a parent company prepare IAS group accounts:

- The company becomes a subsidiary undertaking of another undertaking that does not prepare IAS group accounts.
 - The company ceases to be a company with securities admitted to trading on a UK regulated market.
- Or

- A parent undertaking of the company ceases to be an undertaking with securities admitted to trading on a UK regulated market. [s403(5)].

Section 395's requirements in respect of individual accounts and section 403's requirements in respect of group accounts operate independently of each other. Therefore, a company could be permitted to move from IAS accounts to Companies Act accounts in its individual accounts, while continuing to prepare IAS group accounts.

Paragraph 9.18 of *Guidance for UK Companies on Accounting and Reporting: Requirements under the Companies Act 2006 and the application of the IAS regulation* a document published in June 2008 by the then Department of Business, Enterprise and Regulatory Reform ('BERR') noted that the first example of a relevant change in circumstance in the lists above is "intended to deal with situations where a subsidiary undertaking is sold by a group generally using IAS, to another group or entity not generally using IAS. It is not intended that companies switch between accounting regimes on the basis of an internal group restructuring."

The restriction is 'one-way' i.e., it applies only when changing from IAS accounts to Companies Act accounts. There is no equivalent restriction on a company or group changing from Companies Act accounts to IAS accounts, although other factors might preclude such changes, for example the requirements considered at 5.1.3 below.

The Act does not restrict any changes being made between FRS 101, FRS 102 or FRS 105 since these are all Companies Act accounts.

5.1.3 Consistency of financial reporting framework in individual accounts of group undertakings

The Act requires that the directors of a UK parent company must secure that the individual accounts of the parent company and of each of its subsidiary undertakings are prepared under the same financial reporting framework, be that IAS accounts or Companies Act accounts, except to the extent that in the directors' opinion there are 'good reasons' for not doing so. [s407(1)]. However, this requirement does not apply:

- Where the UK parent company does not prepare group accounts under the Act. [s407(2)].
- To accounts of subsidiary undertakings not required to be prepared under Part 15 of the Act [s407(3)] (e.g., accounts of a foreign subsidiary undertaking).
- To accounts of any subsidiary undertakings that are charities, [s407(4)], (therefore charities and non-charities within a group are not required to use the same financial reporting framework in their accounts). Charities are not permitted to prepare either IAS group or IAS individual accounts. [s395(2), s403(3)].

Additionally, a parent company that prepares both consolidated and separate financial statements under UK-adopted international accounting standards (i.e., IAS group accounts and IAS individual accounts) is not required to ensure that its subsidiary undertakings all prepare IAS individual accounts. However, it must ensure that its subsidiary undertakings use the same financial reporting framework in their individual accounts (i.e., all prepare IAS accounts or all prepare Companies Act accounts) unless there are 'good reasons' for not doing so. [s407(5)].

Although not explicitly stated by FRS 100, there appears to be no requirement that all subsidiary undertakings in a group must use the same GAAP for their Companies Act individual accounts. Some could use, for example, FRS 101, and others could use FRS 102 since all are Companies Act individual accounts and therefore part of the same financial reporting framework. This approach would comply with the statutory requirements of section 407. However, groups that use a 'mix' of GAAP in the individual financial statements may be challenged by HMRC, particularly if this results in tax arbitrage. Examples of 'good reasons' for not preparing all individual accounts within a group using the same financial reporting framework were contained in the June 2008 BERR document mentioned at 6.1.2 above. Paragraph 9.17 of the Guidance noted that this provision is intended to provide a degree of flexibility where there are genuine (including cost/benefit) grounds for using different accounting frameworks within a group of companies and identified the following examples:

- A group using IAS acquired a subsidiary undertaking that had not been using IAS; in the first year of acquisition, it might not be practical for the newly acquired company to switch to IAS straight away.
- The group contains subsidiary undertakings that are themselves publicly traded, in which case market pressures or regulatory requirements to use IAS might come into play, without necessarily justifying a switch to IAS by the non-publicly traded subsidiaries.
- A subsidiary undertaking or the parent were planning to apply for a listing and so might wish to convert to IAS in advance, but the rest of the group was not planning to apply for a listing.
- The group contains minor or dormant subsidiaries where the costs of switching accounting framework would outweigh the benefits.

The key point is that the directors of the parent company must be able to justify any inconsistency to shareholders, regulators or other interested parties.

5.2 Companies Act requirements for the annual report and accounts

Part 15 of the Act sets out the requirements for the annual report and accounts for UK companies.

The company's 'annual accounts' are the company's individual accounts for that year and any group accounts prepared by the company for that year.

Section 408 permits a parent company preparing group accounts (whether as IAS group accounts or Companies Act group accounts) to omit the individual profit and loss account from the annual accounts, where the conditions for this exemption are met (see 5.3.2 below). [s471(1)].

References in Part 15 to the annual accounts (or to a balance sheet or profit and loss account) include notes to the accounts giving information required by any provision of the Act or UK-adopted international accounting standards where that is required or allowed by any such provision to be given in a note to the company's accounts. [s472].

The principal requirements in the Act for annual accounts are set out at 5.2.1 below and for the annual report at 6.2.2 below. While this chapter focuses on the disclosure requirements for UK companies, LLPs and other types of entities other than companies are also subject to similar statutory requirements. Reference should be made to the legislation that applies to such entities.

The Listing Rules, Disclosure and Transparency Rules or rules of the relevant securities market may require additional information beyond that required by the Act (and related regulations) to be included in the annual report. For example, a company listed on the London Stock Exchange in either the commercial companies category or the closed-ended investment funds category must state how they have applied the Principles set out in the UK Corporate Governance Code in a manner that would enable shareholders to evaluate how the Principles have been applied.⁶ It is beyond the scope of this publication to cover such regulatory requirements.

⁶ Listing Rules, FCA, paras. 9.8.6(5), (6).

5.2.1 Companies Act requirements for annual accounts

5.2.1.A Companies Act accounts

Companies Act individual accounts and Companies Act group accounts are prepared in accordance with sections 396 and 404 of the Act respectively. Companies Act accounts comprise:

- A balance sheet as at the last day of the financial year that gives a true and fair view of the state of affairs of the company (and in respect of group accounts, of the parent company and its subsidiary undertakings included in the consolidation as a whole, so far as concerns members of the company) as at the end of the financial year.
And
- A profit and loss account that gives a true and fair view of the profit or loss of the company (and in respect of group accounts, of the parent company and its subsidiary undertakings included in the consolidation as a whole, so far as concerns members of the company) for the financial year. [s396(1), s396(2), s404(1), s404(2)].

The accounts must comply with regulations as to the form and content of the company balance sheet and profit and loss account (and in respect of group accounts, of the consolidated balance sheet and consolidated profit and loss account) and additional information provided by way of notes to the accounts. [s396(3), s404(3)].

These regulations are principally *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (Regulations), as amended. Companies subject to the small companies regime (see 6.5 below) are entitled to apply *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (Small Companies Regulations), as amended.

If compliance with the Regulations and any other provisions made by or under the Act as to the matters to be included in the accounts or notes to those accounts would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or notes to the. [s396(4), s404(4)]. If in special circumstances, compliance with any of those provisions is inconsistent with the requirement to give a true and fair view, the directors must depart from that provision to the extent necessary to give a true and fair view. Particulars of any such departure, the reasons for it and its effect must be given in a note to the accounts. [s396(5), s404(5)]. See Chapter 6 at 9.2 for further discussion of the 'true and fair override' provided for in the Act and FRS 102's requirements for a true and fair view.

5.2.1.B IAS accounts

Where the directors prepare IAS individual and/or IAS group accounts, they must state in the notes to those accounts that they have been prepared in accordance with UK-adopted international accounting standards. [s397(2), s406(2), s474].

5.2.1.C General - Companies Act accounts and IAS accounts

The Act requires two types of disclosures for a UK company:

- Those required by the Regulations (or other applicable regulations, as discussed below) for an entity preparing Companies Act accounts but not for an entity preparing IAS accounts (see 5.7.1 below).
And
- Those required for both IAS accounts and Companies Act accounts (see 5.7.2 below).

The Act distinguishes between companies that are micro-entities (see 5.4 below), companies subject to the small companies regime (see 5.5 below), and medium-sized companies (see 5.6 below). These categories of company are all based on meeting certain size criteria and not being excluded from the applicable regime. These companies benefit from a lighter disclosure regime in their financial statements than for large companies, i.e., the default category of companies that are not medium-sized companies, subject to the small companies regime or the micro-entities regime.

Certain disclosure exemptions are available to companies preparing IAS accounts or Companies Act accounts, whereas others are only available to companies preparing Companies Act accounts. Companies subject to the small companies regime are entitled to follow the Small Companies Regulations and companies subject to the micro-entities regime are entitled to follow the Micro-entities Regulations (in each case rather than the Regulations).

The Act also distinguishes between quoted and unquoted companies. While there is no difference in the disclosures required in the financial statements by the Act and the Regulations for quoted and unquoted companies, there are significant additional disclosures for quoted companies in the annual report. There are also disclosures only required to be given by companies with securities admitted to trading on a UK regulated market.

The Act requires that both group and individual Companies Act and IAS accounts give disclosures to explain the status of a company. A company must state: [s396(A1), s397(1), s404(A1), s406(1)]

- The part of the United Kingdom in which the company is registered
 - The company's registered number
 - Whether the company is a public or private company and whether it is limited by shares or by guarantee
 - The address of the company's registered office
- And
- Where appropriate, the fact that the company is being wound-up

A company's annual accounts must be approved by the board of directors and signed on behalf of the board by a director of the company, with the signature included on the company's balance sheet. [s414(1)].

5.2.1.D Interaction of the Small Companies Regulations with FRS 101 and FRS 102

FRS 101 and FRS 102 (unless Section 1A is applied) do not permit the use of the formats included in the Small Companies Regulations (see 5.5 below). [FRS 101.5(b), FRS 101.AG1(h), FRS 101.AG1(i), FRS 102.4.2, FRS 102.5.5, FRS 102.5.7]. A small entity applying FRS 102 is not required to comply with the requirements of Section 4 *Statement of Financial Position*, Section 5 *Statement of Comprehensive Income and Income Statement*, Section 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings* and Section 7 *Statement of Cash Flows*. [FRS 102.1A.7A]. However, a small entity that applies Section 1A of FRS 102 must present a statement of financial position and profit or loss in accordance with the requirements set out in Part 1 of Schedule 1 to the Small Companies Regulations or Part 1 of Schedule 1 to the Small LLP Regulations (except to the extent that these requirements are not permitted by any statutory framework under which such entities report). [FRS 102.1A.4, FRS 102.1A.12, FRS 102.1A.14].

How we see it

In our view, a company subject to the small companies regime which chooses to apply FRS 101, or which chooses to apply FRS 102 without applying Section 1A, is not precluded from taking advantage of other exemptions applicable to companies subject to the small companies regime. See Chapter 2 at 2.2 and Chapter 3 at 4.1.1.

5.2.2 Companies Act requirements for annual reports

The content of the annual report depends principally on whether the company is an unquoted company or a quoted company.

A quoted company means a company whose equity share capital:

- Has been included in the Official List (as defined in section 103(1) of the Financial Services and Markets Act 2000) in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000.
- Or
- Is officially listed in an EEA State.
- Or
- Is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

A company is a quoted company in relation to a financial year if it is a quoted company immediately before the end of the accounting reference period (defined in section 391 of the Act) by reference to which that financial year was determined. An unquoted company means a company that is not a quoted company. [s385(1), s385(2), s385(3)].

The content of the annual reports and accounts of an unquoted and a quoted company are as follows:

- An unquoted company's annual accounts and reports comprise its annual accounts, strategic report (if required), directors' report (unless a micro-entity), any separate corporate governance statement and the auditor's report (unless the company is exempt from audit).
- And

- A quoted company's annual accounts and reports comprise its annual accounts, directors' remuneration report, strategic report, directors' report, any separate corporate governance statement, and the auditor's report.

Where the company is a parent company preparing group accounts, the directors' and strategic reports must be consolidated reports (i.e., a 'group directors' report' and 'group strategic report') relating to the undertakings included in the consolidation. These group reports may, when appropriate, give greater emphasis to the matters that are significant to the undertakings included in the consolidation. [s414A, s414B, s414C, s414D, s415, s416, s417, s418, s419].

In addition, companies with more than 500 employees that are traded companies, banking companies, authorised insurance companies and companies carrying on insurance market activity are required to comply with the Non-financial Reporting Regulations and must prepare a non-financial information statement within the strategic report. However, there are some scope exceptions. The information should be provided on a consolidated basis for groups. [s414CA, s414CB].

Entities are encouraged to meet the requirements of the non-financial information statement through a title and a series of cross-references, so as to maintain the coherence of the strategic report. Entities are discouraged from replicating information located elsewhere in the strategic report in the non-financial information statement.⁷

Small and medium-sized companies are entitled to certain exemptions. Companies with securities admitted to a regulated market must make statutory corporate governance disclosures in the annual report and quoted companies have extended disclosures. These include the Takeovers Directive disclosures required in the directors' report for companies with securities carrying voting rights admitted to trading on a regulated market at the financial year end. [7 Sch 13]. For large private companies, *The Companies (Miscellaneous Reporting) Regulations 2018* introduce a requirement to include disclosures of their corporate governance arrangements in the Directors' Report. AIM Rule 26 also requires that from 28 September 2018, AIM companies must provide details (on a website) explaining how they comply with, and where they depart from, a chosen 'recognised' corporate governance code.

A company's strategic report (if any), directors' report, directors' remuneration report (if any), and separate corporate governance statement (if any) must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company. [s414D(1), s419(1), s419A, s422(1)].

It is beyond the scope of this publication to set out the content of the directors' report, strategic report, directors' remuneration report or corporate governance statement.

5.3 Preparation of consolidated financial statements

The Act requires a UK company that is a parent company at its financial year end, to prepare group accounts (i.e., consolidated financial statements) unless otherwise exempt. [s399]. A company that is exempt from the requirement to prepare group accounts may still do so. [s399(4)].

A company that is subject to the small companies regime (or would be subject to the small companies regime except for it being a public company) is not required to prepare group accounts, but may do so. This exemption from preparing group accounts does not apply if the company is a member of a group which, at any time during the financial year, has an undertaking as a member which is established under the law of any part of the United Kingdom, has to prepare its accounts in accordance with the requirements of section 399 of the Act, and is an undertaking:

- Whose transferable securities are admitted to trading on a UK regulated market.
- Which is a credit institution within the meaning given by Article 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council, which is a CRR firm within the meaning of Article 4(1)(2A) of that Regulation.

Or

- Which would be an insurance undertaking within the meaning given by Article 2(1) of Council Directive 91/674/EEC of the European Parliament and of the Council on the annual accounts of insurance undertakings were the United Kingdom a member State). [s399(2), s399(2A), s399(2B)].

The other exemptions in the Act relating to the preparation of group accounts comprise:

- Section 400 - parent company is a majority or wholly owned subsidiary undertaking whose immediate parent undertaking is established under the law of any part of the United Kingdom (see Chapter 8 at 3.1.1.A).

⁷ Guidance on the Strategic Report, Financial Reporting Council, July 2018, para. 7B.84.

- Section 401 – parent company is a majority or wholly owned subsidiary undertaking whose parent undertaking is not established under the law of any part of the United Kingdom, and which is consolidated in group accounts of a larger group drawn up by a parent undertaking. Those accounts and, where appropriate, the group's annual report, must be drawn up in a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with the Act, in accordance with UK-adopted international accounting standards or in accordance with accounting standards which are equivalent to UK-adopted international accounting standards. (see Chapter 8 at 3.1.1.B).

And

- Section 402 – parent company, none of whose subsidiary undertakings need be included in the consolidation (see Chapter 8 at 3.1.1.E). [s399(3)].

FRS 102 has been developed to be consistent with the requirements for group accounts (and exemptions) included in Part 15 of the Act. Consequently, the detailed conditions for the above exemptions from preparing group accounts under the Act are discussed further in Chapter 8 at 3.1.1 and Chapter 5 at 6.2.

The application guidance to FRS 100 explains the use of equivalence in the context of the exemption from preparing consolidated financial statements under section 401. This is discussed in Chapter 2 at 2.1.6 in the context of entities applying FRS 101 and Chapter 8 at 3.1.1.C for entities applying FRS 102.

5.3.1 Requirements of accounting standards to prepare consolidated financial statements

FRS 100 does not address the requirements for preparing consolidated financial statements (nor do FRS 101 or FRS 105, since these standards only address individual financial statements).

UK-adopted international accounting standards and FRS 102 both include requirements setting out which entities should prepare consolidated financial statements, and how they should be prepared. Their requirements need to be read in conjunction with the requirements of the relevant statutory framework for preparation of the entity's financial statements.

FRS 102 requires an entity, that is a parent at its year end, to present consolidated financial statements in which it consolidates all its investments in subsidiaries in accordance with the standard (except those permitted or required to be excluded from consolidation) unless it is exempt from the requirement to prepare consolidated financial statements provided in the standard. [FRS 102.9.3]. As noted above, FRS 102's requirements to prepare group accounts (and exemptions) are consistent with the requirements of the Act. A small entity that is a parent entity is not required to prepare consolidated financial statements under Section 1A of FRS 102 (see Chapter 5 at 3.2). [FRS 102.1A.21].

5.3.2 Exemption from publishing the individual profit and loss account where group accounts are prepared

Where a company prepares group accounts in accordance with the Act:

- The company's individual profit and loss account need not contain the information specified in paragraphs 65 to 69 of Schedule 1 to the Regulations (specified information supplementing the profit and loss account).

And

- The company's individual profit and loss account must be approved by the directors in accordance with section 414(1) but may be omitted from the company's annual accounts.

This exemption is conditional on the company's individual balance sheet showing the company's profit or loss for the financial year (determined in accordance with the Act) and the use of this exemption being disclosed in the annual accounts. [s408, Regulations 3(2)].

Illustration 6-1: Example of a s408 exemption statement

Basis of preparation

The group accounts consolidate the financial statements of ABC Limited (the company) and all its subsidiary undertakings drawn up to 31 December each year. No individual profit and loss account is presented for ABC Limited as permitted by section 408 of the Companies Act 2006.

[...]

Parent company balance sheet

The profit for the financial year of the company is £130,000 (20X0: £111,000).

The exemption is available for both Companies Act and IAS group accounts. The exemption in the Act relates only to the profit and loss account and by virtue of section 472(2), to the notes to the profit and loss account.⁸

5.4 Micro-entities regime

The voluntary regime for companies that are micro-entities was introduced into UK companies legislation by *The Small Companies (Micro-Entities' Accounts) Regulations 2013* (SI 2013/3008) (Micro-entities Regulations) for companies filing their accounts on or after 1 December 2013. These regulations implemented the provisions of the EU Accounting Directive, which sets out certain minimum requirements for micro-entities, into UK company law.

The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (SI 2016/575), issued in May 2016, extended the scope of the micro-entities regime to LLPs and qualifying partnerships for accounting periods beginning on or after 1 January 2016.

In response to the introduction of the Micro-entities Regulations the FRC issued FRS 105 (see 3.3.5 above).

A company or an LLP or qualifying partnership can only use the micro-entity provisions if it meets the size criteria and is not excluded from being treated as a micro-entity. The size criteria operate in the same way as for the small companies regime (see 5.5 below and Chapter 5 at 4.3).

The micro-entity provisions are not available to overseas companies and other entities. The Explanatory Note to the Micro-entities Regulations confirms that the regime is only available to companies formed and registered (or treated as formed and registered) under the Act.

The qualifying conditions for UK entities are met in a year in which the entity satisfies two or more of the following requirements: [s384A(4)-(7)]

- Turnover must not exceed £1,000,000
- Balance sheet total (gross assets) must not exceed £500,000
- And
- The number of employees must not exceed 10.

The turnover and balance sheet total thresholds were updated to the above for accounting periods beginning on or after 6 April 2025, the previous thresholds being £632,000 and £316,000 respectively.

In the case of an entity which is a parent entity, the entity qualifies as a micro-entity in relation to a financial year only if the entity qualifies as a micro-entity in relation to that year and the group headed by the entity qualifies as a small group. [s384A(8)].

The micro-entity provisions do not apply to an entity's accounts for a particular financial year if at any time within that year the entity: [s384B(1)]

- Was a company excluded from the small companies regime, or small LLPs regime, by section 384
- Would have been an investment undertaking as defined in Article 2(14) of the EU Accounting Directive (Directive 2013/34/EU)
- Would have been a financial holding undertaking as defined in Article 2(15) of that Directive were the United Kingdom a member State
- Was a credit institution as defined in Article 4 of Directive 2006/48/EC (other than one referred to in Article 2 of that directive)
- Would have been an insurance undertaking as defined in Article 2(1) of Directive 91/674/EEC
- Or
- Was a charity

The micro-entity provisions also do not apply in relation to an entity's accounts for a financial year if the entity is a parent company which prepares group accounts for that year as permitted by section 399(4), or is not a parent entity but its accounts are included in consolidated group accounts for that year. [s384B(2)].

FRS 105 is outside the scope of this publication.

⁸ June 2008 BERR document *Guidance for UK Companies on Accounting and Reporting: Requirements under the Companies Act 2006 and the application of the IAS regulation*

5.5 Small companies

There are two sets of exemptions available for small companies:

- The small companies regime - which applies to the preparation and/or filing of the financial statements.
And
- The small companies exemption - which applies to the preparation and/or filing of the strategic report and directors' report.

The small companies regime and small companies exemption under the Companies Act are discussed in Chapter 5 at 12. This discussion is relevant to companies preparing Companies Act accounts (such as those prepared in accordance with FRS 101 and FRS 102) and IAS accounts (in accordance with UK-adopted international accounting standards).

Chapter 5 also addresses the requirements in Section 1A of FRS 102 for entities subject to the small entities regime.

5.6 Medium-sized companies and groups

Medium-sized companies and groups must apply the Regulations in preparing their annual reports and accounts. A medium-sized company may take advantage of certain disclosure exemptions in its annual reports and accounts for a financial year in which the company qualifies as medium-sized and is not an excluded company. [s465, s466, s467].

There is no requirement for the annual reports and accounts of a medium-sized company to state any use of the disclosure exemptions.

5.6.1 Qualification as medium-sized company

The medium-sized companies regime works in the same way as the small companies regime (described in Chapter 3 at 4.1.2). The size criteria and excluded companies are detailed below.

5.6.1.A Size criteria for medium-sized companies and groups

A company qualifies as medium-sized in relation to its first financial year if the qualifying conditions are met in that year. [s465(1)]. A company qualifies as medium-sized in relation to a subsequent financial year if the qualifying conditions are met in that year. [s465(2)]. In relation to a subsequent financial year, where on its balance sheet date a company meets or ceases to meet the qualifying conditions, then that will affect its qualification as a medium-sized company only if it occurs in two consecutive years. [s465(2)].

Where the company itself is a parent undertaking, then it only qualifies as medium-sized if the group that it heads qualifies as a medium-sized group. This is the case whether or not group accounts are prepared. A group qualifies as medium-sized in relation to its first financial year if the qualifying conditions (as set out below) are met in that year. In relation to a subsequent financial year, where on its balance sheet date a group meets or ceases to meet the qualifying conditions, then that will affect its qualification as a medium-sized company only if it occurs in two consecutive years. [s466].

The qualifying conditions for a medium-sized company are met in a year in which the company satisfies two or more of the following requirements: [s465]

- Turnover must not exceed £54 million
 - Balance sheet total (total assets) must not exceed £27 million
- And

- The number of employees must not exceed 250

The turnover and balance sheet total thresholds were updated to the above for accounting periods beginning on or after 6 April 2025, the previous thresholds being £36 million and £18 million respectively.

The qualifying conditions for a medium-sized group are met in a year in which the group headed by the company satisfies two or more of the following requirements: [s466]

- Turnover must not exceed £54 million net (or £64 million gross)
 - Balance sheet total must not exceed £27 million net (or £32 million gross)
- And
- The number of employees must not exceed 250

The turnover and balance sheet total thresholds were updated to the above for accounting periods beginning on or after 6 April 2025, the previous thresholds being £36 million (or £43.2 million gross) and £18 million (or £21.6 million gross) respectively.

In the case of a group, the aggregate figures for the above limits are ascertained by aggregating the relevant figures determined in accordance with section 466 for each member of that group. The figures used for each subsidiary undertaking are those included in its individual accounts for the relevant financial year. That is, where its financial year is coterminous with that of the parent company, the financial year that ends at the same date as the parent company, or where its financial year is not coterminous, the financial year ending last before the end of the financial year of the parent company. If those figures are not obtainable without disproportionate expense or undue delay, the latest available figures are used.

The turnover and balance sheet total criteria may be satisfied on either the gross or net of consolidation adjustments basis. For Companies Act accounts (such as FRS 102 financial statements), the consolidation adjustments are determined in accordance with regulations made under section 404, i.e., the Regulations. For IAS accounts, the consolidation adjustments are determined in accordance with UK-adopted international accounting standards. It is permissible to satisfy one condition on the 'net' basis and the other on the 'gross' basis. [s466(4), s466(5), s466(6), s466(7)].

5.6.1.B Companies excluded from being treated as medium-sized

A company is not entitled to take advantage of any of the provisions available for companies qualifying as medium-sized if it was at any time within the financial year to which the accounts relate:

- A public company
 - A company that has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on a regulated activity
 - A company that carries on an insurance market activity
 - A company that is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or 39(1) of the Pension Schemes Act (Northern Ireland) 2021
 - An e-money issuer
- Or
- A member of an ineligible group [s467(1)]

A group is ineligible if any of its members is:

- A traded company
 - A body corporate (other than a company) whose shares are admitted to trading on a UK regulated market
 - A person (other than a small company) who has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on a regulated activity
 - An e-money issuer
 - A small company that is an authorised insurance company, banking company, a MiFID investment firm or a UCITS management company
 - A person who carries on an insurance market activity
- Or
- A scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or 39(1) of the Pensions Schemes Act (Northern Ireland) 2021 [s467(2)]

A company is a small company for the purposes of section 467(2) if it qualified as small in relation to its last financial year ending on or before the end of the financial years to which the accounts relate. [s467(3)].

References to a 'company' above is to a company formed and registered (or treated as formed and registered) under the Act. This means a company formed and registered under the Act, or prior to 1 October 2009 under the Companies Act 1985, Companies (Northern Ireland) Order 1986 or former Companies Acts (i.e., an 'existing company' for the purposes of that Act and Order). [s1].

A public company means a company limited by shares or limited by guarantee and having a share capital (a) whose certificate of incorporation states that it is a public company and (b) in relation to which the requirements of the Act or former Companies Acts as to registration or re-registration as a public company have been complied with on or after the relevant date, being 22 December 1980 in Great Britain and 1 July 1983 in Northern Ireland. [s4]. Therefore, a public company means a UK-incorporated company that is a 'plc' or 'PLC' rather than a publicly traded company.

A traded company means a company any of whose transferable securities are admitted to trading on a UK regulated market. [s474].

An authorised insurance company is defined in section 1165(2), a banking company in section 1164(2)-(3) and insurance market activity in section 1165(7). See Chapter 6 at 4.2.2 and 4.2.3.

The terms e-money issuer, MiFID investment firm, regulated activity, and UCITS management company are defined in section 474 of the Act. The term 'e-money issuer' means an electronic money institution within the meaning of *The Electronic Money Regulations 2011* (SI 2011/99) or a person who has permission under Part 4A of the Financial Services and Markets Act 2008 (c 8) to carry on the activity of issuing electronic money within the meaning of article 9B of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 20101/544). [s474].

A body corporate includes a body incorporated outside the UK but does not include (a) a corporation sole or (b) a partnership that, whether or not a legal person, is not regarded as a body corporate under the law by which it is governed. [s1173(1)]. Therefore, a body corporate would include an overseas company or a UK LLP.

5.6.2 Disclosure exemptions available for medium-sized companies

The disclosure exemptions for medium-sized companies include:

- No requirement for Companies Act individual accounts to disclose the information required by paragraph 45 (the statement that the accounts have been prepared in accordance with applicable accounting standards, giving particulars and reasons for any material departures from these standards) or paragraph 72 (related party disclosures) of Schedule 1 to the Regulations (see 4.6.1 above). [Regulations 4(2A), Regulations 4(2B)].
- And
- No requirement to disclose auditor's remuneration in respect of non-audit services. Like companies subject to the small companies regime, only remuneration for the auditing of the annual accounts receivable by the company's auditor (but not the associates of the auditor) is required to be disclosed. [s494].⁹ TECH 01/22 FRF - *Disclosure of auditor information* - provides guidance on disclosure of auditor remuneration.

Medium-sized entities preparing financial statements in accordance with FRS 101 or FRS 102 must still give the disclosures required by accounting standards, e.g., medium-sized companies still need to give the related party disclosures required by accounting standards.

5.7 Disclosures

The Act (particularly Part 15), the Regulations and other statutory instruments include disclosure requirements which apply to Companies Act accounts and IAS accounts. As discussed at 6.7.1 below, only some parts of the Regulations apply to IAS accounts. See 6.7.2 for a list of Companies Act disclosures applicable to both IAS accounts and Companies Act accounts.

The disclosure exemptions for companies subject to the small companies regime in the Act and the Small Companies Regulations are addressed in Chapter 5.

5.7.1 Disclosures required by the Regulations

The Regulations contain the following schedules:

- Schedule 1 (Companies Act individual accounts - companies other than banking and insurance companies)
- Schedule 2 (Companies Act individual accounts: banking companies)
- Schedule 3 (Companies Act individual accounts: insurance companies)
- Schedule 4 (Information about related undertakings - Companies Act or IAS accounts)
- Schedule 5 (Information about directors' benefits: remuneration - Companies Act or IAS accounts)
- Schedule 6 (Companies Act group accounts)
- Schedule 7 (Matters to be dealt with in directors' report)
- Schedule 8 (Directors' remuneration report - quoted companies)

⁹ The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489), para. 4.

- Schedule 9 (Definition of 'provisions')
- And
- Schedule 10 (General interpretation)

A company preparing IAS individual accounts in accordance with section 397 (or IAS group accounts in accordance with section 406) does not apply Schedules 1 to 3, or Schedule 6 to the Regulations.

A company preparing Companies Act accounts must comply with all the requirements of the Regulations, including Schedules 1 to 3 (as applicable) and, where group accounts are prepared, Schedule 6.

Schedules 1 to 3 include the formats for the profit and loss account and balance sheet, recognition and measurement principles, and disclosure requirements. Schedule 1 applies to all companies (other than banking companies and insurance companies), Schedule 2 to banking companies and groups, and Schedule 3 to insurance companies and groups. See Chapter 6 at 4.2.2 and 4.2.3 for definitions of banking and insurance companies and groups respectively.

The Regulations require various disclosures to be given in the financial statements. In particular, Parts 3 of Schedules 1 to 3 for Companies Act accounts require certain disclosures to be made in the notes to the financial statements if not given in the primary statements. The relevant paragraphs are as follows:

- Schedule 1 paragraphs 42 to 72B
- Schedule 2 paragraphs 52 to 92B
- Schedule 3 paragraphs 60 to 90B
- And
- Schedule 6 various paragraphs

Although some of these disclosure requirements are replicated in UK-adopted international accounting standards, others are not. Entities that move to FRS 101 or FRS 102 from UK-adopted international accounting standards are required to provide the additional statutory disclosures for Companies Act accounts and should consider carefully the impact of these new requirements against the benefits of the reduced disclosures under those standards.

5.7.2 Companies Act disclosure requirements applicable to both IAS accounts and Companies Act accounts

Companies preparing IAS accounts or Companies Act accounts are subject to the following disclosure requirements:

- Section 396(A1) and 397(1) - information about the status of the company where individual accounts are prepared.
- Section 404(A1) and 406(1) - information about the status of the company where group accounts are prepared
- Section 409 (and Schedule 4 to the Regulations) - information about related undertakings.
- Section 410A - off-balance sheet arrangements (unless subject to the small companies regime). See Chapter 6 at 8.7.
- Section 411 - employee numbers and costs (unless subject to the small companies regime). See Chapter 6 at 8.6.
- Section 412 (and Schedule 5 and paragraph 22A of Schedule 6 to the Regulations) - directors' benefits: remuneration.
- Section 413 - directors' benefits: advances, credits and guarantees. See Chapter 6 at 8.8.
- Section 414A-D - strategic report (including the non-financial information statement report disclosures required by section 414CA-CB for certain large public interest entities). The FRC's *Guidance on the Strategic Report* (June 2018) provides best practice guidance. This is intended to be persuasive rather than have mandatory force.
- Section 236, sections 415 to 419 (and Schedule 7 to the Regulations) - directors' report.
- Sections 420 to 421 (and Schedule 8 to the Regulations) - directors' remuneration report (quoted companies only). The GC 100 and Investor Group's *Directors' Remuneration Report Guidance 2016* (see 6.2.2 above), provides best practice guidance on the directors' remuneration report prepared by quoted companies.

- Section 494 (and *Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008*) - services provided by auditor and associates and related remuneration.

Medium-sized companies are only required to disclose remuneration for the audit of the annual accounts receivable by the company's auditor (but not the associates of the auditor) and are not required to disclose remuneration for non-audit services. [s494].¹⁰

- TECH 01/22 FRF provides guidance on disclosure of auditor remuneration.

In addition, other disclosure requirements may apply depending on individual circumstances such as the disclosures required for a parent taking advantage of the exemption from preparing consolidated accounts under either sections 400 or 401 of the Act.

5.8 Distributable profits

The determination of realised profits and losses and of profits available for distribution is governed by UK common law and statutory provisions. [TECH 02/17BL.2.1]. The ICAEW issued TECH 02/17BL - *Guidance on realised and distributable profits under the Companies Act 2006* - in April 2017. The purpose of the guidance is to identify, interpret and apply the principles relating to the determination of realised profits and losses for the purposes of making distributions under the Companies Act. [TECH 02/17BL.1.1].

A company may make a distribution only out of profits available for that purpose. A company's distributable profits are its accumulated realised profits (so far as not previously distributed or capitalised) less its accumulated realised losses (so far as not previously written off in a reduction or reorganisation of its share capital). Realised losses cannot be offset against unrealised profits. [TECH 02/17BL.2.7]. A further restriction is placed on public companies, which may only make a distribution if, after giving effect to such distribution, the amount of its net assets (as defined in section 831) is not less than the aggregate of its called up share capital and undistributable reserves (see section 831(4) for a list of undistributable reserves) as shown in the relevant accounts. [s831].

Paragraph 13(a) of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 and the LLP Regulations) require that only profits realised at the balance sheet date are included in the profit or loss account. [FRS 101 Appendix II A2.12, FRS 102 Appendix A3.25]. Consequently, profits that are not realised should normally be included in other comprehensive income rather than profit or loss in financial statements prepared under FRS 101 and FRS 102. Paragraph 40(2) of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 and the LLP Regulations) require that movements in the fair value of financial instruments, investment properties or living animals and plants are recognised in the profit and loss account notwithstanding the usual restrictions allowing only realised profits and losses to be included in the profit and loss account. Therefore, paragraph 40 of Schedule 1 overrides paragraph 13(a) of Schedule 1 and such fair value gains can be recognised in profit and loss under FRS 101 and FRS 102.

[FRS 101 Appendix II A2.14, FRS 102 Appendix III A3.27].

The legal appendices to FRS 101 and FRS 102 both state that entities measuring investment properties, living animals or plants, or financial instruments at fair value may transfer such amounts to a separate non-distributable reserve instead of carrying them forward in retained earnings but are not required to do so. The FRC suggests that presenting fair value movements that are not distributable profits in a separate reserve may assist with the identification of profits available for that purpose. [FRS 101 Appendix II A2.15, FRS 102 Appendix III A3.28].

Discussed below are some of the key terms and principles set out in TECH 02/17BL.

5.8.1 Realised profits

Profit is realised, as a matter of generally accepted accounting practice, where it arises from: [TECH 02/17BL.3.9]

- (a) A transaction where the consideration received by the company is 'qualifying consideration' (see 5.8.2 below).
- (b) An event which results in 'qualifying consideration' being received by the company in circumstances where no consideration is given by the company.
- (c) The recognition in the financial statements of a change in fair value, in those cases where fair value has been determined in accordance with measurement guidance in the relevant accounting standards or company law, and to the extent that the change recognised is readily convertible to cash.

¹⁰ SI 2008/489, para. 4.

- (d) The translation of:
- (i) A monetary asset which comprises qualifying consideration
 - Or
 - (ii) A liability
- denominated in a foreign currency.
- (e) The reversal of a loss previously regarded as realised.
- (f) A profit previously regarded as unrealised (such as amounts taken to a revaluation reserve, merger reserve, or other similar reserve) becoming realised as a result of:
- (i) Consideration previously received by the company becoming 'qualifying consideration'.
 - (ii) The related asset being disposed of in a transaction where the consideration received by the company is 'qualifying consideration'.
 - (iii) A realised loss being recognised on the scrapping or disposal of the related asset.
 - (iv) A realised loss being recognised on the write-down for depreciation, amortisation, diminution in value or impairment of the related asset.
 - (v) The distribution in kind of the asset to which the unrealised profit relates.
 - (vi) The receipt of a dividend in the form of qualifying consideration when no profit is recognised because the dividend is deducted from the book value of the investment to which the unrealised profit relates.

In which case the appropriate proportion of the related unrealised profit becomes a realised profit.

Or

- (g) The remeasurement of a liability, to the extent that the change recognised is readily convertible to cash.

If the write down in (f)(iv) above is subsequently reversed, an equal amount of profit should be regarded as becoming unrealised. In other words, the amount of profit regarded as becoming realised is equal to the cumulative amount of any write down treated as a realised loss.

In addition to those instances of realised profit included in the definition of realised profit set out above, the following would also constitute a realised profit per the guidance in TECH 02/17BL: [TECH 02/17BL.3.14]

- The receipt or accrual of investment or other income receivable in the form of qualifying consideration.
 - A gain arising on a return of capital on an investment where the return is in the form of qualifying consideration.
 - A gift (such as a 'capital contribution') received in the form of qualifying consideration. However, this does not apply when the legal form of the transaction is a loan even though it is accounted for as a capital contribution (see paragraph 6.20 of the TECH 02/17BL guidance regarding the proceeds of issue of convertible debt and paragraph 9.53 of the TECH 02/17BL guidance regarding intra-group off-market loans).
 - The release of a provision for a liability or loss which was treated as a realised loss.
- Or
- The reversal of a write-down or provision for diminution in value or impairment of an asset which was treated as a realised loss.

5.8.2 Qualifying consideration

Qualifying consideration comprises: [TECH 02/17BL.3.11]

- (a) Cash
 - (b) An asset that is readily convertible to cash
 - (c) The release, or the settlement or assumption by another party, of all or part of a liability of the company
 - (d) An amount receivable in any of the above forms of consideration where:
 - (i) The debtor is capable of settling the receivable within a reasonable period of time
 - (ii) There is a reasonable certainty that the debtor will be capable of settling when called upon to do so

And

 - (iii) there is an expectation that the receivable will be settled
- Or

- (e) An amount receivable from a shareholder where and to the extent that:
- (i) The company intends to make a distribution to the shareholder of an amount equal to or less than its receivable from that shareholder
 - (ii) The company intends to settle such distribution by off-setting against the amount receivable (in whole or in part)
- And
- (iii) Within the meaning of paragraph 3.5 and 3.5A of the TECH 02/17BL guidance, (i) and (ii) are linked.

5.8.3 Realised losses

Losses should be regarded as realised losses except to the extent that the law, accounting standards or the guidance in TECH 02/17BL provide otherwise. [TECH 02/17BL.3.10].

Realised losses will include: [TECH 02/17BL.3.15]

- A cost or an expense (other than one charged to the share premium account) which results in a reduction in recorded net assets.
 - B loss arising on the sale or other disposal or scrapping of an asset.
 - The writing down, or providing for the depreciation, amortisation, diminution in value or impairment, of an asset (except in the circumstances set out in paragraphs 2.33 and 2.36 of the TECH 02/17BL guidance).
 - The creation of, or increase in a provision for a liability or loss (other than deferred tax arising in the circumstances discussed in paragraph 3.17 of the TECH 02/17BL guidance) which results in an overall reduction in recorded net assets.
 - A gift made by the company (or the release of all or part of a debt due to that company or the assumption of a liability by the company) to the extent that it results in an overall reduction in recorded net assets.
- And
- A loss arising from fair value accounting where profits on remeasurement of the same asset or liability would be treated as realised profits.

5.8.4 Disclosure of distributable profits

Except for companies authorised to carry on long-term insurance business (e.g., life insurers), there is no requirement under UK law or accounting standards for financial statements to distinguish between realised and unrealised profits or between distributable profits and non-distributable profits. However, companies should maintain sufficient records to enable them to distinguish between those profits that are available for distribution and those which are not. [TECH 02/17BL.2.25].

For companies authorised to carry on long-term insurance business, Schedule 3 to the Regulations requires that every balance sheet of such a company must show separately as an additional item the aggregate of any capital and reserves which are not required to be treated as realised profits under section 843 of the Act. [3 Sch 11(1)].

For companies authorised to carry on long-term insurance business in accordance with Article 14 of the Solvency 2 Directive, the realised profit or loss of the company in respect of which its relevant accounts are prepared is the amount calculated by a given formula. [s833A]. In summary, this formula is the company's net assets as calculated by the Solvency 2 Directive less share capital, share premium, any capital redemption reserve and any other reserve that the company is prohibited from distributing.

For companies that are not required to comply with the Solvency 2 Directive, realised profits or losses are determined using the normal UK common law and statutory requirements (see 5.8 above).

5.8.5 Impact of transition on distributable profits

Certain impacts on distributable profits on transition to FRS 101 and FRS 102 are discussed at 4.5 above.

6 Financial Reporting Council (FRC) and accounting standard setting

This section discusses the role of the FRC in accounting standard setting and draws on information concerning the FRC structure that is included on the FRC website.

6.1 Accounting standards setting

Accounting standards are statements of standard accounting practice issued by such body or bodies prescribed by regulations. [s464(1)]. Prior to 2 July 2012, this body was the Accounting Standards Board and from 2 July 2012, the Financial Reporting Council.¹¹ New accounting standards, or amendments to or withdrawal of existing accounting standards must be approved by the FRC Board. The FRC Board is supported by two governance committees (Audit & Risk Committee, People Committee), one regulatory committee (Conduct Committee) and an Advisory Panel

The FRC's objective in setting accounting standards is to enable users of accounts to receive high quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. [Foreword.8]. The FRC collaborates with accounting standard setters from other countries and the IASB to influence the development of international accounting standards and to ensure that its standards are developed with due regard for international developments.

The FRC Advisory Panel, which comprises subject matter specialists (including practising professionals) is responsible, *inter alia*, for advising the FRC Board on maintaining an effective framework of UK codes and standards for Corporate Governance, Stewardship, Accounting, Auditing and Assurance, and Actuarial technical standards.

The FRC's Codes & Standards activities include setting and maintaining Codes, Standards, Statement of Practice and Guidance in accordance with its *Framework for developing standards, statements of practice, codes and guidance*.¹²

The following principles will guide FRC decisions about when to introduce, amend or withdraw a code, standard, guidance or other similar material. The FRC will only consider making a change where it is satisfied that:

- There is a clearly defined issue relevant to the FRC's mission and responsibilities
- The change is the most appropriate way to address the issue
- One or more of the following conditions is met:
 - A change is necessary to comply or align with a legal requirement
 - A change is required in the light of developments in international standards or in UK or European regulation
 - The risks to the public interest of not acting are significant, for example, a risk of systemic and/or market failure
 - It is possible to eliminate or significantly simplify a current requirement
 - It is necessary to clarify a current requirement
 - It is possible to create significant additional benefits in the public interest
- Or
- A change is necessary to underpin the effectiveness of the FRC's enforcement and disciplinary activities
- The anticipated benefits of the change outweigh the costs

11 The Accounting Standards (Prescribed Bodies) (United States of America and Japan) Regulations 2015 extend the prescribed bodies for issuing accounting standards to include the FASB and the Accounting Standards Board of Japan for group accounts of parent companies with securities registered with the Securities Exchange Commission of the United States of America and specified Japanese exchanges respectively, with the restrictions set out in the statutory instrument.

12 [Framework and Process for the Development of Standards, Codes and Guidance](#)

6.2 Scope and authority of accounting standards

The *Foreword to Accounting Standards*, last updated in January 2022, explains the authority, scope and application of accounting standards, known as Financial Reporting Standards (FRSs) issued by the FRC.

Accounting standards are applicable to the financial statements of a reporting entity that are required to give a true and fair view of its financial position at the reporting date; and of its profit or loss (or income and expenditure) for the reporting period. (See Chapter 6 at 9.2). *[Foreword.4]*.

Accounting standards developed by the FRC are designated Financial Reporting Standards (FRSs). The FRC may issue FRSs that relate to other aspects of financial reporting, but which are not accounting standards. Each FRS will indicate its status, i.e., that it is an accounting standard or, if not, the circumstances in which it may be applied. *[Foreword.9, Foreword.10, Foreword.11]*. FRS 100 to FRS 103 and FRS 105 (but not FRS 104) are accounting standards for the purpose of company law.

Where exposure drafts are issued for comment and are subject to revision, until it is finalised as an accounting standard the requirements of any existing accounting standard that would be affected by proposals in the exposure draft remain in force. *[Foreword.13]*.

6.3 UK GAAP

UK GAAP is a wider concept than accounting standards. For example, UK GAAP can include:

- SORPs (where an entity is within the scope of a SORP – see 3.6 above).
- Other pronouncements issued by the FRC or its predecessor bodies (such as FREDs or best practice Reporting Statements) – providing these do not conflict with an extant accounting standard.
- Pronouncements by authoritative bodies, such as Technical Releases issued by the Institute of Chartered Accountants in England and Wales and/or the Institute of Chartered Accountants in Scotland (examples include TECH 02/17BL).

And

- Generally accepted accounting practice where areas are not covered by specific accounting standards. This could include reference to the requirements of other bodies of GAAP where it addresses an issue, but does not conflict with accounting standards. For example, FRS 102 permits but does not require management to refer to the requirements of UK-adopted international accounting standards dealing with similar and related issues in developing and applying a reliable and relevant accounting policy. *[FRS 102.10.6]*. Generally accepted accounting practice can also include established industry practice in accounting for transactions.

In addition, an entity must comply with any legal or regulatory requirements applicable to its annual report and financial statements, including the overall requirement for directors of a company to prepare accounts that give a true and fair view.

Appendix A - Defined terms

Extract from FRS 100 Appendix 1 Glossary

Definitions

Accounting Directive	Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013
Act	The Companies Act 2006
adopted IFRS	IFRS Accounting Standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards In the Republic of Ireland, this refers to EU-adopted IFRS
date of transition	The beginning of the earliest period for which an entity presents full comparative information under a given standard in its first financial statements that comply with that standard.
EU-adopted IFRS	IFRS Accounting Standards that have been adopted in the European Union in accordance with EU Regulation 1606/2002.
FRS 101	FRS 101 Reduced Disclosure Framework
FRS 102	FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland
FRS 103	FRS 103 Insurance Contracts
FRS 104	FRS 104 Interim Financial Reporting
FRS 105	FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime
IAS / IFRS Accounting Standards	IFRS® Accounting Standards issued by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) IAS® Standards; (c) IFRIC® Interpretations developed by the IFRS Interpretations Committee; and (d) SIC® Interpretations developed by the former Standing Interpretations Committee.
IAS Regulation	EU Regulation 1606/2002
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term
micro-entity	A micro-entity is: (a) a company meeting the definition of a micro-entity as set out in section 384A of the Act ¹⁷ , and not prevented from applying the micro-entity provisions by section 384B of the Act; (b) an LLP which qualifies as a micro-entity and is not prevented from applying the micro-entity provisions in accordance with Regulation 5A of the Limited Liability Partnerships (Accounts and

Extract from FRS 100 Appendix 1 Glossary

	Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911); or (c) A qualifying partnership that would meet the definition of a micro-entity as set out in section 384A of the Act, and not be prevented from applying the micro-entity provisions by section 384B of the Act, if the partnership were a company.
qualifying entity (for the purposes of FRS 100 and FRS 101)	A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation¹⁸. The following are not qualifying entities: (a) charities; (b) entities that are both required to apply Schedule 3 to the Regulations and have contracts that are within the scope of IFRS 17 Insurance Contracts; and (c) entities that are not companies but are both required to apply requirements similar to those in Schedule 3 to the Regulations¹⁹ and have contracts that are within the scope of IFRS 17.
small entity	A small entity is: (a) a company meeting the definition of a small company as set out in section 382 or 383 of the Act and not excluded from the small companies regime by section 384; (b) an LLP qualifying as small and not excluded from the small LLPs regime, as set out in LLP Regulations; or (c) any other entity that would have met the criteria in (a) had it been a company incorporated under company law.
Statement of Recommended Practice (SORP)	An extant Statement of Recommended Practice developed in accordance with Policy on Developing Statements of Recommended Practice (SORPs). SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.
UK-adopted international accounting standards	IAS that have been adopted for use within the UK in accordance with the International Accounting Standards and European Public Limited Liability Company (Amendment etc.) (EU Exit) Regulations 2019 (SI 2019/685).

Appendix B - Index of Illustrations

Illustration 6-1: Example of a s408 exemption statement

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Overview

FRS 101 *Reduced Disclosure Framework* is a UK accounting standard providing an optional reduced disclosure framework. It outlines the financial reporting requirements and exemptions from disclosures for the individual financial statements of subsidiaries and ultimate parent companies that otherwise apply the recognition, measurement, and disclosure requirements of adopted IFRS.

Disclosure exemptions are available to a qualifying entity, as defined in the glossary to this FRS, for its individual financial statements. A qualifying entity which is required to prepare consolidated financial statements cannot apply FRS 101 in its consolidated financial statements. A qualifying entity is permitted to apply the reduced disclosure framework, irrespective of the financial reporting framework used in the group's consolidated financial statements.

An entity applying FRS 101 must prepare a balance sheet and profit and loss account in accordance with *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410) or, where applicable, *The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008*. UK companies (other than banking or insurance companies) and LLPs may either apply statutory formats or adapted formats.

What you need to know

- FRS 101 is an optional UK accounting standard which permits qualifying entities to apply the recognition and measurement requirements of adopted IFRS but with significantly reduced disclosures.
- Qualifying entities are those which produce separate (or individual financial statements) and are members of a group which prepares publicly available financial statements in which the reporting entity is consolidated. FRS 101 cannot be used in consolidated financial statements.
- An entity using FRS 101 can take advantage of various disclosure exemptions from adopted IFRS, including the requirement to prepare a cash flow statement and disclosures related to financial instruments. Some disclosure exemptions are conditional on equivalent disclosures being made in the consolidated financial statements of the reporting entity's parent.
- An entity defined as a 'financial institution' has fewer disclosure exemptions than entities that are not financial institutions.
- As FRS 101 financial statements are Companies Act financial statements, they are subject to disclosures required by the Regulations as well as other disclosures required by the Companies Act or other related regulations. These disclosures are in addition to those required by adopted IFRS. In addition, there are several conflicts between the recognition and measurement rules of adopted IFRS and those required by the Regulations. Consequently, entities applying FRS 101 apply a modified version of adopted IFRS designed to eliminate these limited recognition, measurement and presentational differences.
- An entity that is both required to apply Schedule 3 of the Regulations (or requirements similar to those in Schedule 3 of the Regulations) and has contracts that are within the scope of IFRS 17 *Insurance Contracts*, cannot apply FRS 101. Those entities must apply either adopted IFRS or FRS 102.
- Amendments to FRS 101 Reduced Disclosure Framework - 2024/25 Cycle made amendments in relation to developments in IFRS Accounting Standards, in particular new standard, IFRS 18 *Presentation and Disclosure in Financial Statements*. IFRS 18 is applicable for accounting periods beginning on or after 1 January 2027, but can be early adopted when endorsed for use in the UK.

1 Introduction

This chapter deals only with the application of FRS 101 *Reduced Disclosure Framework: Disclosure exemptions from adopted IFRS for qualifying entities* as issued in September 2024. References made to FRS 101 throughout this chapter are to the September 2024 edition of the standard unless otherwise indicated.

FRS 101 sets out an optional framework which addresses the financial reporting requirements and disclosure exemptions for the individual financial statements of subsidiaries and parents that otherwise apply the recognition, measurement and disclosure requirements of standards and interpretations issued by the International Accounting Standards Board (IASB) that have been adopted in the relevant jurisdiction ('adopted IFRS').

To use the framework in FRS 101, an entity needs to be a 'qualifying entity', i.e., a parent or subsidiary which is included in publicly available consolidated financial statements of its parent which are intended to give a true and fair view.

An entity preparing financial statements in accordance with FRS 101 ('FRS 101 financial statements') complies with adopted IFRS except as modified in accordance with FRS 101. This chapter does not discuss adopted IFRS, which is covered in the EY publication, International GAAP®. The FRC's overriding objective is to enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and the users' information needs. In other words, the objective of FRS 101 is to enable the financial statements of subsidiaries and parents to be prepared under the recognition and measurement rules of adopted IFRS, without the need for some of the copious disclosures which are perceived to act as a barrier to those entities preparing those financial statements under adopted IFRS.

An entity using the reduced disclosure framework of FRS 101 is unable to make the explicit and unreserved statement that its financial statements comply with adopted IFRS. This is because an accounting framework that allows such reduced disclosures cannot be described as adopted IFRS. UK companies that prepare FRS 101 financial statements in accordance with Part 15 of the Companies Act 2006 ('CA 2006') prepare Companies Act individual accounts as defined in s395(1)(a) of the CA 2006. This means that FRS 101 financial statements are subject to different Companies Act requirements from financial statements prepared under adopted IFRS (which are IAS accounts prepared under s395(1)(b) of the CA 2006). In particular, FRS 101 financial statements prepared by a UK company must comply with Schedule 1, Schedule 2 (if a banking company) or Schedule 3 (if an insurance company) to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), as amended ('the Regulations'). Schedules 1-3 of the Regulations do not apply to IAS accounts. LLPs and certain other entities also prepare financial statements in accordance with Part 15 of the CA 2006 and are subject to similar requirements. Generally, this chapter refers to UK companies and the Regulations. The requirements for LLPs and *The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008*, as amended ('the LLP Regulations') are similar, although there are some minor differences.

This chapter discusses FRS 101 only as it applies to UK companies, LLPs and other entities preparing financial statements under Part 15 of CA 2006. However, FRS 101 may also be applied by non-UK entities currently applying IFRS as issued by the IASB, or another GAAP, although this may depend on local legislation (or regulatory or other requirements).

1.1 Summary of FRS 101

Application of FRS 101 can be summarised as follows:

- Adoption of FRS 101 is voluntary, being one of several accounting standards available for financial reporting in the UK and Republic of Ireland (see Chapter 1).
- FRS 101 can only be applied in individual financial statements (see 2 below).
- FRS 101 can only be applied by a 'qualifying entity' (see 2.1 below).
- Entities can transition to FRS 101 from IFRS or another GAAP (usually this other GAAP will be FRS 102) (see 3 below).
- Entities using FRS 101 apply the recognition and measurement principles of adopted IFRS, as amended by FRS 101 (see 4 below).

- Entities using FRS 101 must prepare a balance sheet and profit and loss account (either as a separate income statement or as a section of the statement of comprehensive income) in accordance with the Regulations or, where applicable, the LLP Regulations. UK companies (other than banking or insurance companies) and LLPs may either apply statutory formats or adapted formats (which are based on adopted IFRS) (see 5 below).
- Entities using FRS 101 can take advantage of various disclosure exemptions from adopted IFRS. Entities defined as 'financial institutions' have fewer available exemptions than entities that are not financial institutions. Some of these disclosure exemptions are conditional on equivalent disclosures being included in the publicly available consolidated financial statements of the group in which the entity is consolidated, and which are intended to give a true and fair view (see 6 below).
And
- In addition to IFRS disclosures, entities using FRS 101 must comply with any legal requirements relating to financial statements, e.g., disclosures required by the CA 2006 and the Regulations, if subject to those requirements (see 7 below).

1.2 Effective date of FRS 101

FRS 101 was issued originally on 22 November 2012. Consolidated versions of the standard incorporating subsequent amendments were subsequently issued in August 2014, September 2015, March 2018, January 2022 and September 2024. This chapter reflects the September 2024 version of FRS 101. The changes made to FRS 101 since the March 2018 version are discussed at 1.2.1 below.

FRS 101 has been available for use for accounting periods beginning on or after 1 January 2015. Early application was permitted but was required to be disclosed. [FRS 101.11].

The September 2024 version of FRS 101 is effective for accounting periods beginning on or after 1 January 2026. Early application of the September 2024 version of FRS 101 for accounting periods beginning prior to 1 January 2026 is permitted provided that all amendments made to this FRS by the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs - Periodic Review 2024* (Periodic Review 2024) are applied at the same time. If an entity applies the Periodic Review 2024 for an accounting period beginning before 1 January 2026 it must disclose that fact. [FRS 101.18].

Since FRS 101 is based on adopted IFRS, any disclosure exemptions referring to a specific requirement of IFRS are effective only once the IFRS has been adopted and is first applied by the entity. [FRS 101.1, FRS 101.8].

The FRC reviews FRS 101 annually to ensure that the reduced disclosure framework maintains consistency with adopted IFRS. In addition, limited amendments have been made to FRS 101 (compared to adopted IFRS) for compliance with the CA 2006 and the Regulations.

1.2.1 Amendments to FRS 101 incorporated into the September 2024 edition

The September 2024 edition of FRS 101 updates the edition of FRS 101 issued in January 2022 for all amendments to the standard issued between those dates. The amendments are as follows:

- *Amendments to Basis for Conclusions FRS 101 Reduced Disclosure Framework - 2021/2022 cycle* issued in May 2022. The Basis for Conclusions was amended to reflect that no amendments were made to FRS 101 after the 2021/22 annual review of FRS 101.
- *Amendments to Basis for Conclusions FRS 101 Reduced Disclosure Framework - 2022/23* issued in May 2023. The Basis for Conclusions was amended to reflect the adoption and endorsement status of IFRS Accounting Standards and that no amendments were made to FRS 101 after the 2022/23 annual review of FRS 101.
- *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRS 101 Reduced Disclosure Framework - International tax reform - Pillar Two model rules* issued in July 2023. The amendments provide disclosure exemptions in relation to certain Pillar Two model rules disclosures within IAS 12 Income Taxes, when an entity is included in the consolidated financial statements of the group in which equivalent disclosures are included (see 6.1.13 below). [FRS 101.8(iZA)].
- Amendments made by the Periodic Review 2024 issued in March 2024. These amendments apply for accounting periods beginning on or after 1 January 2026. Early application is permitted (but this must be disclosed) for accounting periods beginning prior to 1 January 2026 provided all amendments made by the Periodic Review 2024 are applied at the same time.

- Amendments to FRS 101 Reduced Disclosure Framework - 2023/2024 cycle issued in September 2024, which:
 - Provides a disclosure exemption in relation to presenting certain comparative information in respect of IFRS 16 *Leases* (see 6.1.9 below). [FRS 101.8(f)(i)].
 - Introduces a conditional exemption in respect of certain disclosures about supplier finance arrangements in respect of IAS 7 *Statement of Cash Flows* (see 6.1.11 below). [FRS 101.8(h)(i), FRS 101.8(h)(ii)].
- And
 - Clarifies that under UK-adopted international accounting standards, a liability is classified as current when, at the end of the reporting period, an entity does not have the right to defer settlement of the liability for at least twelve months after the reporting period. [FRS 101.A2.9B(c)].
- There are also some minor typographical, presentational or editorial corrections.

1.2.2 Amendments to FRS 101 issued in May 2025

Amendments to *FRS 101 Reduced Disclosure Framework - 2024/25 Cycle* made amendments to FRS 101 in relation to developments in IFRS Accounting Standards, in particular new standards, IFRS 18 and IFRS 19 *Subsidiaries without Public Accountability: Disclosures*. The amendments that have arisen from IFRS 18 replacing IAS 1, are effective from when a qualifying entity applies the standard. IFRS 18 is applicable for accounting periods beginning on or after 1 January 2027 but can be early adopted, only when endorsed for use in the UK. All other amendments are effective from May 2025.

The key amendments include:

- The following disclosure exemptions from adopted IFRS as a result of IFRS 18 replacing IAS 1:
 - Maintaining extant exemptions from disclosure requirements in IAS 1 that have been transferred to the new standard IFRS 18 (see 6.1 below).
 - Exemptions from new IFRS 18 disclosures for (see 6.1.10B below):
 - Management-defined performance measures
 - Additional expense disaggregation information
- Preventing a qualifying entity using FRS 101 from applying IFRS 19. This means that an entity that wishes to use IFRS 19 must apply adopted IFRS and not FRS 101. Both standards allow reduced disclosures, however the IASB's approach to the development of IFRS 19 was different to the FRC's approach to the development of FRS 101, therefore creating significant differences between the two standards.
- Introducing an exemption to present reconciliations of items of 'fixed assets' for prior periods for qualifying entities disclosing the reconciliations in accordance with paragraph 51 of Schedule 1 of the Regulations (see 6.1A below).
- Amending IFRS 5 to require the analysis of discontinued operations into its component parts to be shown on the face of the statement of comprehensive income in a discontinued operations category in a separate column and also present a total column (i.e., the sum of continuing and discontinued operations) (see 5.4 below).

The FRC has not proposed additional disclosure exemptions to FRS 101 for disclosures where an exemption is provided under IFRS 19 but not FRS 101. The FRC intend to consider more broadly in due course how the overall level of disclosure required under FRS 101 compares with the overall level of disclosure required under IFRS 19.

1.3 Statement of compliance with FRS 101

A set of financial statements prepared in accordance with FRS 101 must contain a statement in the notes to the financial statements that "These financial statements were prepared in accordance with Financial Reporting Standard 101 Reduced Disclosure Framework". Since the standard does not comply with all of the requirements of adopted IFRS, financial statements prepared in accordance with FRS 101 must not contain the unreserved statement of compliance referred to in adopted IFRS. [FRS 101.10].

The Regulations require a large and medium-sized UK company (except a medium-sized company preparing individual accounts) preparing Companies Act accounts to state in the notes to the accounts whether the accounts have been prepared in accordance with applicable accounting standards, giving particulars of any material departure from those standards and the reasons for it. [1 Sch 45]. Financial statements prepared in accordance with FRS 101 are prepared in accordance with applicable accounting standards (which are defined in section 464 of CA 2006), [s464], and therefore this statement would be required. See Chapter 1 at 3.5.1.

2 Scope of FRS 101

Extract from FRS 101

Scope

- 2 This FRS may be applied to the individual financial statements of a **qualifying entity**, as defined in the glossary, that are intended to give a true and fair view of the assets, liabilities, financial position and profit or loss for a period. [FRS 101.2]

Individual financial statements to which FRS 101 applies are accounts that are required to be prepared by an entity in accordance with the CA 2006 or relevant legislation, for example: individual accounts as set out in section 394 of the CA 2006 or as set out in section 72A of the Building Societies Act 1986. Separate financial statements, as defined by IAS 27 *Separate Financial Statements*, are included in the meaning of the term individual financial statements. [FRS 101 Appendix I].

This means that FRS 101 can only be used in:

- Individual financial statements of subsidiaries.
- Separate financial statements of an intermediate parent which does not prepare consolidated financial statements.

And

- Separate financial statements of a parent which does prepare consolidated financial statements.

However, an entity applying FRS 101 must be included in a set of publicly available consolidated financial statements intended to give a true and fair view (see 2.1.6 below).

A parent company that prepares consolidated financial statements, but applies FRS 101 in its separate financial statements, can also use the exemption in the CA 2006 from presenting a profit and loss account and related notes in its individual financial statements, as well as taking advantage of the reduced disclosures from adopted IFRS. [s408].

FRS 101 cannot be applied in consolidated financial statements even if the entity preparing consolidated financial statements, is a qualifying entity. [FRS 101.3].

FRS 101 financial statements are not prepared in accordance with adopted IFRS. A qualifying entity must ensure it complies with any relevant legal requirements applicable to it. Individual financial statements prepared by UK companies in accordance with FRS 101 are Companies Act accounts rather than IAS accounts as set out in section 395(1) of the CA 2006. Accordingly, UK companies that apply FRS 101 must comply with the requirements of the CA 2006 and any relevant regulations such as the Regulations.

[FRS 101.4A]. The presentation requirements of relevant regulations applying to UK entities, including the requirements of the Regulations (which cover rules on recognition and measurement, the formats for the balance sheet and profit and loss account, and notes disclosures) are discussed in Chapter 6.

In order to ensure that FRS 101 financial statements comply with the CA 2006 and the Regulations, some limited recognition, measurement and presentational changes have been made in FRS 101 to adopted IFRS. The amendments necessary to remove conflicts between adopted IFRS, the CA 2006 and the Regulations are set out in paragraph AG1 of the Application Guidance to FRS 101. The standard emphasises that, for the avoidance of doubt, the Application Guidance is an integral part of the standard and is applicable to any qualifying entity applying FRS 101, not just to UK companies. [FRS 101.5(b)]. These amendments are discussed at 4 and 5 below.

FRS 101 does not permit use of the formats for the balance sheet and profit and loss account included in Part 1 'General Rules and Formats' of *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409) ('the Small Companies Regulations'). This chapter does not generally refer to the Small Companies and Small LLP Regulations.

How we see it

Companies subject to the small companies' regime can still apply FRS 101, and, in doing so, are not prevented from taking advantage of other Companies Act exemptions applicable to companies subject to the small companies' regime. Likewise, medium-sized entities applying FRS 101 can still take advantage of applicable Companies Act disclosure exemptions for medium-sized entities.

An entity that is both required to apply Schedule 3 of the Regulations (or requirements similar to those in Schedule 3 of the Regulations) and has contracts that are within the scope of IFRS 17 cannot apply FRS 101 (see 4.8 below).

While the discussion above refers to UK companies, there are similar requirements for LLPs (see 4.11 below).

2.1 Definition of a qualifying entity

Extract from FRS 101

Appendix I

Glossary

qualifying entity (for the purposes of this FRS)	A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation⁶. The following are not qualifying entities: (a) charities; (b) entities that are both required to apply Schedule 3 to the Regulations and have contracts that are within the scope of IFRS 17 <i>Insurance Contracts</i>; and (c) entities that are not companies but are both required to apply requirements similar to those in Schedule 3 to the Regulations⁷ and have contracts that are within the scope of IFRS 17.

The phrase ‘requirements similar to those in Schedule 3 of the Regulations’ is referenced to the following:

- Schedules 1 and 2 to The Friendly Societies (Accounts and Related Provisions) Regulations 1994 (SI 1994/1983)
 - Schedule 1 to the *Insurance Accounts Directive (Lloyd’s Syndicate and Aggregate Accounts) Regulations 2008* (SI 2008/1950)
 - *Syndicate Accounting Byelaw* (No 8 of 2005)
- And
- *The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008* (SI 2008/565)

How we see it

There is no requirement in the definition of a qualifying entity that a qualifying entity is a member of the group in which it is consolidated for its entire reporting period. There is also no requirement that the financial statements of the qualifying entity and the consolidated financial statements of the parent of that group (which may be the reporting entity itself) must be coterminous or have reporting dates within a particular timeframe. In our view, the use of the present tense in the definition above implies that the intention is only that the qualifying entity (where it does not prepare its own consolidated financial statements) is a subsidiary of the parent at its reporting date. This interpretation is consistent with UK Company Law which requires that an entity which is a parent at the end of a financial year must prepare group accounts unless it is exempted from the requirement.

The phrase “included in the consolidation” is referenced to section 474(1) of the CA 2006 which states that this means that “the undertaking is included in the accounts by the method of full (and not proportional) consolidation, and references to an undertaking excluded from consolidation shall be construed accordingly”. Therefore, entities that are not fully consolidated in the consolidated financial statements, such as subsidiaries of investment entities which are accounted for at fair value through profit or loss where required by IFRS 10 *Consolidated Financial Statements*, cannot use FRS 101. Associates and joint ventures are not qualifying entities since they are not members of a group (see 2.1.2 below).

There is no requirement for the consolidated financial statements in which the qualifying entity is included to be prepared under adopted IFRS nor that the parent that prepares the consolidated financial statements

is a UK entity. However, the consolidated financial statements must be intended to give a true and fair view (see 2.1.6 below).

2.1.1 Reporting date of the consolidated financial statements of the parent

FRS 101 is silent on whether the reporting date and period of those consolidated financial statements has to be identical to that of the qualifying entity. In contrast, both sections 400 and 401 of the CA 2006 require that the exemption from preparing group accounts for a parent company that is a subsidiary undertaking is conditional on the inclusion of the company in the consolidated financial statements of a parent undertaking with the same reporting date or with an earlier reporting date in the same financial year. The company must also deliver the audited consolidated financial statements and annual report of the parent undertaking to the registrar within the period for filing its accounts and reports for the financial year.

2.1.2 Definition of group and subsidiary

The definition of a qualifying entity contains a footnote that refers to section 474(1) of the CA 2006 which defines a “group” as “a parent undertaking and its subsidiary undertakings”. Adopted IFRS defines a group as “a parent and its subsidiaries”. [IFRS 10 Appendix A, s474(1)].

Adopted IFRS defines a parent as “an entity that controls one or more entities” and a subsidiary as “an entity that is controlled by another entity”. [IFRS 10 Appendix A].

The CA 2006 states that an undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if:

- It holds a majority of the voting rights in the undertaking.
- It is a member of the undertaking and has the right to appoint or remove a majority of its board of directors.
- It has the right to exercise a dominant influence over the undertaking by virtue of provisions in the undertaking’s articles or by virtue of a control contract.

Or

- It is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.

An undertaking must also be treated as a member for the purposes above if any of its subsidiary undertakings is a member of that undertaking or if any shares in that other undertaking are held by a person acting on behalf of the undertaking or any of its subsidiary undertakings.

An undertaking is also a parent undertaking in relation to another undertaking, a subsidiary undertaking, if it has the power to exercise, or actually exercises, dominant influence or control over it, or it and the subsidiary undertaking are managed on a unified basis.

A parent undertaking is treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings; and references to its subsidiary undertakings must be construed accordingly. [s1162(1), s1162(2), s1162(3), s1162(4), s1162(5)]. Schedule 7 to the CA 2006 provides interpretation and references to “shares” in section 1162 and in Schedule 7 are to “allotted shares”. [s1162(6), s1162(7)].

These differences in definition make it possible for an entity to be a subsidiary undertaking under the CA 2006 but not under adopted IFRS. For example an entity in which a parent owns a majority of the voting rights but does not have control over the subsidiary (as defined in adopted IFRS). However, the key issue for the application of FRS 101 is whether the subsidiary is included in the consolidation of the parent’s consolidated financial statements. A company that meets the definition of a subsidiary undertaking under the CA 2006 but is not included in the consolidation of the consolidated financial statements of its parent cannot apply FRS 101.

2.1.3 Publicly available consolidated financial statements

How we see it

By ‘publicly available’, FRS 101 requires that the consolidated financial statements can be accessed by the public as the use of the disclosure exemptions set out in the standard is conditional on a disclosure by the qualifying entity indicating from where those consolidated financial statements can be obtained (see 2.2 below). This does not mean that the consolidated financial statements must be filed with a regulator.

Therefore, for example, consolidated financial statements of a UK company that have not been filed with the Registrar of Companies, at the date the subsidiary's FRS 101 financial statements are approved, must be publicly available via some other medium.

2.1.4 Non-UK qualifying entities

There is no requirement that a qualifying entity is a UK entity. Non-UK entities can apply FRS 101 in their individual or separate financial statements subject to meeting the criteria for the use of the standard (see 2.2 below) and provided FRS 101 is allowed for use in their own jurisdiction.

2.1.5 Non-controlling interests

There is no ownership threshold for a subsidiary to apply FRS 101. Therefore, a qualifying entity can apply FRS 101 even if its parent holds less than a majority of the voting rights, provided it is a subsidiary undertaking.

There is no requirement for a qualifying entity to notify its shareholders about the proposed use of the disclosure exemptions and shareholders with non-controlling interests do not have a right to object to the use of FRS 101. The FRC consider that it is not cost-effective in practice to give such rights to shareholders and sufficient information exists for non-controlling shareholders to understand the effects of the reduced disclosure framework. [FRS 101.BC27].

2.1.6 Intended to give a true and fair view

In the definition of a qualifying entity (see 2.1 above), the consolidated financial statements in which the qualifying entity is included are not required to give an explicit true and fair view of the assets, liabilities, financial position and profit or loss. Rather, they are '*intended to give a true and fair view*' (our emphasis). This means that the consolidated financial statements in which the qualifying entity is consolidated need not contain an explicit opinion that they give a 'true and fair view' but, in substance, they must be intended to give such a view. The FRC guidance - *True and Fair* - issued in June 2014 states that 'Fair presentation under IFRS is equivalent to a true and fair view'.¹³

A UK parent company that wishes to claim an exemption from preparing group accounts under either section 400 or section 401 of the CA 2006 must be a subsidiary included in the consolidated accounts for a larger group. Those consolidated accounts (and where appropriate, the group's annual report) must be drawn up and audited: [s400(2)(b), s401(2)(b), s401(2)(c)]

- In accordance with the requirements of Part 15 of CA 2006 if the undertaking is a company, or the legal requirement which apply to the drawing up of consolidated accounts for the undertaking if that undertaking is not a company. (for section 400).
 - In a manner equivalent to consolidated accounts and consolidated reports so drawn up (for section 401).
 - In accordance with UK-adopted international standards (for sections 400 and 401).
- Or
- in accordance with accounting standards which are equivalent to such international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 (for section 401).

There are similar requirements for a parent LLP but for section 401, there is no reference to the basis on which the consolidated reports are drawn up. [s400(2)(b)(LLP), s401(2)(b)(LLP)].

How we see it

A set of consolidated financial statements that would meet the above criteria (i.e., the consolidated financial statements drawn up are in accordance with or in a manner equivalent to Part 15 of CA 2006, or in accordance with UK-adopted international standards or accounting standards which are equivalent to such international accounting standards as determined by the mechanism established by the EU Commission) is intended to give a true and fair view.

The Application Guidance to FRS 100 *Application of Financial Reporting Requirements* states that consolidated financial statements of a higher parent will meet the test of equivalence if they are intended to give a true and fair view and:

¹³ *True and Fair*, FRC, June 2014.

- Are prepared in accordance with FRS 102.

Or

- Are prepared using other GAAPs which are closely related to IFRS Accounting Standards, subject to consideration of the effect of any differences from UK-adopted international accounting standards.

Consolidated financial statements of the higher parent prepared in any other manner must be assessed for equivalence with Part 15 of CA 2006 based on the particular facts, including the similarities to and differences from the requirements of Part 15 of CA 2006. [FRS 100.AG14].

The UK government has recognised equivalence to UK-adopted international accounting standards of the following GAAPs, which include those GAAPs previously recognised by the European Commission as equivalent to EU-adopted IFRS: [FRS 100.AG9]

- GAAP of Canada
- GAAP of the People's Republic of China
- GAAP of Japan
- GAAP of the Republic of Korea
- GAAP of the United States of America
- EU-adopted IFRS
- IFRS as issued by the IASB

The concept of equivalence for the purposes of section 401 is discussed further in Chapter 8 at 3.1.1.C.

In theory, there is no reason why consolidated financial statements of a parent prepared under a GAAP that is not 'equivalent' to Part 15 of CA 2006 cannot be used provided those consolidated financial statements in which the entity is included are publicly available and are intended to give a true and fair view.

In addition, as set out above, a number of the disclosure exemptions from adopted IFRS in FRS 101 are conditional on 'equivalent' disclosures being made in those consolidated financial statements in which the qualifying entity is included. Where the equivalent disclosure is not made, the relevant disclosure exemptions cannot be applied in the qualifying entity's financial statements prepared under FRS 101 (see 6.2 below). A GAAP that is not 'equivalent' to Part 15 of CA 2006 is less likely to have those 'equivalent' disclosures.

One issue not addressed by FRS 101 is the impact of a qualified audit opinion on the parent's consolidated financial statements on a qualifying entity's ability to use FRS 101. A Queen's Counsel's opinion obtained by the FRC in 2008 stated that "the scope for arguing that financial statements which do not comply with relevant accounting standards nevertheless give a true and fair view, or a fair presentation, is very limited".¹⁴

2.2 Use of the disclosure exemptions

The use of the disclosure exemptions in FRS 101 (see 6 below) is conditional on all of the following criteria being met: [FRS 101.5]

- The reporting entity must not apply IFRS 19.
- The reporting entity applies, as its financial reporting framework, the recognition, measurement and disclosure requirements of adopted IFRS but makes those amendments to adopted IFRS as required by the Application Guidance to FRS 101 that are necessary in order to comply with the CA 2006 and the Regulations. This is because financial statements prepared under FRS 101 are Companies Act individual accounts as defined in section 395(1) of the CA 2006 but the Application Guidance applies to any qualifying entity applying FRS 101, including those that are not companies (see 4 and 5 below).
- The reporting entity discloses in the notes to its financial statements a brief narrative summary of the disclosure exemptions adopted.
- The reporting entity discloses the name of the parent of the group in whose consolidated financial statements its financial statements are consolidated (i.e., the parent identified in the definition of a 'qualifying entity') and from where those financial statements may be obtained.

A qualifying entity which is a financial institution is entitled to more limited disclosure exemptions (see 6.4 below).

¹⁴ The Financial Reporting Council: The True and Fair Requirement Revised - Opinion, Martin Moore QC, May 2008, para. 4(F).

2.3 The impact of section 400 and section 401 of the CA 2006 on FRS 101

FRS 101 does not override either section 400 or section 401 of the CA 2006. Section 400 exempts a UK parent company from preparing consolidated accounts if it is a subsidiary undertaking (whose immediate parent undertaking is established under the law of any part of the UK) and is included in the consolidated accounts of a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking established under the law of any part of the UK. Section 401 exempts a UK parent company from preparing consolidated accounts if it is a subsidiary undertaking of a parent undertaking not established under the law of any part of the UK and the company and all of its subsidiary undertakings are included in the consolidated accounts of a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking. The exemptions from preparing consolidated accounts in both sections 400 and 401 are subject to various conditions including 'equivalence' (in respect of section 401, which is discussed at 2.1.6 above). The detailed conditions for the above exemptions from preparing group accounts under the CA 2006 are discussed further in Chapter 8 at 3.1.1.

If a UK parent company does not meet all of the conditions set out in either section 400 or section 401 (and is not otherwise exempt under the CA 2006) then it must prepare consolidated financial statements. Such consolidated financial statements cannot be prepared under FRS 101. However, the parent entity could still prepare its individual financial statements under FRS 101.

2.4 Interim financial statements

FRS 101 does not address the preparation of interim financial statements. However, entities applying FRS 101 to annual financial statements may use FRS 104 *Interim Financial Reporting* as a basis for their interim financial reports. FRS 104 is discussed in Chapter 39.

3 Transition to FRS 101

An entity can transition to FRS 101 from either adopted IFRS or another form of GAAP (e.g., another form of UK GAAP). In this context, another form of UK GAAP currently means either FRS 102 or FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

FRS 101 is adopted in the first accounting period for which a reporting entity makes a statement of compliance with the standard (see 1.3 above). The date of transition is the beginning of the earliest period for which an entity presents full comparative information under a given standard in its first financial statements that comply with that standard. [FRS 100 Appendix I]. For example, the date of transition is 1 January 20X5 for an entity with a 31 December year-end adopting FRS 101 for the first time in its 20X6 financial statements. [FRS 100 Appendix I].

3.1 Companies Act restrictions on changes to FRS 101

Under the CA 2006, a company that wishes to change from preparing IAS individual accounts to preparing individual accounts under FRS 101 may do so either:

- If there is a 'relevant change of circumstance' as defined in section 395(4) of the CA 2006.
- Or
- For financial years ending on or after 1 October 2012, for a reason other than a relevant change of circumstance, once in a five-year period. [FRS 100.A2.14].

There is no restriction on the number of times an entity can move from Companies Act accounts to IAS accounts or *vice versa*. Theoretically, an entity could 'flip' from IAS accounts to FRS 101 and back again several times without a 'relevant change in circumstance' provided such flips are done no more than once every five years and provided that the entity is also complying with the requirements of the CA 2006 such as those relating to consistency of financial reporting within groups (see 3.2 below).

There are no Companies Act restrictions on a change from FRS 102 or FRS 105 to FRS 101 and back again or *vice versa* since these are all Companies Act accounts.

3.2 Consistency of financial statements within the group

The CA 2006 requires that the directors of a UK parent company secure that the individual accounts of the parent company and of each of its subsidiary undertakings are prepared under the same financial reporting framework, be it IAS accounts or Companies Act accounts, except to the extent that in the directors' opinion there are good reasons for not doing so. [s407(1)]. However, this rule does not apply:

- If the parent company does not prepare group accounts. [s407(2)].
- If the accounts of the subsidiary undertaking are not required to be prepared under Part 15 of the CA 2006 (for example, foreign subsidiary undertakings). [s407(3)].
- Or
- To any subsidiary undertakings that are charities (charities and non-charities within a group are not required to use the same accounting framework). [s407(4)]. This is because charities are not permitted to prepare either IAS group or individual accounts. [s395(2), s403(3)].

Additionally, a UK parent company that prepares both consolidated and separate financial statements under adopted IFRS (i.e., IAS group accounts and IAS individual accounts) is not required to ensure that its subsidiary undertakings all prepare IAS individual accounts. However, it must ensure that each of its subsidiary undertakings use the same accounting framework in their individual accounts unless there are good reasons for not doing so. [s407(5)].

Therefore, a group that decides to use FRS 101 for any of its UK subsidiary undertakings, must ensure, unless there are good reasons for not doing so, that all its UK subsidiary undertakings prepare Companies Act individual accounts (i.e., the same financial reporting framework). This requirement only applies to subsidiary undertakings in scope of the section 407 consistency requirements.

Although not explicitly stated by FRS 100, there appears to be no requirement that all UK subsidiary undertakings in a group must use FRS 101 for their Companies Act individual accounts. Some subsidiary undertakings could also use FRS 102, since these are all Companies Act individual accounts and therefore, they are all under the same financial reporting framework. However, while this approach would comply with the statutory requirements, groups that use a 'mix' of GAAP in the individual financial statements may be challenged by HMRC, particularly if this results in tax arbitrage.

Examples of 'good reasons' for not preparing all individual accounts within a group using the same reporting framework are contained in the document *Guidance for UK Companies on Accounting and Reporting: Requirements under the Companies Act 2006 and the application of the IAS Regulation* issued by the Department for Business Enterprise and Regulatory Reform (BERR) in June 2008.

3.3 Transition from adopted IFRS to FRS 101

In substance, the transition requirements for entities that have been applying adopted IFRS prior to conversion to FRS 101 treat the qualifying entity as not having changed its financial reporting framework. Disclosure is required only where changes are made on transition. [FRS 100.12, FRS 101.7A]. FRS 101 modifies adopted IFRS in certain respects, in order to comply with the Companies Act and the Regulations.

A qualifying entity that is applying adopted IFRS prior to the date of transition to FRS 101 will be preparing Companies Act individual accounts in accordance with s395(1)(a) of the CA 2006 (rather than IAS individual accounts in accordance with s395(1)(b) of the CA 2006) post-transition. It therefore must consider whether amendments are required to comply with paragraph 5(b) of FRS 101 - see 4 and 5 below - but it does not reapply the provisions of IFRS 1. Where amendments in accordance with paragraph 5(b) of FRS 101 are required, the entity must determine whether the amendments have a material effect on the first FRS 101 financial statements presented. [FRS 100.12]. Details of measurement differences between adopted IFRS and FRS 101 which might result in a material effect on the financial statements are discussed at 4 below.

Where there is no material effect of such changes, the qualifying entity must disclose that it has undergone transition to FRS 101 and give a brief narrative of the disclosure exemptions taken for all periods presented in the financial statements. [FRS 100.12(a)].

Where there is a material effect caused by such changes, the qualifying entity's first FRS 101 financial statements must include: [FRS 100.12(b)]

- A description of the nature of each material change in accounting policy.
 - Reconciliations of its equity determined in accordance with adopted IFRS to its equity determined in accordance with FRS 101 for both the date of transition to FRS 101 and for the end of the latest period presented in the entity's most recent annual financial statements prepared in accordance with adopted IFRS.
- And
- A reconciliation of the profit or loss determined in accordance with adopted IFRS to its profit or loss determined in accordance with FRS 101 for the latest period presented in the entity's most recent annual financial statements prepared in accordance with adopted IFRS.

This means that, for an entity adopting FRS 101 for the first time in its annual financial statements ending on 31 December 20X6 (and presenting one comparative period), reconciliations will be required of:

- Equity as at 1 January 20X5 and 31 December 20X5.
- And
- Profit or loss for the year ended 31 December 20X5.

There is no requirement for a transition balance sheet to be prepared. [FRS 100.12, FRS 101.7A].

Amendments with a material effect must be applied retrospectively on transition unless impracticable. When it is impracticable to apply the amendments retrospectively, the qualifying entity must apply the amendment to the earliest period for which it is practicable to do so and it must identify the data presented for prior periods that are not comparable with the data for the period in which it prepares its first financial statements that conform to FRS 101. [FRS 100.13]. 'Impracticable' is defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Paragraph 5(b) of FRS 101 cross-refers to Application Guidance 1 to the standard (which forms an integral part of the standard) that includes presentational as well as recognition and measurement modifications to adopted IFRS required when applying the standard. The transitional rules contain no explicit requirement to disclose material presentational changes such as the use of balance sheet and profit and loss formats in accordance with the Regulations (especially where statutory rather than adapted formats are used).

How we see it

We recommend that entities explain any material presentational changes compared to adopted IFRS arising from adoption of FRS 101 in order to assist readers' understanding of the financial statements.

3.4 Transition from another version of UK GAAP or another GAAP to FRS 101

In substance, the transition requirements treat conversion to FRS 101 from another version of UK GAAP (currently FRS 102 or FRS 105) or another GAAP as a full first-time conversion to adopted IFRS (as modified by FRS 101).

A qualifying entity that transitions to FRS 101 must, unless it is applying adopted IFRS prior to the date of transition (see 3.3 above), apply the requirements of paragraphs 6 to 33 of IFRS 1 (as adopted in the relevant jurisdiction) including the relevant appendices, except for the requirement of paragraphs 6 and 21 to present an opening statement of financial position at the date of transition. References to IFRS Accounting Standards in IFRS 1 are interpreted to mean adopted IFRS as amended in accordance with paragraph 5(b) of FRS 101. [FRS 100.11(b)]. This means that all of the recognition, measurement and disclosure rules for an IFRS first-time adopter apply (except for the requirement to present an opening statement of financial position) to the extent they do not conflict with adopted IFRS as amended by paragraph 5(b) of FRS 101. First-time adoption of IFRS is discussed in the EY publication, International GAAP®

IFRS 1 sets out specific requirements for where a subsidiary becomes a first-time adopter later than its parent ('the D16 election') or where a parent becomes a first-time adopter later than its subsidiary, or a parent becomes a first-time adopter in its separate financial statements earlier or later than in its consolidated financial statements ('the D17 requirements'). [IFRS 1. Appendix D.16, IFRS 1. Appendix D.17]. These requirements are both amended by FRS 101 as described at 3.4.1 and 3.4.2 below.

3.4.1 The D16 election

FRS 101 amends the D16 election to: [FRS 101.AG1(a)]

- Remove the sentence stating that the election to use the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's transition to IFRSs, is not available to a subsidiary of an investment entity that is required to be measured at fair value through profit or loss.
And
- Add a sentence stating that "A qualifying entity that applies this provision must ensure that its assets and liabilities are measured in accordance with company law".

The purpose of the second amendment is to restrict the application of the D16 election to situations where the measurement of assets and liabilities in the subsidiary's or parent's individual financial statements based on consolidated financial statements would comply with Company Law. FRS 101 financial statements must comply with the measurement requirements of the CA 2006 which may be inconsistent with those of adopted IFRS applied in the consolidated financial statements. [FRS 101 Appendix II. Table 1].

The FRC does not explain the first amendment although an entity which is not consolidated by its parent cannot apply FRS 101 (see 2.1 above).

3.4.2 The D17 requirements

FRS 101 amends the D17 requirements by adding a sentence stating that "A qualifying entity that applies this provision must ensure that its assets and liabilities are measured in accordance with company law". [FRS 101.AG1(b)].

FRS 101 also amends the D17 requirements to remove the sentence "Notwithstanding this requirement, a non-investment entity parent shall not apply the exception to consolidation that is used by any investment entity subsidiaries". However, this sentence is not relevant to FRS 101 financial statements, which are not consolidated financial statements.

3.5 The impact of transition on realised profits

There may be circumstances where a conversion to FRS 101 eliminates a qualifying entity's realised profits or turns those realised profits into a realised loss. TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006* issued by the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland (ICAS), (TECH 02/17BL) states that the change in the treatment of a retained profit or loss as realised (or unrealised) as a result of a change in the law or in accounting standards or interpretations would not render unlawful a distribution already made out of realised profits determined by reference to 'relevant accounts' which had been prepared in

accordance with generally acceptable accounting principles applicable to those accounts. This is because the CA 2006 defines realised profits or losses for determining the lawfulness of a distribution as “such profits and losses of the company as fall to be treated as realised in accordance with principles generally accepted at the time when the accounts are prepared, with respect to the determination for accounting purposes of realised profits or losses”. [TECH 02/17BL.3.28, TECH 02/17BL.3.29].

The effects of the introduction of a new accounting standard or of the adoption of IFRS become relevant to the application of the common law capital maintenance rule only in relation to distributions accounted for in periods in which the change will first be recognised in the accounts. This means that a change in accounting policy known to be adopted in a financial year needs to be taken into account in determining the dividend to be approved by shareholders in that year. Therefore, for example, an entity converting to FRS 101 in 20X6 must have regard to the effect of adoption of FRS 101 in respect of all dividends payable in 20X6 (including any final dividends in respect of 20X5) even though the ‘relevant accounts’ may still be those for 20X5 prepared under another GAAP. [TECH 02/17BL.3.30, TECH 02/17BL.3.31, TECH 02/17BL.3.32, TECH 02/17BL.3.33, TECH 02/17BL.3.34, TECH 02/17BL.3.35, TECH 02/17BL.3.36, TECH 02/17BL.3.37].

Statutory ‘interim accounts’ are required to be prepared under sections 836(2) and 838 of the CA 2006 (and delivered to the Registrar if the company is a public company) if a proposed distribution cannot be justified by reference to the relevant accounts. See Chapter 1 at 4.5 for further discussion.

4 Measurement differences between FRS 101 and adopted IFRS

As noted at 2 above, entities applying FRS 101 use adopted IFRS as amended by the standard in order to comply with the CA 2006 and the Regulations. This is because financial statements prepared under FRS 101 are Companies Act individual accounts and not IAS individual accounts. There are several conflicts between the recognition and measurement rules of adopted IFRS and those required by the Regulations. Consequently, entities applying FRS 101 apply a modified version of adopted IFRS designed to eliminate these differences.

FRS 101 does not modify adopted IFRS in respect of goodwill and indefinite-life intangible assets. However, non-amortisation of those assets conflicts with the Regulations necessitating use of a 'true and fair override' as explained at 4.1 below.

Similarly, FRS 101 does not modify the requirement under IFRS 9 *Financial Instruments* to present changes in the fair value of a financial liability attributable to own credit risk in other comprehensive income. However, this presentation conflicts with the Regulations necessitating use of a 'true and fair override' as explained at 4.2 below.

In respect of the matters discussed at 4.3 to 4.11 below, FRS 101 specifically amends adopted IFRS to remove conflicts identified between adopted IFRS and the Regulations. Therefore, the issue of invoking a 'true and fair override' does not arise in respect of these other matters.

FRS 101 changes adopted IFRS in respect of the following matters:

- Negative goodwill (see 4.3 below).
- Contingent consideration balances arising from business combinations (see 4.4 below).
- Government grants deducted from the cost of fixed assets (see 4.5 below).
- Provisions, contingent assets and contingent liabilities (see 4.6 below).
- Realised profits (see 4.7 below).
- Equalisation provisions (see 4.8 below).
- Investments in subsidiaries, associates and joint ventures by banking and insurance entities (see 4.9 below).

And

- Investment entities (see 4.10 below).

The position as regards limited liability partnerships (LLPs) is discussed at 4.11 below.

4.1 Positive goodwill and indefinite-life intangible assets

No changes have been made to adopted IFRS in respect of positive goodwill that is not amortised. Instead, FRS 101 states that paragraph B63(a) of IFRS 3 *Business Combinations*, which requires that goodwill is measured at cost less impairment, must be read in accordance with paragraph A2.8 of FRS 101.

[FRS 101.AG1(f)]. The non-amortisation of goodwill required by IFRS 3 conflicts with paragraph 22 of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3) which require that an intangible asset (including goodwill) must be written off over its useful economic life.

FRS 101 notes that the non-amortisation of goodwill will usually be a departure, for the overriding purpose of giving a true and fair view, from the requirements of the Regulations. FRS 101 goes on to state that this is not a new instance of the use of the 'true and fair override' and it would have been required for companies reporting under previous UK GAAP which used an indefinite life for goodwill as permitted by FRS 10 *Goodwill and intangible assets*. [FRS 101.A2.8, 1 Sch 22].

This means that the FRC expects that entities with positive goodwill must not amortise that goodwill under FRS 101. Those entities must invoke a true and fair override as permitted by paragraph 10(2) of Schedule 1 to the Regulations (or its equivalents in Schedules 2 and 3) to overcome the requirement to write off goodwill over its useful economic life in paragraph 22 of Schedule 1 to the Regulations (or its equivalents in Schedules 2 and 3). The use of the true and fair override requires disclosure of the particulars of the departure from the Regulations, the reasons for it and its effect. [FRS 101.A2.8, 1 Sch 10(2)]. Continuation of goodwill amortisation, if permitted under previous GAAP, is not allowed by FRS 101.

It is anticipated that the use of a true and fair override in respect of goodwill amortisation will be limited in application since, in individual financial statements, there will only be goodwill where a business that is not an entity has been acquired.

FRS 101 goes on to state that similar considerations (i.e., the need for a true and fair override) may apply to other intangible assets that are not amortised because they have an indefinite life and intangible assets that have a residual value that is not zero (i.e., intangible assets that are not written off over their useful economic life). [FRS 101.A2.8A, 1 Sch 22].

4.2 Presentation of fair value gains and losses attributable to changes in own credit risk on financial liabilities designated at fair value through profit or loss in other comprehensive income

IFRS 9 requires qualifying entities to present fair value gains or losses attributable to changes in own credit risk on financial liabilities designated at fair value through profit or loss in other comprehensive income. The Note on Legal Requirements to FRS 101 observes that this will usually be a departure from the requirement of paragraph 40 of Schedule 1 of the Regulations (and its equivalents in Schedules 2 and 3) for the overriding purpose of giving a true and fair view. As a result, when applicable, disclosure will need to be given in the notes to the accounts of 'particulars of the departure, the reasons for it and its effect'.

[FRS 101.A27F].

FRS 101 is silent about the other two circumstances in IFRS 9 in which accounting for fair value gains and losses are required in other comprehensive income.

How we see it

In our view:

- Accounting for changes in the fair value of an equity instrument through other comprehensive income (without recycling fair value changes to profit and loss) makes use of the alternative accounting rules in the Regulations and does not therefore require the use of a true and fair override (see Chapter 6 at 8.2).
- The model used for accounting for changes in the fair value of a debt instrument through other comprehensive income is similar, but not identical, to the available-for-sale asset model under IAS 39 *Financial Instruments: Recognition and Measurement*. It is inferred from FRS 101's silence on the matter that this model is included within the fair value accounting rules in the Regulations (see Chapter 6 at 8.2) and does not therefore require the use of a true and fair override.

4.3 Negative goodwill

FRS 101 changes paragraph 34 of IFRS 3 so that any gain arising from a bargain purchase (i.e., negative goodwill) is not recognised immediately in profit and loss. Instead, any amount of negative goodwill resulting from a business combination must be shown on the face of the statement of financial position on the acquisition date immediately below goodwill, and followed by a subtotal of the net amount of positive and negative goodwill. Subsequently, the negative goodwill up to the fair value of the non-monetary assets acquired must be recognised in profit and loss in the periods in which the non-monetary assets are recovered. Any amount of the negative goodwill in excess of the fair values of the non-monetary assets acquired must be recognised in profit or loss in the periods expected to be benefited. [FRS 101.AG1(c)].

This change to adopted IFRS was necessary because certain principles and rules (on which the requirements of the Act are based on) may be inconsistent with the recognition requirements for negative goodwill under adopted IFRS. [FRS 101 Appendix II Table 1].

Monetary assets are defined in adopted IFRS as "money held and assets to be received in fixed or determinable amounts of money". [IAS 38.8]. Conversely, an essential feature of a non-monetary asset is the absence of a right to receive a fixed or determinable number of units of currency. IAS 21 *The Effects of Changes in Foreign Exchange Rates* gives examples of non-monetary assets as amounts prepaid for goods and services, goodwill, intangible assets, inventories, property, plant and equipment and right-of-use assets. [IAS 21.16]. In addition, IFRS 9 states that investments in equity instruments are non-monetary items. [IFRS 9.B5.7.3]. This suggests that equity investments in subsidiaries, associates or joint ventures are also non-monetary items.

4.4 Contingent consideration balances arising from business combinations

Contingent consideration balances arising from business combinations are treated differently depending on whether the business combination occurred before or after the application of amendments to UK Company Law issued in 2015, which were mandatory for accounting periods beginning on or after 1 January 2016. In summary: [FRS 101.AG1(d)].

- All contingent consideration arising in business combinations occurring in accounting periods beginning on or after 1 January 2016 is initially recognised at fair value with changes in fair value of consideration not classified as equity recognised in profit or loss. [IFRS 3.58].

And

- All contingent consideration balances arising from business combination occurring in accounting periods beginning before 1 January 2016 must be accounted for using the entity's previous accounting policies for such transactions. Prior to amendments which incorporate the 2015 Company Law changes, FRS 101 required that an adjustment to the cost of a business combination contingent on future events be recognised only if the estimated amount of the adjustment was probable and could be measured reliably. If the potential adjustment was not recognised at the acquisition date but subsequently became probable and could be measured reliably, the additional consideration was treated as an adjustment to the cost of the combination (i.e., goodwill).

The amendments to Company Law, which changed this accounting were set out in *The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015* (SI 2015/980). These amendments could have been early adopted prior to 2016 in which case the fair value requirements may apply to certain business combinations occurring in 2015. Given the time that has now elapsed, we believe that there are limited situations in which contingent consideration relating to pre-2016 business combinations, which is not revalued at fair value through profit or loss, still exists.

FRS 101 is silent on accounting for contingent consideration on the acquisition of a subsidiary, associate or joint venture which is accounted for as an investment under IAS 27. However, in practice, if contingent consideration is included in the initial measurement of the asset, subsequent payments are either recognised in profit or loss or capitalised as part of the cost of the asset.

How we see it

Consistent with the view expressed in the EY publication, International GAAP®, until the IASB issues further guidance, differing views remain about the circumstances in which, and to what extent, variable payments, such as contingent consideration must be recognised when initially recognising the underlying asset. There are also differing views about the extent to which subsequent changes must be recognised through profit or loss or capitalised as part of the cost of the asset. Where entities have made an accounting policy choice regarding recognition of contingent consideration and subsequent changes in accounting for the cost of investments in subsidiaries, associates or joint ventures in separate financial statements, the policy must be disclosed and consistently applied.

4.5 Government grants deducted from the cost of fixed assets

FRS 101 has deleted paragraph 28 of IAS 16 *Property, Plant and Equipment* and has amended or deleted paragraphs 24 to 29 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* in order to eliminate the option in adopted IFRS that permits a government grant relating to an asset to be deducted in arriving at the carrying amount of the asset. Consequently, all government grants related to assets must be presented in the financial statements by setting up the grant as deferred income which is recognised in profit or loss on a systematic basis over the useful life of the asset. In addition, the option in paragraph 29 of IAS 20 that permits grants related to income to be deducted in reporting the related expense has been deleted. Consequently, in profit or loss the grant must be reported either separately or under a general heading such as 'Other income'. [FRS 101.AG1(l), FRS 101.AG1(m), FRS 101.AG1(n), FRS 101.AG1(o), FRS 101.AG1(p), FRS 101.AG1(q), FRS 101.AG1(r)].

These changes to adopted IFRS were necessary because the Regulations prohibit off-setting of items that represent assets against items that represent liabilities, unless specifically permitted or required.

[FRS 101 Appendix II Table 1].

4.6 Provisions, contingent assets and contingent liabilities

FRS 101 changes paragraph 92 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to state that when, in extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 of IAS 37 can be expected to prejudice seriously the position of the entity in a dispute with other parties, on the subject matter of the provision, contingent liability or contingent asset, the entity need not disclose all of the information required by those paragraphs insofar as it relates to the dispute, but must disclose at least the following: [FRS 101.AG1(s)]

- In relation to provisions:
 - A table showing the reconciliation required by paragraph 84 in aggregate, including the source and application of any amounts transferred to or from provisions during the reporting period.
 - Particulars of each provision in any case where the amount of the provision is material.
 - And
 - The fact that, and reason why, the information required by paragraphs 84 and 85 has not been disclosed.
- In relation to contingent liabilities:
 - Particulars and the total amount of any contingent liabilities (excluding those which arise out of insurance contracts) that are not included in the statement of financial position.
 - The total amount of contingent liabilities which are undertaken on behalf of or for the benefit of:
 - Any parent or fellow subsidiary of the entity.
 - Any subsidiary of the entity.
 - Or
 - Any entity in which the reporting entity has a participating interest, must each be stated separately.
 - And
 - The fact that, and reason why, the information required by paragraph 86 has not been disclosed.
- In relation to contingent assets, the entity must disclose the general nature of the dispute, together with the fact that, and reason why, the information required by paragraph 89 has not been disclosed.

This amendment was made because the 'seriously prejudicial' exemption in IAS 37 does not apply to disclosures required by the Regulations. Although this matter is implicitly covered by paragraph 4A of FRS 101, which requires that the requirements of the Regulations must be complied with (see 2 above), the FRC decided to specifically highlight this constraint on the IAS 37 exemption. [FRS 101.BC79].

These amended disclosures apply to all entities applying FRS 101, not just entities subject to the requirements of the Regulations.

4.7 Realised profits

FRS 101 has changed adopted IFRS to clarify the precedence of the Regulations over IFRS in this matter by adding the words "or unless prohibited by the Act" after "an entity shall recognise all items of income and expense arising in a period in profit or loss unless an IFRS requires or permits otherwise". [FRS 101.AG1(h), FRS 101.AG1(k)].

Paragraph 13(a) of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 (the related requirement in Schedule 3 is modified)) require that only profits realised at the balance sheet date are included in the profit or loss account. [FRS 101.A2.12]. Paragraph 39 of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3) allow stocks, investment property and living animals or plants to be held at fair value in Companies Act accounts. [FRS 101.A2.13]. Paragraph 40(2) of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3) requires that, in general, movements in the fair value of financial instruments, stocks, investment properties or living animals and plants are recognised in the profit and loss account notwithstanding the usual restrictions allowing only realised profits and losses to be included in the profit and loss account. Therefore, paragraph 40 of Schedule 1 overrides paragraph 13(a) of Schedule 1 and such fair value gains can be recognised in profit and loss under FRS 101. [FRS 101.A2.14].

The Note on Legal Requirements to FRS 101 states that entities measuring investment properties, living animals or plants, or financial instruments at fair value may transfer such amounts to a separate non-distributable reserve instead of carrying them forward in retained earnings but are not required to do so. The FRC suggests that presenting fair value movements that are not distributable profits in a separate reserve may assist with the identification of profits available for that purpose. [FRS 101.A2.15].

Whether profits are available for distribution must be determined in accordance with applicable law. Entities may also refer to TECH 02/17BL to determine the profits available for distribution. [FRS 101.A2.16].

4.8 IFRS 17 Insurance Contracts

Entities that are both required to apply Schedule 3 of the Regulations (or requirements similar to those in Schedule 3 of the Regulations) and have contracts that are within the scope of IFRS 17 cannot apply FRS 101. This means that these entities, namely insurers, cannot apply FRS 101. [FRS 101.BC61G].

Insurance companies preparing Companies Act accounts are required to comply with Schedule 3 of the Regulations. Unlike companies preparing accounts under Schedule 1 to the Regulations, the formats and content of accounts under Schedule 3 cannot be adapted. [FRS 101.BC61C].

The FRC concluded that the approach and methodology that underpins IFRS 17 is so fundamentally different to the one that underpins the formats of Schedule 3 that, for Companies Act accounts (but not IAS accounts), it is not possible to apply IFRS 17 whilst continuing to maintain compliance with Company Law. [FRS 101.BC61E]. Other conflicts between IFRS 17 and Company Law also exist in respect of measurement. [FRS 101.BC61F].

However, entities that have contracts that are within the scope of IFRS 17 but are not insurers can apply FRS 101. This is because these entities are not required to comply with Schedule 3 of the Regulations.

4.9 Equity accounting for investments in subsidiaries, associates and joint ventures

IAS 27, Schedule 1 to the Regulations and the LLP Regulations permit the use of equity accounting for investments in subsidiaries, associates and joint ventures.

The use of equity accounting for these interests is conditional on the investment in subsidiary, associate or joint venture qualifying as a participating interest (see Chapter 6 at 4.3.4.D), which will usually be the case. If participating interests are accounted for using the equity method and the profit attributable to a participating interest recognised in profit and loss account exceeds the amount of any dividends (including dividends already paid and those whose payment can be claimed), the difference must be placed in a reserve which cannot be distributed to shareholders. [1 Sch 29A(2)(b)].

However, Schedule 2 and Schedule 3 to the Regulations do not permit the use of equity accounting for participating interests. Therefore, entities applying either Schedule 2 or Schedule 3 to the Regulations (i.e., banking and insurance entities, respectively) may not take advantage of the option in paragraph 10(c) of IAS 27 to account for investments in subsidiaries, joint ventures and associates using the equity method. [FRS 101.A2.7E].

4.10 Investment entities

FRS 101 does not apply to consolidated financial statements. However, a parent that meets the definition of an investment entity under IFRS 10 and is therefore required (in most situations) to measure its investment in a subsidiary at fair value through profit or loss, must measure that investment in the same way in its separate financial statements, as required by paragraph 11A of IAS 27. In other words, a qualifying entity that meets the definition of an investment entity must measure its investment in subsidiaries at fair value through profit or loss in its individual financial statements. [FRS 101.A2.17].

An investment entity which measures its investments in subsidiaries at fair value through profit or loss will be required to make the additional disclosures required by paragraph 36(4) of Schedule 1 to the Regulations (see 6.3 below). [FRS 101.A2.20].

4.11 Limited liability partnerships (LLPs)

LLPs applying FRS 101 will be doing so in conjunction with *The Limited Liability Partnerships, (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911)* and the LLP Regulations, both as amended. It is considered by the FRC that in many cases these regulations are similar to the Regulations, limiting the situations in which legal matters relevant to the financial statements of LLPs are not addressed in Appendix II to FRS 101. [FRS 101.A2.21].

Therefore, generally, the issues identified in relation to Schedule 1 to the Regulations at 4.1 to 4.10 above also apply to Schedule 1 to the LLP Regulations.

5 Presentational differences between FRS 101 and adopted IFRS

As noted at 2 above, UK companies applying FRS 101 must prepare their financial statements in accordance with the CA 2006 and the Regulations. This is because financial statements prepared under FRS 101 are Companies Act accounts and not IAS accounts. [FRS 101.A2.3]. The presentation requirements of the CA 2006 and the Regulations are discussed in Chapter 6. While, generally, this chapter refers to companies and the Regulations, the requirements for LLPs are similar, although there are some minor differences.

The following presentational matters are discussed below:

- Balance sheet and profit and loss account formats required by FRS 101 (see 5.1 below).
- Order of presentation of the notes to the financial statements (see 5.2 below).
- Presentation of extraordinary activities (see 5.3 below).

And

- Presentation of discontinued operations (see 5.4 below).

The Regulations address the balance sheet and profit and loss account formats, and the notes required in the statutory accounts of UK companies. Accordingly, the presentation amendments made in Application Guidance 1 to FRS 101 (which apply to all qualifying entities, not just UK companies) relate to the balance sheet and profit and loss section of the statement of comprehensive income (whether in one or two statements). The adopted IFRS requirements for presentation of other comprehensive income still apply. FRS 101 makes no amendments to the requirement in adopted IFRS to present a statement of changes in equity for the reporting period.

There is no requirement to present a statement of cash flows when the reduced disclosure exemption is taken and the use of the disclosure exemption is disclosed in the financial statements (see 6.1.11 below).

A UK parent company presenting both consolidated financial statements (either IAS group accounts or Companies Act group accounts) and individual financial statements under FRS 101, can take advantage of the exemption in section 408 of the CA 2006 from presenting a profit and loss account and related notes in respect of its individual profit and loss account. [s408].

5.1 Balance sheet and profit and loss formats required by FRS 101

Qualifying entities subject to Schedule 1 to the Regulations have a choice regarding the presentation of the balance sheet and the profit and loss account. These entities can either:

- Comply with the balance sheet and profit and loss format requirements in Section B of Part 1 of Schedule 1 to the Regulations (i.e., use 'statutory formats').

Or

- Adapt one of the balance sheet or profit and loss account formats in Section B of Part 1 of Schedule 1 to the Regulations (i.e., use 'adapted formats') so as:

- (In the case of the balance sheet) to distinguish between current and non-current items in a different way.

And

- Provided that (for both the balance sheet and profit and loss account):
- The information given is at least equivalent to that which would have been required by the use of such format had it not been thus adapted.

And

- The presentation is in accordance with generally accepted accounting principles or practice.

[1 Sch 1A].

The LLP Regulations allow the same choice for LLPs. [1 Sch 1A (LLP)].

The choice to apply the adapted balance sheet and profit and loss formats (i.e., the presentation requirements of adopted IFRS) is available only for those entities applying Schedule 1 to the Regulations or the LLP Regulations. The choice is not available to entities applying Schedule 2 to the Regulations (banking companies) or Schedule 3 to the Regulations (insurance companies).

FRS 101 states that when a qualifying entity chooses to use the adapted formats as described above, it must apply the relevant presentation requirements of adopted IFRS and, in addition, the profit and loss account (whether presented as a component of the statement of comprehensive income, or as a separate statement) must disclose 'profit or loss before taxation'. [FRS 101.AG1(h), FRS 101.AG1(i), FRS 101.AG1(k), FRS 101.AG1(kA), FRS 101.AG1(kB)]. The presentation requirements of adopted IFRS are discussed in the EY publication, International GAAP®

A qualifying entity not permitted or not choosing to apply the adapted formats, [1 Sch 1A(1), 1 Sch 1A(2)], must comply with the balance sheet format requirements and present the components of profit or loss in the statement of comprehensive income (in either the single statement or two statement approach) in accordance with the profit and loss account formats of the CA 2006 (i.e., the statutory formats), instead of the presentation requirements of adopted IFRS.

A qualifying entity must apply, as required by Company Law, either Part 1 *General Rules and Formats* of Schedule 1 to the Regulations; Part 1 *General Rules and Formats* of Schedule 2 to the Regulations; Part 1 *General Rules and Formats* of Schedule 3 to the Regulations; or Part 1 *General Rules and Formats* of Schedule 1 to the LLP Regulations ('the General Rules to the formats'). [FRS 101.AG1(h), FRS 101.AG1(i), FRS 101.AG1(k), FRS 101.AG1(kA), FRS 101.AG1(kB)].

The General Rules to the formats apply to statutory formats. So far as is practicable, the General Rules to the formats (set out in paragraphs 2 to 9A of Section A of Part 1 of Schedule 1 to the Regulations) also apply to the adapted formats. [1 Sch 1A(3)]. There are similar requirements in the LLP Regulations. The General Rules to the formats are discussed in Chapter 6 at 3.4.

When an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the accounts. [1 Sch 9A]. This requirement in the General Rules to the formats applies to both statutory and adapted formats.

Banking and insurance companies, as well as those entities applying Schedule 1 to the Regulations but choosing not to use the adapted formats, must use the statutory balance sheet and profit and loss account formats set out in Section B of Part 1 of the relevant schedule to the Regulations. The Note on Legal Requirements to FRS 101 confirms that the requirements of adopted IFRS do not apply unless the adapted formats in Schedule 1 to the Regulations (i.e., the option to use the IAS formats) are chosen.

[FRS 101 Appendix II Table 1].

FRS 101 can also be applied by qualifying entities not subject to the Regulations or the LLP Regulations. The requirements in the Application Guidance to FRS 101 apply to all entities not just companies. [FRS 101.5(b)]. A qualifying entity must also ensure it complies with any relevant legal requirements applicable to it. [FRS 101.4A].

How we see it

FRS 102 is more specific than FRS 101 and requires entities to apply the formats included in one of Schedules 1, 2 or 3 to the Regulations or the LLP Regulations (so allowing the choice of statutory or adapted formats where Schedule 1 to the Regulations or the LLP Regulations are applied), except to the extent that these requirements are not permitted by any statutory framework under which such entities report.

In our view, a similar approach is intended under FRS 101.

The required format to be used by a qualifying entity that is not a company or an LLP may be determined by the legal framework governing the financial statements of such entities (see discussion in Chapter 6 at 3.1 on which formats apply to different types of entities). In other cases, management of such entities must apply judgement in determining the most appropriate format in the Regulations or LLP Regulations to use for the circumstances of the entity concerned, where the statutory framework is not prescriptive.

The General Rules to the formats to Schedule 1 to the Regulations state that once a particular format (in Section B of Part 1 to that schedule) for the balance sheet (or profit and loss account) has been adopted for any financial year, the company's directors must use the same format in preparing Companies Act accounts for subsequent financial years, unless in their opinion there are special reasons for a change. Particulars of any such change must be given in a note to the accounts in which the new format is first used, and the reasons for the change must be explained. [1 Sch 2]. Schedule 1 to the Regulations provides a choice of two balance sheet and two profit and loss account statutory formats. There is a similar requirement in the LLP Regulations. There is, however, no choice of statutory formats available in Schedules 2 or 3 of the Regulations.

The above paragraph is discussing a change in the statutory format adopted but, as the paragraph is included in the General Rules to the formats, its requirements apply so far as is practicable where adapted formats are used.

FRS 101 is silent on how an entity would implement a change from a statutory balance sheet and profit and loss account format to an adopted IFRS format (i.e., adapted format) (or *vice versa*) in an accounting period subsequent to adoption of FRS 101.

How we see it

A change from a statutory balance sheet and profit and loss account format to an adapted format, or *vice versa*, is a voluntary change in accounting policy to which IAS 8 applies. Consequently, the change must be applied retrospectively, prior periods must be restated and the disclosures required by paragraph 29 of IAS 8 must be made (as well as the disclosures required by the Regulations described above).

5.1.1 Additional presentation requirements where an entity is using the adapted (IAS 1) balance sheet and profit and loss account formats

The legal appendix to FRS 101 clarifies that an entity applying the adapted balance sheet and profit and loss account formats - see 5.1 above - must apply the relevant presentation requirements of IAS 1, i.e., paragraphs 54 to 76B of IAS 1 or paragraphs 24 and 47 to 82 of IFRS 18, subject to: [FRS 101.A2.9A]

- The disclosure of profit or loss before taxation and the amendment to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations included in paragraph AG1(g) of FRS 101, as set out at 5.4 below.
- And
- Any further disaggregation of the statement of financial position, for example in relation to trade and other receivables and trade and other payables (which may be provided in the notes to the financial statements), that is necessary to meet the requirement to give the equivalent information.

The Note on Legal Requirements does not elaborate what is meant by a 'further disaggregation of the statement of financial position' other than provide the examples above. It reiterates that the option to apply the presentation requirements of adopted IFRS is not available to a qualifying entity applying Schedule 2 or Schedule 3 to the Regulations. [FRS 101.A2.9A].

As discussed at Section 5.1 above, the purpose of permitting adapted formats is to allow an entity to distinguish between current and non-current balance sheet items in a different way to statutory formats provided the information given is at least equivalent to the statutory formats and is in accordance with generally accepted accounting principles or practice.

The presentation requirements of adopted IFRS require an entity to present assets and liabilities in the statement of financial position in order of liquidity instead of a current/non-current basis if presentation in order of liquidity provides information that is reliable and more relevant, [IAS 1.60], or provides a more useful structured summary, [IFRS 18.96].

How we see it

In our view, where adapted formats are applied, the use of a liquidity presentation for assets and liabilities is not prohibited if it provides information that is reliable and more relevant (when IAS 1 is applied) or provides a more useful structured summary (when IFRS 18 is applied). A liquidity presentation can be considered as providing 'equivalent' information to that required by the statutory formats. However, qualifying entities using a liquidity presentation under adapted formats must disclose the amounts expected to be recovered or settled within one year and those expected to be recovered or settled after more than one year, as required by adopted IFRS.

The Regulations (and LLP Regulations) require supplementary information to be given in the notes to the accounts. These disclosure requirements apply where statutory formats or adapted formats are used. One complexity is that the information required sometimes refers to items found in the statutory formats (which may differ to the line items identified where the adapted formats are used). For example, the adapted formats do not refer to fixed assets, creditors: amounts falling due within one year, creditors: amounts falling due after more than one year, investments, land or buildings, or turnover. Therefore, a UK company using adapted formats in Companies Act accounts will need to identify which of its assets, liabilities and revenue streams needs to be included in the required disclosures. While the classification of non-current assets and current assets used in adapted formats differs to the fixed assets and current assets

classification required in statutory formats, the statutory definition of 'fixed assets' (see Chapter 6 at 4.2.2) is relevant for the purposes of disclosures in respect of fixed assets in the Regulations.

5.1.2 Additional presentation requirements needed to comply with IFRS by an entity using the Companies Act balance sheet and profit and loss account formats (statutory formats)

The Note on Legal Requirements to FRS 101 clarifies that for a qualifying entity not permitted or not choosing to apply the adapted (i.e., adopted IFRS) balance sheet or profit and loss account formats - see 5.1 above - the format and presentation requirements of adopted IFRS may conflict with those of Company Law because of the following: [FRS 101.A2.9B]

- Differences in the definition of 'fixed assets' (the term used in the Regulations meaning assets which are intended for use on a continuing basis in the entity's activities) and 'non-current assets' (the term used in adopted IFRS). See Chapter 6 at 4.1.1 and Chapter 6 at 4.2.2.
- Differences in the definition of 'current assets' as the term is used in the Regulations and UK-adopted international accounting standards. See Chapter 6 at 4.1.1 and Chapter 6 at 4.2.2.
- Differences in the definition of 'creditors: amounts falling due within or after more than one year' (the terms used in the Regulations) and 'current and non-current liabilities' (the terms used in UK-adopted international accounting standards). See Chapter 6 at 4.1.2 and Chapter 6 at 4.2.3. Under the CA 2006, a loan is treated as due for repayment on the earliest date on which a lender could require repayment, whilst under UK-adopted international accounting standards the due date is based on when the entity expects to settle the liability or has no unconditional right to defer payment.

And

- The CA 2006 requires presentation of debtors falling due after more than one year within current assets. Under UK-adopted international accounting standards, these items will (usually) be presented in non-current assets. The Note on Legal Requirements to FRS 101 provides further guidance on the presentation of debtors falling due after more than one year (which are shown in current assets) in the statutory formats - see 5.1.2.A below.

The statutory formats for the balance sheet and profit and loss account (and the related notes to the formats that must be followed) in Schedule 1 to the Regulations and the LLP Regulations are discussed in Chapter 6 at 4.2, 4.3 and 5.6.

5.1.2.A Debtors due after more than one year

The statutory balance sheet formats require all debtors to be shown under 'current assets'. However, the Regulations require the amount falling due after more than one year to be shown separately for each item included under debtors. The Note on Legal Requirements to FRS 101 reproduces the consensus of UITF 4 *Presentation of long-term debtors in current assets* that "in most cases it will be satisfactory to disclose the size of debtors due after more than one year in the notes to the accounts. There will be some instances, however, where the amount is so material in the context of the total net current assets that in the absence of disclosure of debtors due after more than one year on the face of the balance sheet readers may misinterpret the accounts. In such circumstances, the amount must be disclosed on the face of the balance sheet within current assets". [FRS 101.A2.10].

This disclosure is only relevant where statutory formats rather than adapted (i.e., adopted IFRS) formats are applied.

5.1.2.B Non-current assets or disposal groups held for sale

IFRS 5 requires an entity to present: [IFRS 5.38]

- A non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the statement of financial position.
- And
- The liabilities of a disposal group classified as held for sale separately from other liabilities in the statement of financial position.

IAS 1 and IFRS 18 require a single line approach in the balance sheet for "the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5" and for "liabilities included in disposal groups classified as held for sale in accordance with IFRS 5". Detailed analysis of the components of the assets and liabilities held for sale is required in the notes to the financial statements. [IAS 1.54, IFRS 18.103].

However, a qualifying entity that has a disposal group classified as held for sale must ensure that its presentation of the disposal group, in accordance with IFRS 5, meets Company Law requirements. The Note on Legal Requirements to FRS 101 states that a single line presentation of non-current assets (or liabilities) held for sale will usually not meet Company Law requirements when the Company Law formats are applied. Therefore, additional disaggregation must be provided either in the statement of financial position (for example by disaggregating each relevant line item or by presenting the information in a columnar format) or in the notes. When the items are material, this must be on the face of the statement of financial position. [FRS 101.A2.10A]. This conflict between the Regulations and IFRS arises because the statutory formats included in the Regulations (and LLP Regulations) do not otherwise permit the aggregation of different types of assets and liabilities in this way. One practical solution could be to present the disposal group aggregations as a memorandum on the statement of financial position cross-referenced to the detailed analysis in the notes.

5.2 Notes to the financial statements

Schedule 1 to the Regulations (and its equivalents in Schedule 2 and Schedule 3 and the LLP Regulations) require the notes to the financial statements to be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and the income statement. [1 Sch 42(2)]. A qualifying entity preparing financial statements in accordance with FRS 101 must have regard to this requirement when determining a systematic manner for the presentation of its notes to the financial statements in accordance with adopted IFRS. [FRS 101.A2.11A].

5.2.1 Particulars of turnover

Schedule 1 to the Regulations (and its equivalents in Schedule 2 and Schedule 3 and the LLP Regulations) require particulars of turnover to be disclosed, including the amount of turnover attributable to each class of business carried on by the company. Where relevant, turnover attributable to different markets must also be disclosed. Although FRS 101 provides an exemption from paragraph 114 of IFRS 15 *Revenue from Contracts with Customers*, the requirements of the Regulations must still be complied with. [FRS 101.A2.11B].

5.3 Extraordinary items

IFRS has no concept of 'extraordinary items'. The concept of extraordinary items has also been removed for entities applying Schedule 1 to the Regulations or the LLP Regulations.

Consequently, only entities applying Schedule 2 or Schedule 3 to the Regulations (i.e., banking companies and insurance companies) are still required to present extraordinary items separately in the profit and loss account. However, we would expect this requirement to have no practical impact as we would not expect to see any extraordinary items under FRS 101. The Note on Legal Requirements to FRS 101 states that "entities should note that extraordinary items are extremely rare as they relate to highly abnormal events or transactions". [FRS 101.A2.11].

Ordinary activities (for entities reporting under Schedule 2 or Schedule 3 to the Regulations) are defined as "any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities. Ordinary activities include any effects on the reporting entity of any event in the various environments in which it operates, including the political, regulatory, economic and geographical environments, irrespective of the frequency or unusual nature of the events". [FRS 101.AG1(j)].

Extraordinary activities are "material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur. They do not include items occurring within the entity's ordinary activities that are required to be disclosed by IAS 1.97 or IFRS 18.42, nor do they include prior period items merely because they relate to a prior period". [FRS 101.AG1(j)].

5.4 Presentation of discontinued operations

FRS 101 amends IFRS 5 to: [FRS 101.AG1(g)]

- Remove the option to present the analysis of discontinued operations into its component parts (i.e., revenue, expenses, pre-tax profit, related income tax expense, gain or loss on remeasurement to fair value less costs to sell or on disposal of the discontinued operation and the related income tax expense) in the notes to the financial statements. This analysis must be presented on the face of the statement of comprehensive income.

- Require the analysis above to be shown on the face of the statement of comprehensive income in a discontinued operations category and displayed in a column.
- Require a total column (i.e., the sum of continuing and discontinued operations) to be presented on the face of the statement of comprehensive income.

And

- Remove the option to present income from continuing operations and from discontinued operations attributable to owners of the parent in the notes to the financial statements. This analysis must be presented on the face of the statement of comprehensive income.

This amended presentation is required for all entities applying FRS 101, even those who have chosen to apply the adapted (i.e., adopted IFRS) balance sheet and profit and loss account presentation formats (see 5.1 above). This separate presentation of discontinued operations will also be required on the face of the income statement when IFRS 18 is applied.

In substance, this means that the single line presentation of discontinued operations in adopted IFRS is replaced by a three-column approach with the detailed analysis of the results from the discontinued operation shown on the face of the statement of comprehensive income. This is shown in the following Illustration which uses the Schedule 1 statutory formats:

Illustration 5-1: Example of presentation of discontinued operations (statutory format)

Statement of comprehensive income

For the year ended 31 December 20X6

	Continuing operations	Dis- continued operations	Total	Continuing operations	Dis- continued operations	Total
	20X6	20X6	20X6	20X5	20X5	20X5
	£000	£000	£000	£000	£000	£000
Turnover	4,200	1,232	5,432	3,201	1,500	4,701
Cost of Sales	(2,591)	(1,104)	(3,695)	(2,281)	(1,430)	(3,711)
Gross profit	1,609	128	1,737	920	70	990
Administrative expenses	(452)	(110)	(562)	(418)	(120)	(538)
Other operating income	212	-	212	198	-	198
Operating profit	1,369	18	1,387	700	(50)	650
Profit on disposal of operations		301	301		-	-
Interest receivable and similar income	14	-	14	16	-	16
Interest payable and similar expenses	(208)	-	(208)	(208)	-	(208)
Profit before tax	1,175	319	1,494	508	(50)	458
Tax on profit or loss	(390)	(4)	(394)	(261)	3	(258)
Profit after taxation and profit for the financial year	785	315	1,100	247	(47)	200
Other comprehensive income						
Remeasurement changes on defined benefit pension plans			(108)			(68)
Deferred tax movement relating to remeasurement changes			28			18
Total Comprehensive income for the year			1,020			150

6 Disclosure exemptions for qualifying entities

Qualifying entities may take advantage in their financial statements of a number of disclosure exemptions from adopted IFRS (see 6.1 below).

Qualifying entities that are financial institutions, as defined by FRS 101, are not entitled to some disclosure exemptions (see 6.4 below).

Some, but not all, of these exemptions are conditional on 'equivalent' disclosures in the consolidated financial statements of the group in which the entity is consolidated (see 6.2 below).

In addition, disclosures required by the Regulations (or the LLP Regulations) for certain financial instruments that are held at fair value must be made even if the qualifying entity takes advantage of the disclosure exemptions from the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* and/or IFRS 13 *Fair Value Measurement* (see 6.3 below). [FRS 101.A2.5B].

6.1 Disclosure exemptions before IFRS 18 adoption

Qualifying entities are permitted the following disclosure exemptions from adopted IFRS when the relevant standard is applied: [FRS 101.7, FRS 101.8]

- The requirement of paragraphs 6 and 21 of IFRS 1 to present an opening statement of financial position at the date of transition and related notes on first-time adoption of FRS 101 (see 3.4 above).
- The requirements of paragraphs 45(b) and 46 to 52 of IFRS 2 *Share-based Payments* provided that for a qualifying entity that is:
 - A subsidiary, the share-based payment arrangement concerns equity instruments of another group entity.
 - An ultimate parent, the share-based payment arrangement concerns its own equity instruments and its separate financial statements are presented alongside the consolidated financial statements of the group.

and, in both cases, provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.1 below).

- The requirements of paragraphs 62, B64(d), (e), (g), (h), (j) to (m), n(ii), (o)(ii), (p), (q)(ii), B66 and B67 of IFRS 3 provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.2 below).
- The requirements of paragraph 33(c) of IFRS 5 (see 6.1.3 below).
- The requirements of paragraph 24(b) of IFRS 6 to disclose the operating and investing cash flows arising from the exploration for and evaluation of mineral resources (see 6.1.4 below).
- The requirements of IFRS 7 provided that equivalent disclosures are included in the financial statements of the group in which the entity is consolidated (see 6.1.5A below). However, entities which are subject to the CA 2006 and the Regulations (or the LLP Regulations) are legally required to provide disclosures related to financial instruments including those measured at fair value (see 6.3 and 7.2 below). Qualifying entities that are financial institutions do not receive this exemption and must apply the disclosure requirements of IFRS 7 in full (see 6.4 below).
- The requirements of paragraphs 91 to 99 of IFRS 13 provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.6 below). However, entities which are subject to the CA 2006 and the Regulations (or the LLP Regulations) are legally required to provide disclosures related to financial instruments including those measured at fair value (see 6.3 and 7.2 below). Qualifying entities that are financial institutions can only take advantage of the exemptions to the extent that they apply to assets and liabilities other than financial instruments (see 6.4 below).
- The requirements of the second sentence of paragraph 110 and paragraphs 113(a), 114, 115, 118, 119(a) to (c), 120 to 127 and 129 of IFRS 15 (see 6.1.7 below).
- The requirements of paragraph 52, the second sentence of paragraph 89, and paragraphs 90, 91 and 93 of IFRS 16 as well as the requirements of paragraph 58 of IFRS 16, provided that the disclosure of details of indebtedness required by paragraph 61(1) of Schedule 1 to the Regulations is presented separately for lease liabilities and other liabilities, and in total (see 6.1.8 below).

- The requirement in paragraph 38 of IAS 1 to present comparative information in respect of:
 - Paragraph 53(a), (h) and (j) of IFRS 16
 - Paragraph 79(a)(iv) of IAS 1
 - Paragraph 73(e) of IAS 16
 - Paragraph 118(e) of IAS 38 *Intangible Assets*
 - Paragraphs 76 and 79(d) of IAS 40 *Investment Property*
 And
 - Paragraph 50 of IAS 41 *Agriculture* (see 6.1.9 below).
 - The requirements of paragraphs 10(d), 10(f), 16, 38A to 38D, 40A to 40D, 111 and 134 to 136 of IAS 1 (see 6.1.10A below). However, qualifying entities that are financial institutions are not permitted to take advantage of the exemptions in paragraphs 134 to 136 of IAS 1 (see 6.4 below).
 - The requirements of:
 - Paragraphs 1 to 44E, 44H(b)(ii) and 45 to 63 of IAS 7.
 And
 - Paragraphs 44F, 44G, 44(H)(a), 44H(b)(i), 44H(b)(iii) and 44H(c) of IAS 7 provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included (see 6.1.11A below).
 - The requirements of paragraphs 30 and 31 of IAS 8 (see 6.1.12A below).
 - The requirements of paragraphs 88C and 88D of IAS 12, provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.13 below).
 - The requirements of paragraph 74A(b) of IAS 16 (see 6.1.14 below).
 - The requirements of paragraphs 17 and 18A of IAS 24 *Related Party Disclosures* and the requirements in IAS 24 to disclose related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member (see 6.1.15 below).
- And
- The requirements of paragraphs 130(f)(ii), 130(f)(iii), 134(d) to 134(f) and 135(c) to 135(e) of IAS 36 *Impairment of Assets* provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.16 below).

When a paragraph within a given standard cross-refers to the requirements of an exempted paragraph listed above, the qualifying entity is nevertheless permitted to take the exemption in the exempted paragraph. [FRS 101.8A].

Use of the disclosure exemptions is conditional on the following disclosures in the notes to the financial statements: [FRS 101.5(c)]

- A brief narrative summary of the exemptions adopted.
- And
- The name of the parent of the group in whose consolidated financial statements the reporting entity is consolidated and from where those financial statements may be obtained (i.e., the parent identified in the term 'qualifying entity').

There is no requirement to list all of the disclosure exemptions in detail. Reporting entities can also choose to apply the disclosure exemptions on a selective basis. This may be necessary, for example, where not all of the relevant 'equivalent' disclosures are made in the consolidated financial statements of the parent on the grounds of materiality (see 6.2 below).

Each of the disclosure exemptions listed above is discussed in 6.1.1 to 6.1.16 below.

6.1.A Disclosure exemptions after IFRS 18 adoption

Qualifying entities are permitted the following disclosure exemptions from adopted IFRS from when the relevant standard is applied:

- The requirement of paragraphs 6 and 21 of IFRS 1 to present an opening statement of financial position at the date of transition and related notes on first-time adoption of FRS 101 (see 3.4 above).

- The requirements of paragraphs 45(b) and 46 to 52 of IFRS 2 *Share-based Payments* provided that for a qualifying entity that is:
 - A subsidiary, the share-based payment arrangement concerns equity instruments of another group entity.
 - An ultimate parent, the share-based payment arrangement concerns its own equity instruments and its separate financial statements are presented alongside the consolidated financial statements of the group.

and, in both cases, provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.1 below);

- The requirements of paragraphs 62, B64(d), (e), (g), (h), (j) to (m), n(ii), (o)(ii), (p), (q)(ii), B66 and B67 of IFRS 3 provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.2 below).
- The requirements of paragraph 33(c) of IFRS 5 (see 6.1.3 below).
- The requirements of paragraph 24(b) of IFRS 6 to disclose the operating and investing cash flows arising from the exploration for and evaluation of mineral resources (see 6.1.4 below).
- The requirements of paragraphs 1 to 19 and 20 to 45 of IFRS 7 provided that equivalent disclosures are included in the financial statements of the group in which the entity is consolidated (see 6.1.5B below). However, entities which are subject to the CA 2006 and the Regulations (or the LLP Regulations) are legally required to provide disclosures related to financial instruments including those measured at fair value (see 6.3 and 7.2 below). Qualifying entities that are financial institutions do not receive this exemption and must apply the disclosure requirements of IFRS 7 in full (see 6.4 below).
- The requirements of paragraphs 91 to 99 of IFRS 13 provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.6 below). However, entities which are subject to the CA 2006 and the Regulations (or the LLP Regulations) are legally required to provide disclosures related to financial instruments including those measured at fair value (see 6.3 and 7.2 below). Qualifying entities that are financial institutions can only take advantage of the exemptions to the extent that they apply to assets and liabilities other than financial instruments (see 6.4 below).
- The requirements of the second sentence of paragraph 110 and paragraphs 113(a), 114, 115, 118, 119(a) to (c), 120 to 127 and 129 of IFRS 15 (see 6.1.7 below).
- The requirements of paragraph 52, the second sentence of paragraph 89, and paragraphs 90, 91 and 93 of IFRS 16 as well as the requirements of paragraph 58 of IFRS 16, provided that the disclosure of details of indebtedness required by paragraph 61(1) of Schedule 1 to the Regulations is presented separately for lease liabilities and other liabilities, and in total (see 6.1.8 below).
- The requirement in paragraph 31 of IFRS 18 to present comparative information in respect of:
 - Paragraph 53(a), (h) and (j) of IFRS 16
 - Paragraph 130(a)(iv) of IFRS 18
 - Paragraph 73(e) of IAS 16
 - Paragraph 118(e) of IAS 38 *Intangible Assets*
 - Paragraphs 76 and 79(d) of IAS 40 *Investment Property*
 - And
 - Paragraph 50 of IAS 41 *Agriculture* (see 6.1.9 below).
- The requirements of paragraphs 10(d) and (g), 22(e), 32, 37 to 40, 83(b), 121 to 125, 126 to 129 and B13 to B15, and the last two sentences of paragraph 3, of IFRS 18 (see 6.1.10B below). However, qualifying entities that are financial institutions are not permitted to take advantage of the exemptions in paragraphs 126 to 129 of IFRS 18 (see 6.4 below).
- The requirements of:
 - Paragraphs 1 to 44E, 44H(b)(ii) and 45 to 65 of IAS 7.
 - And
 - Paragraphs 44F, 44G, 44H(a), 44H(b)(i), 44H(b)(iii) and 44H(c) of IAS 7 provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included (see 6.1.11B below).
- The requirements of paragraphs 6B, 30 and 31 of IAS 8 *Basis of Preparation of Financial Statements* (see 6.1.12B below).

- The requirements of paragraphs 88C and 88D of IAS 12, provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.13 below).
- The requirements of paragraph 74A(b) of IAS 16 (see 6.1.14 below).
- The requirements of paragraphs 17 and 18A of IAS 24 *Related Party Disclosures* and the requirements in IAS 24 to disclose related party transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member (see 6.1.15 below).
- The requirements of paragraphs 130(f)(ii), 130(f)(iii), 134(d) to 134(f) and 135(c) to 135(e) of IAS 36 *Impairment of Assets* provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated (see 6.1.16 below).

And

- A qualifying entity providing reconciliations of items of 'fixed assets', in accordance with paragraph 51 of Schedule 1 to the Regulations, need not present these reconciliations for prior periods.

When a paragraph within a given standard cross-refers to the requirements of an exempted paragraph listed above, the qualifying entity is nevertheless permitted to take the exemption in the exempted paragraph. [FRS 101.8A].

Use of the disclosure exemptions is conditional on the following disclosures in the notes to the financial statements: [FRS 101.5(c)]

- A brief narrative summary of the exemptions adopted.

And

- The name of the parent of the group in whose consolidated financial statements the reporting entity is consolidated and from where those financial statements may be obtained (i.e., the parent identified in the term 'qualifying entity').

There is no requirement to list all of the disclosure exemptions in detail. Reporting entities can also choose to apply the disclosure exemptions on a selective basis. This may be necessary, for example, where not all of the relevant 'equivalent' disclosures are made in the consolidated financial statements of the parent on the grounds of materiality (see 6.2 below).

Each of the disclosure exemptions listed above is discussed in 6.1.1 to 6.1.16 below.

6.1.1 Share-based Payment (IFRS 2)

The disclosure exemption eliminates all IFRS 2 disclosures apart from those required by paragraphs 44 and 45(a), 45(c) and 45(d). In summary, this reduces the specific minimum disclosure requirements of IFRS 2 to:

- A description of each type of share-based payment arrangement that existed during the reporting period, including general terms and conditions, the maximum terms of options granted, and the method of settlement (e.g., whether in cash or equity).
- The weighted average share price at the date of exercise for share options exercised during the reporting period (or the weighted average share price during the period, if options were exercised on a regular basis throughout the period).

And

- The range of exercise prices and weighted average remaining contractual life for share options outstanding at the end of the reporting period.

In addition, an entity is still subject to the general disclosure objective of IFRS 2 to disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period which may require additional disclosures beyond those specially required above.

6.1.2 Business Combinations (IFRS 3)

In summary, this disclosure exemption eliminates the qualitative disclosures required for a business combination. However, a number of factual or quantitative disclosures are still required for each business combination including:

- The name and description of the acquiree, acquisition date and percentage of voting equity interests acquired.
- The acquisition-date fair value of total consideration transferred split by major class of consideration.

- The amount recognised at the acquisition date for each major class of assets acquired and liabilities assumed.
 - The amount of any negative goodwill recognised and the line item in the statement of comprehensive income in which it is recognised.
 - The amount of any non-controlling interest recognised and the measurement basis for the amount (although there would be no non-controlling interests for acquisitions in individual financial statements).
 - The amounts of revenue and profit or loss of the acquiree since acquisition date included in comprehensive income for the period.
- And
- The information above (except for the information in the first bullet) in aggregate for individually immaterial business combinations that are collectively material.

In addition, an acquirer is still subject to the general requirements of paragraphs 59 to 61 of IFRS 3 which may require additional disclosures beyond those specially required. These require disclosure of information that enables users of the financial statements to evaluate the nature and effect of a business combination that occurs, either during the current reporting period or at the end of the financial reporting period but before the financial statements are authorised for issue. These paragraphs also require disclosure of information that enables users of the financial statements to evaluate the financial effects of adjustments recognised in the current reporting period relating to business combinations that occurred in the current or previous periods.

6.1.3 Discontinued Operations (IFRS 5)

This exemption eliminates the requirement to disclose cash flows attributable to discontinued operations. The FRC considered that disclosure exemptions linked to the statement of cash flows must be based on the same conditions as the exemption from the preparation of the statement itself. Consequently, the exemption from the requirement of paragraph 33(c) of IFRS 5 was amended to extend it to any qualifying entity. [FRS 101.BC67C].

6.1.4 Exploration for and Evaluation of Mineral Resources (IFRS 6)

This exemption eliminates the requirement to disclose operating and investing cash flows arising from the exploration for and evaluation of mineral resources. However, the entity must disclose the amounts of assets, liabilities, income and expense as required by paragraph 24(b) of IFRS 6.

The FRC considered that the preparation of disclosures related to the statement of cash flows could lead to costs that are similar to those associated with the preparation of the statement itself. Therefore, the FRC concluded that exemptions from the disclosure of cash flows required by adopted IFRS are necessary to ensure cost savings that arise from the exemption from the requirement of IAS 7. Consequently, an exemption from the requirement of paragraph 24(b) of IFRS 6 was introduced (see 6.1.4 above). [FRS 101.BC67B].

6.1.5.A Financial Instruments: Disclosures (IFRS 7) before IFRS 18 endorsement

This exemption removes all of the disclosure requirements of IFRS 7. However, notwithstanding this exemption, some IFRS 7 disclosures are still required for certain financial instruments measured at fair value (see 6.3 below). In addition, some specific financial instruments disclosures are required by the Regulations or the LLP Regulations (see 7.2 below).

Financial institutions are not permitted to use this exemption (see 6.4 below).

6.1.5.B Financial Instruments: Disclosures (IFRS 7) after IFRS 18 endorsement

This exemption removes all the disclosure requirements of IFRS 7, except the disclosure requirements in paragraphs 19A and 19B. However, notwithstanding this exemption, some IFRS 7 disclosures are still required for certain financial instruments measured at fair value (see 6.3 below). In addition, some specific financial instruments disclosures are required by the Regulations or the LLP Regulations (see 7.2 below).

Financial institutions are not permitted to use this exemption (see 6.4 below).

IFRS 18 has moved some of the disclosure requirements about instruments classified as equity from IAS 1 to paragraphs 19A and 19B of IFRS 7. The FRC consider that affected qualifying entities are already providing disclosures required by those paragraphs and the information could be useful for users of financial statements that hold such instruments. Therefore, exemptions to remove the disclosure requirements of those paragraphs are not introduced by the amendments to FRS 101 Reduced Disclosure Framework - 2024/25 cycle.

6.1.6 Fair Value Measurement (IFRS 13)

This exemption removes all disclosure requirements of IFRS 13. However, notwithstanding this exemption, some IFRS 13 disclosures are still required for certain financial instruments measured at fair value (see 6.3 below). In addition, specific disclosures in respect of the fair value of stocks, financial instruments, investment property and living animals and plants carried at fair value are required by the Regulations (see 6.3 and 7.2 below).

Financial institutions are not permitted to use this disclosure exemption in respect of financial instruments. However, they can use this exemption in respect of fair value disclosures of non-financial assets and liabilities (see 6.4 below).

6.1.7 Revenue from Contracts with Customers (IFRS 15)

The intention of these disclosure exemptions is to confine the revenue disclosures to those that the FRC consider would be of relevance to a provider of credit to a qualifying entity (identified as being the likely external users of a qualifying entity's financial statements). That is, information supporting the statement of financial position rather than the income statement. [FRS 101.BC48]. Hence, exemptions are given from the following disclosures:

- The disclosure objectives (paragraph 110).
- Revenue recognised from contracts with customers (paragraph 113(a)).
- Disaggregation of revenue (paragraph 114).
- Disclosure of the relationship between disaggregated revenue and revenue information disclosed for each reportable segment, if IFRS 8 *Operating Segments* is applied (paragraph 115).
- A qualitative and quantitative explanation of significant changes in contract assets and contract liabilities during the reporting period (paragraph 118).
- Information about satisfying performance obligations, significant payment terms and the nature of goods and services transferred (paragraphs 119(a), 119(b) and 119(c)).
- Information about allocating the transaction price to performance obligations (paragraphs 120 to 122).
- Significant judgements made in applying IFRS 15 (paragraph 123).
- The methods used to recognise revenue satisfied over time and, for performance obligations satisfied at a point in time, the significant judgements in evaluating when a customer obtains control (paragraphs 124 and 125).
- Information about the methods, inputs and assumptions used for determining the transaction price, assessing whether the estimate of variable consideration is constrained, allocating the transaction price, and measuring obligations for returns, refunds and other similar obligations (paragraph 126).
- Judgements made in determining costs to obtain and fulfil a contract with a customer, and the method used to determine amortisation of those costs (paragraph 127).

And

- The use of any practical expedients concerning the existence of significant financing components or the incremental costs of obtaining a contract (paragraph 129).

Qualifying entities are still required to make the following specific disclosures:

- Impairment losses on receivables or contract assets arising from an entity's contracts with customers, to be disclosed separately from impairment losses on other contracts (paragraph 113(b)).
- The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers (paragraph 116(a)).
- Revenue recognised in the reporting period included in the contract liability at the beginning of the period (paragraph 116(b)).
- Revenue recognised in the reporting period from performance obligations satisfied or partially satisfied in prior periods (paragraph 116(c)).

- An explanation (which may use qualitative information) as to how the timing of satisfaction of performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and liability balances (paragraph 117).
- A description of obligations for return, refunds and other similar obligations and types of warranties and related obligations (paragraph 119(d)-(e)).

And

- The closing balances of assets recognised from the costs incurred to obtain or fulfil a contract by main category of asset and the amount of amortisation and impairment in the reporting period (paragraph 128).

Qualifying entities are also still required to make the following disclosure requirements:

- Company Law requirements relating to disaggregation of turnover (see 5.2.1 above).

And

- The requirements of adopted IFRS related to judgements having a significant effect on the amounts recognised in the entity's financial statements. *[FRS 101.BC49]*.

The Basis for Conclusions also clarifies that, for the avoidance of doubt, although paragraph 117 of IFRS 15 (from which a qualifying entity is not exempt) cross-refers to paragraph 119, it is not necessary to comply with paragraph 119 in order to meet the requirements of paragraph 117. *[FRS 101.8A, FRS 101.BC50]*.

6.1.8 Leases (IFRS 16)

The intention of the disclosure exemptions for lessors is to provide similar disclosure exemptions to those given from disclosures in IFRS 15. *[FRS 101.BC61]*. The disclosure exemptions are as follows:

- The requirement for a lessee to provide all lease disclosures in a single note or separate section in its financial statements (paragraph 52).
- A lessee's maturity analysis of lease liabilities, separately from that of other financial liabilities (paragraph 58) provided that the disclosure of details of indebtedness required by paragraph 61(1) of Schedule 1 to the Regulations is presented separately for lease liabilities and other liabilities, and in total.
- The sentence that states that paragraphs 90 to 97 specify requirements on how to meet the disclosure objective for lessors (second sentence of paragraph 89). Some of these disclosures are not required.
- A lessor's lease income, finance income and selling profit/loss disclosures (paragraphs 90 to 91).

And

- A qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases (paragraph 93).

The exemption from the requirement of a lessee to provide all lease disclosures in a single note (or separate section in the financial statements) is provided because the FRC consider that it would result in unnecessary additional work that would provide minimal additional benefits to the users of the financial statements. This is because paragraph 42(2) of Schedule 1 to the Regulations (and its equivalents in Schedule 2 and Schedule 3 to the Regulations and the LLP Regulations) require entities to present the notes to the accounts in the order in which, where relevant, the items to which they relate are presented in the balance sheet and in the profit and loss account. *[FRS 101.BC52, FRS 101.BC53, FRS 101.BC54]*.

The exemption from the requirement for lessees to disclose a maturity analysis of lease liabilities is provided because FRS 101 provides an exemption for non-financial institutions from the maturity analysis requirements of IFRS 7 for financial liabilities (provided that equivalent disclosures are included in the consolidated financial statements of the group in which the qualifying entity is included). However, this exemption is conditional on an entity providing the Company Law disclosures about details of indebtedness separately for lease liabilities and other liabilities, and in total. This is because it was considered that users would find separate disclosures of lease liabilities useful. *[FRS 101.BC55, FRS 101.BC56, FRS 101.BC57, FRS 101.BC58, FRS 101.BC59]*.

An exemption from paragraphs 94 and 97 of IFRS 16 (which require lessors to provide a maturity analysis of finance and operating lease receivables) was not introduced as no equivalent requirements exist under Company Law and the FRC consider that these maturity analyses provide useful information to users about the lessor's liquidity and solvency. *[FRS 101.BC60]*. Apart from the exemptions above, lessees and lessors are subject to the detailed disclosure requirements of IFRS 16.

6.1.9 Comparatives

This exemption eliminates the requirement for comparatives to be presented for reconciliations of:

- The carrying amount of right-of-use assets by class of underlying assets at the beginning and end of the current period (IFRS 16).
- Outstanding shares at the beginning and end of the current period (IAS 1/IFRS 18).
- The carrying amount of property, plant and equipment at the beginning and end of the current period (IAS 16).
- The carrying amount of intangible assets at the beginning and end of the current period (IAS 38).
- The carrying amount of investment property held at either fair value or cost at the beginning and end of the current period (IAS 40).

And

- The carrying amount of biological assets at the beginning and end of the current period (IAS 41).

6.1.10.A Presentation (IAS 1)

This exemption removes:

- The requirement to present a cash flow statement (paragraphs 10(d) and 111 - see 6.1.11 below).
- The requirement to present a statement of financial position and related notes at the beginning of the earliest comparative period (or third balance sheet) whenever an entity applies an accounting policy retrospectively, makes a retrospective restatement, or when it reclassifies items in its financial statements (paragraph 10(f) and paragraphs 40A-40D).
- The requirement to make an explicit statement of compliance with IFRS. Indeed, FRS 101 prohibits such a statement of compliance and an FRS 101 statement of compliance is required instead (paragraph 16 - see 1.3 above).
- The requirements to present two primary statements as a minimum, information about narrative information in previous reporting periods relevant to understanding the current period's financial statements, and the suggestion that entities may present additional comparative information (paragraphs 38A-38D).

And

- The requirement to disclose information about capital and how it is managed (paragraphs 134-136).

Financial institutions are not permitted to use the exemption in respect of the disclosure of information about capital and how it is managed. This is because financial institutions are usually subject to externally imposed capital requirements.

6.1.10.B Presentation (IFRS 18)

This exemption removes:

- The requirement to present a cash flow statement (paragraphs 10(d), 22(e) and the last two sentences of paragraph 3)- see 6.1.11 below).
- The requirement to present a statement of financial position and related notes at the beginning of the earliest comparative period (or third balance sheet) whenever an entity applies an accounting policy retrospectively, makes a retrospective restatement, or when it reclassifies items in its financial statements (paragraphs 10(g) and 37 to 40).
- The requirements to present two primary statements as a minimum, information about narrative information in previous reporting periods relevant to understanding the current period's financial statements, and the suggestion that entities may present additional comparative information (paragraphs 32 and B13 to B15).
- The requirements to disclose information about the disaggregation of expenses in the operating category and outside the operating category (paragraph 83(b)).
- The requirements to disclose information about management-defined performance measures (paragraphs 121 to 125).

And

- The requirement to disclose information about capital and how it is managed (paragraphs 126 to 129 of IFRS 18).

Financial institutions are not permitted to use the exemption in respect of the disclosure of information about capital and how it is managed. This is because financial institutions are usually subject to externally imposed capital requirements.

6.1.11.A Statement of Cash Flows (IAS 7) before IFRS 18 amendments

The exemption removes:

- The requirement for a cash flow statement for any qualifying entity (paragraphs 1 to 44E and 45 to 63).
- The requirement to disclose information about an entity's supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on its liabilities and cash flows and on its exposure to liquidity risk (paragraphs 44F, 44G, 44H(a), 44H(b)(iii) and 44H(c)), provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included.

And

- The requirement to disclose the carrying amounts, and associated line items presented in the statement of financial position, of the financial liabilities that are part of a supplier finance arrangement, for which suppliers have already received payment from the finance providers, as at the beginning and end of the reporting period, for any qualifying entity (paragraph 44H(b)(ii)).

The exemption to disclose information about supplier finance arrangement is contingent on equivalent disclosures in the consolidated financial statements in which the qualifying entity is included (except for paragraph 44H(b)(ii) which is applicable to all qualifying entity). This is because the FRC consider that this information is likely to be useful to users of the financial statements. [FRS 101.BC67CZB].

6.1.11.B Statement of Cash Flows (IAS 7) after IFRS 18 adoption

The exemption removes:

- The requirement for a cash flow statement for any qualifying entity (paragraphs 1 to 44E and 45 to 63).
- The requirement to disclose information about an entity's supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on its liabilities and cash flows and on its exposure to liquidity risk (paragraphs 44F, 44G, 44H(a), 44H(b)(iii) and 44H(c)), provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included.

- The requirement to disclose the carrying amounts, and associated line items presented in the statement of financial position, of the financial liabilities that are part of a supplier finance arrangement, for which suppliers have already received payment from the finance providers, as at the beginning and end of the reporting period, for any qualifying entity (paragraph 44H(b)(ii)).

And

- The requirement to apply the amendments made to IAS 7 by IFRS 18 when qualifying entities apply IFRS 18 and amendments made by (paragraph 64).

The exemption to disclose information about supplier finance arrangements is contingent on equivalent disclosures in the consolidated financial statements in which the qualifying entity is included (except for paragraph 44H(b)(ii) which is applicable to all qualifying entity). This is because the FRC consider that this information is likely to be useful to users of the financial statements. [FRS 101.BC67CZB].

6.1.12.A Standards Issued but not Effective (IAS 8) before IFRS 18 adoption

This exemption removes the requirement to provide information about the impact of IFRSs that have been issued but are not yet effective.

6.1.12.B Basis for Preparation of Financial Statements (IAS 8) after IFRS 18 adoption

This exemption removes the requirement to provide information about the impact of IFRSs that have been issued but are not yet effective.

IFRS 18 updates the title of IAS 8 to *IAS 8 Basis of Preparation of Financial Statements* and also introduces a new paragraph 6B which requires an entity to make an explicit and unreserved statement of compliance to IFRS Accounting Standards in the notes (previously in paragraph 16 of IAS 1). The amendments to FRS 101 Reduced Disclosure Framework - 2024/25 cycle introduces an additional exemption to remove the requirement to make this disclosure when IFRS 18 is adopted for use in the UK (see 1.3 above).

6.1.13 Income Taxes (IAS 12)

This exemption removes the requirement to disclose qualitative and quantitative information about its exposure to Pillar Two income taxes at the end of the reporting period, provided that equivalent disclosures are included in the consolidated financial statements of the group in which the entity is consolidated.

The exemption from the requirements of paragraphs 88C and 88D of IAS 12 was introduced as the FRC consider that top-up taxes are determined on a group basis and hence useful information about the exposure to paying top-up taxes can be obtained from consolidated financial statements of the group in which the qualifying entity is included. [FRS 101.BC67CB].

6.1.14 Property, Plant and Equipment (IAS 16)

This exemption eliminates the requirement to disclose the amounts of proceeds and costs included in profit or loss that relate to items produced that are not an output of the entity's ordinary activities, and in which line items such proceeds and costs are presented in the statement of comprehensive income.

6.1.15 Related Party Transactions (IAS 24)

The exemptions in respect of IAS 24 remove:

- The requirement to disclose information about key management personnel compensation (paragraphs 17).
 - The requirement to disclose amounts incurred for the provision of key management personnel services that are provided by a separate management entity (paragraph 18A).
- And
- The requirements to disclose related party transactions between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

The last disclosure exemption above refers to transactions only and not to outstanding balances. As explained in the Basis for Conclusions to FRS 102, this is because there is a separate legal requirement in relation to the format of the balance sheet which requires disclosure of outstanding balances in aggregate for group undertakings and, separately, for undertakings in which the company has a participating interest. As a result, it is not possible to provide an effective exemption from the disclosure of outstanding balances with group undertakings. [FRS 102.B33.2].

Although the requirement to disclose information about key management personnel compensation is eliminated, UK companies are required separately by Schedule 5 to the Regulations to disclose information in respect of directors' remuneration. Additionally, quoted companies must prepare a directors' remuneration report as required by Schedule 8 to the Regulations. There is no exemption from other IAS 24 disclosure requirements, so disclosure of other transactions with key management personnel (e.g., director loans) is still required.

The wording of the exemption from disclosure of transactions with other wholly owned subsidiaries has been taken directly from the Regulations. [FRS 101.BC68].

Extract from FRS 101

Basis for Conclusions

IAS 24 Related Party Disclosures

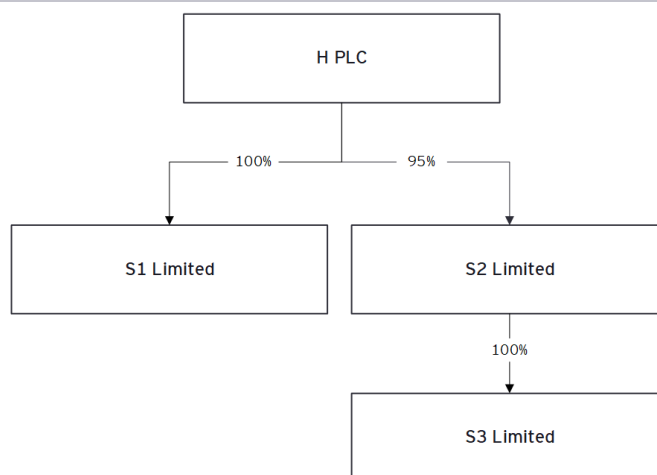
Transactions with wholly-owned subsidiaries

69 In December 2017, amendments were made to Appendix II *Note on legal requirements to FRS 102* to clarify the FRC's view that:

- (a) This exemption may be applied to transactions between entities within a sub-group when the transacting subsidiary is wholly owned by the intermediate parent of that sub-group, even if that intermediate parent is not wholly owned by the ultimate controlling parent.
- (b) This exemption may not be applied to transactions between entities in an intermediate parent's sub-group (including the intermediate parent itself) and the entities in the larger group if the intermediate parent is not wholly owned by the parent of that larger group.

This is shown by Illustration 6-1 below.

Illustration 6-1: Application of the exemption from disclosure of transactions between wholly-owned subsidiary undertakings



Because H PLC only owns 95% of S2 Limited, the wholly owned subsidiaries exemption cannot be used in: (a) the separate financial statements of H PLC in respect of transactions with S2 Limited and S3 Limited; (b) the individual financial statements of S1 Limited in respect of transactions with S2 Limited and S3 Limited; (c) the separate financial statements of S2 Limited in respect of any transactions with H PLC and S1 Limited; or (d) the individual financial statements of S3 Limited in respect of any transactions with H PLC and S1 Limited.

The exemption can be used for any transactions in individual financial statements between H PLC and S1 Limited and between S2 Limited and S3 Limited.

However, if the remaining 5% of S2 Limited (not directly held by H PLC) was held by another wholly owned subsidiary undertaking of H PLC, then S2 Limited would be a wholly owned subsidiary undertaking of H PLC. In those circumstances, the exemption from disclosing transactions with the other entities in the group is available in the individual financial statements of H PLC, S1 Limited, S2 Limited and S3 Limited (as S1 Limited, S2 Limited and S3 Limited would all be wholly owned subsidiary undertakings of the H PLC group).

The exemption has no other conditions: it can be applied, for example, to an entity with an overseas parent.

6.1.16 Impairment of Assets (IAS 36)

This exemption eliminates all requirements to disclose information about estimates used to measure recoverable amounts of each cash-generating unit (or group of units) containing goodwill or intangible assets with indefinite useful lives, including details of fair value measurements where the recoverable amount is fair value less costs of disposal other than:

- The carrying amounts of goodwill and carrying amounts of indefinite life intangibles allocated to each such cash generating unit (or group of units) (paragraphs 134(a), 134(b), 135(a), 135(b)).
- And
- The basis on which the recoverable amount of those units has been determined (i.e., value in use or fair value less costs of disposal) (paragraph 134(c)).

Qualifying entities must still give the other disclosures required by paragraphs 126 to 135 of IAS 36 in respect of impairment losses (and reversal of impairment losses) recognised or reversed in the period. These include, *inter alia*, the recoverable amount of the asset (or cash generating unit) and whether the recoverable amount is its fair value less costs of disposal or its value in use. However, where an impairment loss has been recognised or reversed during the period in respect of an individual asset (including goodwill) or a cash-generating unit, and the recoverable amount was based on fair value less costs of disposal, the information on the valuation techniques used (and the key assumptions) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy are not required.

6.2 'Equivalent' disclosures

Certain of the disclosure exemptions in FRS 101 are dependent on the provision of 'equivalent' disclosures in the publicly available consolidated financial statements of the parent in which the entity is included.

The following table summarises which disclosure exemptions need 'equivalent' disclosures in the consolidated financial statements of the parent and which do not.

Disclosure exemption	Equivalent disclosures required in parent consolidated financial statements
First-time adoption exemption (see 6.1 above)	No
Share-based Payment (see 6.1.1 above)	Yes
Business Combinations (see 6.1.2 above)	Yes
Discontinued Operations (see 6.1.3 above)	No
Exploration for and Evaluation of Mineral Resources (see 6.1.4 above)	No
Financial Instruments: Disclosures (see 6.1.5.A and 6.1.5.B above)	Yes
Fair Value Measurement (see 6.1.6 above)	Yes
Revenue from Contracts with Customers (see 6.1.7 above)	No
Leases (see 6.1.8 above)	No
Comparatives (see 6.1.9 above)	No
Presentation (see 6.1.10.A and 6.1.10.B above)	No
Statement of Cash Flows (see 6.1.11.A and 6.1.11.B above) as follows:	
Preparation of a statement of cash flows	No
Supplier finance arrangement disclosures	Yes
Standards Issued but not Effective (see 6.1.12.A above)	No
Basis for Preparation of Financial Statements (see 6.1.12.B above)	No
Income Taxes (see 6.1.13 above)	Yes
Property, Plant and Equipment (see 6.1.14 above)	No
Related Party Transactions (see 6.1.15 above)	No
Impairment of Assets (see 6.1.16 above)	Yes

FRS 101 refers to the Application Guidance in FRS 100 in deciding whether the consolidated financial statements of the group in which the reporting entity is included provides disclosures that are 'equivalent' to the requirements of adopted IFRS from which relief is provided. [FRS 101.9].

The Application Guidance in FRS 100 states that:

- "...it is necessary to consider whether the publicly available consolidated financial statements of the parent provide disclosures that meet the basic disclosure requirements of the relevant standard issued (or adopted) by the relevant standard setter without regarding strict conformity with each and every disclosure. This assessment must be based on the particular facts, including the similarities to and differences from the requirements of the relevant standard from which relief is provided." The concept of 'equivalence' is intended to be aligned to that described in section 401 of the CA 2006 for UK entities, and section 300 of the Companies Act 2014 for Irish entities. [FRS 100.AG25].
- And
- "Disclosure exemptions for subsidiaries are permitted where the relevant disclosure requirements are made in the consolidated financial statements, even where the disclosures are made in aggregate or abbreviated form, or in relation to intra-group balances, those intra-group balances have been eliminated on consolidation. If, however, no disclosure is made in the consolidated financial statements

on the grounds of materiality, the relevant disclosures should be made at the subsidiary level if material in those financial statements". [FRS 100.AG10].

This means that a qualifying entity must review the consolidated financial statements of its parent to ensure that 'equivalent' disclosures have been made for each of the above exemptions that it intends to use. Where a particular 'equivalent' disclosure has not been made (unless the disclosure relates to an intra-group balance eliminated on consolidation) then the qualifying subsidiary cannot use the exemption in respect of that disclosure.

6.3 Disclosures required by the Regulations for certain financial instruments (and other assets) which may be held at fair value

Paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents in Schedule 2 and Schedule 3 to the Regulations and the LLP Regulations) state that financial instruments which under adopted IFRS may be included in accounts at fair value, may be so included, provided that the disclosures required by such accounting standards are made. [FRS 101.A2.6]. The financial instruments referred to by paragraph 36(4) of Schedule 1 of the Regulations (and its equivalents) are those listed in paragraphs 36(2)(c) and 36(3) of Schedule 1 to the Regulations (and its equivalents). These are: [1 Sch 36]

- Any financial liability which is not held for trading or a derivative, i.e., a financial liability measured or designated at fair value through profit or loss (FVPL) under paragraphs 4.2.2, 4.3.5 or 4.3.6 of IFRS 9.
 - Loans and receivables originated by the reporting entity, not held for trading purposes, and measured or designated at either fair value through other comprehensive income (FVOCI) or FVPL under paragraphs 4.1.2A, 4.1.4 or 4.1.5 of IFRS 9.
 - Interests in subsidiary undertakings, associated undertakings and joint ventures accounted at FVOCI or FVPL under IFRS 9 via paragraphs 10, 11 or 11A of IAS 27 or paragraph 18 of IAS 28 *Investments in Associates and Joint Ventures*.
 - Contracts for contingent consideration in a business combination measured at FVPL.
- Or
- Other financial instruments with such special characteristics that the instruments according to generally accepted accounting principles or practice, are to be accounted for differently from other financial instruments.

The Note on legal requirements to FRS 101 confirms that a qualifying entity that has any of the above sub-set of financial instruments measured at fair value in accordance with the requirements of paragraph 36(4) of Schedule 1 to the Regulations (or its equivalents) is legally required to provide the relevant disclosures set out in extant UK-adopted international accounting standards. [FRS 101.A2.7].

This means that an entity with any of the above sub-set of financial instruments measured at fair value must make all material disclosures required by IFRS 7 and IFRS 13.

In addition, qualifying entities that are preparing Companies Act accounts must provide the disclosures required by paragraph 55 of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 to the Regulations and the LLP Regulations) which set out requirements relating to financial instruments at fair value. [FRS 101.A2.7D]. These disclosures relate to financial instruments and other assets held at fair value generally and not just to those financial instruments measured at fair value in accordance with paragraph 36(4) as discussed above. Disclosures are required of: [1 Sch 55]

- The significant assumptions underlying the valuation models and techniques used when determining the fair value of the instruments or other assets.
 - For each category of financial instrument or other asset, the fair value of the assets and the changes in value included directly in the profit and loss account or credited to or debited from the fair value reserve in respect of those assets.
 - For each class of derivatives, the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.
- And
- Where any amount is transferred to or from the fair value reserve during the financial year, disclosure (in tabular form) of the opening and closing balance of the reserve, the amount transferred to or from the reserve during the year and the source and application respectively of the amounts so transferred.

6.4 Disclosure exemptions for financial institutions

Financial institutions are permitted to apply FRS 101 but receive fewer disclosure exemptions. A qualifying entity which is a financial institution may take advantage in its individual financial statements of the disclosure exemptions set out at 6.1 above except for: *[FRS 101.7]*

- The disclosure exemptions from IFRS 7.
- The disclosure exemptions from paragraphs 91 to 99 of IFRS 13 to the extent that they apply to financial instruments. Therefore, a financial institution can take advantage of the disclosure exemptions from paragraphs 91 to 99 of IFRS 13 for assets and liabilities other than financial instruments (e.g., property plant and equipment, intangible assets, and investment property).

And

- The capital disclosures required by adopted IFRS.

Entities which are subject to the CA 2006 and the Regulations or the LLP Regulations are legally required to provide disclosures related to financial instruments and assets and liabilities including those measured at fair value (see 6.3 above and 7.2 below).

The FRC has opted not to provide a generic definition of a financial institution. Instead, it has provided a list of entities that are stated to be financial institutions.

Extract from FRS 101

Appendix I

Glossary

financial institution	Any of the following:
	(a) a bank which is:
	(i) a firm with a Part 4A permission ⁵ which includes accepting deposits and:
	(a) which is a credit institution; or
	(b) whose Part 4A permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, a friendly society or a credit union;
	(ii) an EEA bank which is a full credit institution;
	(b) a building society which is defined in section 119(1) of the Building Societies Act 1986 as a building society incorporated (or deemed to be incorporated) under that act;
	(c) a credit union, being a body corporate registered under the Co-operative and Community Benefit Societies Act 2014 as a credit union in accordance with the Credit Unions Act 1979, which is an authorised person;
	(d) a custodian bank or broker-dealer;
	(e) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities;
	(f) an incorporated friendly society incorporated under the Friendly Societies Act 1992 or a registered friendly society registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment which it replaced, including any registered branches;
	(g) an investment trust, Irish investment company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC); or
	[Deleted]
	(h) any other entity whose principal activity is similar to those listed above but is not specifically included in that list.
	(i) A parent entity whose sole activity is to hold investments in other group entities is not a financial institution.

The list of entities considered to be a financial institution above does not include stockbrokers, retirement benefit plans and any other entity who generates wealth or manages risk through financial instruments but whose principal activity is not similar to those listed above. [FRS 101.BC19].

However, in some cases, judgement, based on the facts and circumstances, may be needed in assessing whether an entity's principal activities are similar to those listed at (a) to (g) above. For example, the Basis for Conclusions observes that judgement will need to be applied in determining whether a group treasury company is similar to the other entities listed in the definition of a financial institution. [FRS 101.BC21].

7 Additional Companies Act disclosures

FRS 101 individual financial statements (which are Companies Act accounts) are subject to disclosures required by the Regulations as well as other disclosures required by the Companies Act or other related regulations. These disclosures are in addition to those required by adopted IFRS.

There are two types of Companies Act disclosures that are required for a UK entity applying FRS 101:

- Those required for both IAS accounts (prepared under adopted IFRS) and Companies Act accounts (prepared under a form of UK GAAP) (see 7.1 below).

And

- Those required by the Regulations for Companies Act accounts but not for IAS accounts (see 7.2 below).

This means that, in certain scenarios, a move from adopted IFRS to FRS 101 would result in increased disclosures for an entity despite the use of the disclosure exemptions described at 6 above.

There may also be additional disclosures for an entity other than a company where that entity is subject to separate regulations.

7.1 Existing Companies Act disclosures in the financial statements for adopted IFRS and UK GAAP reporters that also apply under FRS 101

FRS 100 identifies the following required disclosures: *[FRS 100.A2.19]*

- Section 410A *Off-balance sheet arrangements*
- Section 411 *Employee numbers and costs*
- Section 412 *Directors' benefits: Remuneration*
- Section 413 *Directors' benefits: Advances, credit and guarantees*
- Sections 414A to 414D *Strategic Report*
- Sections 415 to 419 *Directors' Report*
- Sections 420 to 421 *Directors' Remuneration Report*

And

- Section 494 *Services provided by auditor and associates and related remuneration.*

The disclosures identified by FRS 100 above is incomplete and omits, for example, the information about related undertakings required by section 409. There are also certain disclosure exemptions for small companies and medium-sized companies (see Chapter 5 at 6 and Chapter 1 at 5.6.2).

LLPs are not subject to equivalent statutory requirements to those in sections 412 to 421 above although banking and insurance LLPs are required to prepare a strategic report for financial years beginning on or after 1 January 2017.

In addition, other Companies Act or related disclosures may apply depending on individual circumstances such as the disclosures required for a parent taking advantage of the exemption from preparing group accounts under either section 400 or section 401 of the CA 2006.

7.2 Disclosures required by the Regulations and the LLP Regulations in FRS 101 financial statements but not required under adopted IFRS

The Regulations and the LLP Regulations require various disclosures in financial statements. In particular, Part 3 of Schedules 1 to 3 to the Regulations (and Part 3 and Part 4 of Schedule 1 to the LLP Regulations) require certain disclosures to be made in the notes to the financial statements if not given in the primary statements. The relevant paragraphs are as follows:

- Schedule 1 paragraphs 42 to 75
 - Schedule 2 paragraphs 52 to 92B
 - Schedule 3 paragraphs 60 to 90B
- Or
- The LLP Regulations paragraphs 42 to 71

Although some of these disclosure requirements are replicated in adopted IFRS, others are not. Entities that move to FRS 101 from FRS 102 will have made these disclosures previously and therefore these requirements will not increase their reporting burden. Entities that move to FRS 101 from adopted IFRS will not have made these disclosures previously or any other disclosures required by the applicable schedule above and must consider carefully the impact of these new requirements against the benefits of the reduced disclosures discussed at 6 above.

In addition, entities subject to the Regulations and LLP Regulations are required to present the notes to the financial statements in the order in which, where relevant, the items to which they relate are presented in the balance sheet and profit and loss accounts (see 5.2 above). The General Rules to the formats in the Regulations and LLP Regulations require that where an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the accounts (see 5.1 above). [1 Sch 9A].

Some examples of disclosures not required under adopted IFRS in individual or separate financial statements are shown below. The disclosures illustrated below are not intended to be an exhaustive list of additional disclosures required by the Regulations and LLP Regulations for entities applying FRS 101 that have previously reported under adopted IFRS.

- Schedule 1 companies (i.e., companies other than banking and insurance companies):
 - Disclosures required for certain financial instruments which may be held at fair value (see 6.3 above). [1 Sch 36].
 - A statement required by large companies that the accounts have been prepared in accordance with applicable accounting policies. [1 Sch 45].
 - Disclosures in respect of share capital and debentures including information about shares and debentures allotted and contingent rights to shares. [1 Sch 47, 1 Sch 48, 1 Sch 49, 1 Sch 50].
 - Disclosure of the split of land between freehold and leasehold and the leasehold land between that held on a long lease and that held on a short lease. [1 Sch 53].
 - Disclosure of information about listed investments. [1 Sch 54].
 - Disclosure of information about the fair value of financial assets and liabilities, investment property, living animals and plant which, in substance, 'reinstates' some parts of IFRS 7 and IFRS 13. In particular, there are requirements to disclose significant assumptions underlying the valuation models and techniques used when determining fair value of the instruments, details of the fair value of financial instruments by category and details concerning significant terms and conditions of derivatives (see 6.3 above). [1 Sch 55].
 - Disclosure of information about creditors due after five years. [1 Sch 61].
 - Disclosure of information about guarantees and other financial commitments including charges on assets to secure liabilities, the particulars and total amount of any guarantees, contingencies and commitments not recorded in the balance sheet, the nature and form of valuable security given and separate disclosure of pension commitments and guarantees and commitments given to certain related entities. [1 Sch 63].
 - Disclosure of information about loans made in connection with the purchase of own shares. [1 Sch 64].
 - Disclosure of particulars of taxation. [1 Sch 67].
- And
- Disclosure of information about turnover by class of business and geographical markets. IFRS 8 does not require segmental information if an entity's debt or equity instruments are not traded in a public market or the entity is not in the process of filing financial statements for that purpose. However, the disclosures in the Regulations are required even if the entity is out of scope of IFRS 8. See also 5.2.1 above. [1 Sch 68].

The profit and loss account of a company that falls within section 408 of the CA 2006 (individual profit and loss account where group accounts prepared) need not contain the information specified in paragraphs 65 to 69 of Schedule 1. [Regulations 3(2)].

- Schedule 2 companies (i.e., banking companies):
 - A statement that the accounts have been prepared in accordance with applicable accounting policies. [2 Sch 54].
 - Disclosures in respect of share capital and debentures including information about shares and debentures allotted and contingent rights to shares. [2 Sch 58, 2 Sch 59, 2 Sch 60, 2 Sch 61].

- Disclosure of the split of land between freehold and leasehold and the leasehold land between that held on a long lease and that held on a short lease. [2 Sch 64].
- Disclosure of a specific maturity analysis for loans and advances and liabilities. [2 Sch 72].
- Disclosure of arrears of fixed cumulative dividends. [2 Sch 75].
- Disclosure of information about guarantees and other financial commitments including charges on assets to secure liabilities, the particulars and total amount of any guarantees, contingencies and commitments not recorded in the balance sheet, the nature and form of valuable security given and separate disclosure of pension commitments and guarantees and commitments given to certain related entities. [2 Sch 77].
- Disclosure of details of transferable securities. [2 Sch 79].
- Disclosure of leasing transactions. [2 Sch 80].
- Disclosure of assets and liabilities denominated in a currency other than the presentational currency. [2 Sch 81].
- Disclosure of details of unmatured forward transactions. [2 Sch 83].
- Disclosure of loans made in connection with the purchase of own shares. [2 Sch 84].
- Disclosure of particulars of taxation. [2 Sch 86].

And

- Disclosure of certain profit and loss account information by geographical markets. IFRS 8 does not require segmental information if an entity's debt or equity instruments are not traded in a public market or the entity is not in the process of filing financial statements for that purpose. However, the disclosures in the Regulations are required even if the entity is out of scope of IFRS 8. [2 Sch 87].

The profit and loss account of a banking company that falls within section 408 of the CA 2006 (individual profit and loss account where group accounts prepared) need not contain the information specified in paragraphs 85 to 91 of Schedule 2. [Regulations 5(2)].

- Schedule 3 companies (i.e., companies required to prepare Schedule 3 financial statements which do not issue insurance contracts):
 - A statement that the accounts have been prepared in accordance with applicable accounting policies. [3 Sch 62].
 - Disclosures in respect of share capital and debentures including information about shares and debentures allotted and contingent rights to shares. [3 Sch 65, 3 Sch 66, 3 Sch 67, 3 Sch 68].
 - Disclosure of the split of land between freehold and leasehold and the leasehold land between that held on a long lease and that held on a short lease. [3 Sch 71].
 - Disclosure of information about listed investments. [3 Sch 72].
 - Disclosure of creditors due after five years. [3 Sch 79].
 - Disclosure of information about guarantees and other financial commitments including charges on assets to secure liabilities, the particulars and total amount of any guarantees, contingencies and commitments not recorded in the balance sheet, the nature and form of valuable security given and separate disclosure of pension commitments and guarantees and commitments given to certain related entities. [3 Sch 81].
 - Disclosure of loans made in connection with the purchase of own shares. [3 Sch 82].
 - Disclosure of particulars of taxation. [3 Sch 84].
 - Disclosure of certain profit and loss account information by type of business and by geographical area. IFRS 8 does not require segmental information if an entity's debt or equity instruments are not traded in a public market or the entity is not in the process of filing financial statements for that purpose. However, the disclosures in the Regulations are required even if the entity is out of scope of IFRS 8. [3 Sch 85, 3 Sch 86, 3 Sch 87].

And

- Disclosure of total commissions for direct insurance business. [3 Sch 88].

The profit and loss account of an insurance company that falls within section 408 of the CA 2006 (individual profit and loss account where group accounts prepared) need not contain the information specified in paragraphs 83 to 89 of Schedule 3. [Regulations 6(2)].

Banking and insurance companies are financial institutions (see 6.4 above) and therefore must comply with IFRS 7 disclosures in full and IFRS 13 disclosures in respect of financial instruments, including disclosures about the fair value of financial assets and liabilities.

- LLPs (i.e., entities subject to the LLP Regulations)
 - A statement required by large LLPs that the accounts have been prepared in accordance with applicable accounting policies. [1 Sch 45 (LLP)].
 - Disclosures in respect of loans and debts due to members. [1 Sch 47 (LLP)].
 - Disclosures in respect of debentures. [1 Sch 48 (LLP)].
 - Disclosure of the split of land between freehold and leasehold and the leasehold land between that held on a long lease and that held on a short lease. [1 Sch 51 (LLP)].
 - Disclosure of information about listed investments. [1 Sch 52 (LLP)].
 - Disclosure of information about the fair value of financial assets and liabilities, stocks, investment property and living animals and plant where those assets and liabilities have been valued at fair value which, in substance, 'reinstates' some parts of IFRS 7 and IFRS 13. In particular, there are requirements to disclose information about significant assumptions where the fair value of a financial instrument results from generally accepted valuation models and techniques, details of the fair value of financial instruments by category and details concerning significant terms and conditions of derivatives (see 6.3 above). [1 Sch 53 (LLP)].
 - Disclosure of information about creditors due after five years. [1 Sch 59 (LLP)].
 - Disclosure of information about guarantees and other financial commitments including charges on assets to secure liabilities, the particulars and total amount of any guarantees, contingencies and commitments not recorded in the balance sheet, the nature and form of valuable security given and separate disclosure of pension commitments and guarantees and commitments given to certain related entities. [1 Sch 60 (LLP)].
 - Disclosure of particulars of taxation. [1 Sch 64 (LLP)].
 - Disclosure of information about turnover by class of business and geographical markets. IFRS 8 does not require segmental information if an entity's debt or equity instruments are not traded in a public market or the entity is not in the process of filing financial statements for that purpose. [1 Sch 65 (LLP)].
- And
 - Disclosure of particulars of members. [1 Sch 66 (LLP)].

8. Future changes to IFRS and their impact on FRS 101

Although not specifically addressed by FRS 101, future changes to adopted IFRS are automatically incorporated into FRS 101 unless they are modified by the FRC.

The FRC reviews FRS 101 annually to ensure that the reduced disclosure framework continues to be effective in providing disclosure reductions for qualifying entities when compared with adopted IFRS.

[FRS 101.BC10].

The principles established for FRS 101 is that the FRC aims to provide succinct financial reporting standards that: [FRS 101.BC4]

- Have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective.
 - Balance improvement, through reflecting up-to-date thinking and developments in the way businesses operate and the transactions they undertake, with stability.
 - Balance consistent principles for accounting by all UK and Republic of Ireland entities with proportionate and practical solutions, based on size, complexity, public interest and users' information needs.
 - Promote efficiency within groups.
- And
- Are cost-effective to apply.

Whenever a new IFRS is issued or an amendment is made to an existing adopted IFRS, the FRC has to consider the following on qualifying entities: [FRS 101.BC7]

- Relevance - does the disclosure requirement provide information that is capable of making a difference to the decisions made by users of the financial statements of a qualifying entity?
 - Cost constraint on useful financial reporting - does the disclosure requirement impose costs on the preparers of the financial statements of a qualifying entity that are not justified by the benefits to the users of those financial statements?
- And
- Avoid gold plating - Does the disclosure requirement override an existing exemption provided by Company Law?

Appendix A - Defined terms

Extract from FRS 101

Appendix I

Glossary

adopted IFRS	IFRS Accounting Standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. In the Republic of Ireland, this refers to EU-adopted IFRS.
date of transition	The beginning of the earliest period for which an entity presents full comparative information under a given standard in its first financial statements that comply with that standard
IAS / IFRS Accounting Standards	IFRS Accounting Standards issued by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) IAS[®] Standards; (c) IFRIC[®] Interpretations developed by the IFRS Interpretations Committee; and (d) SIC[®] Interpretations developed by the former Standing Interpretations Committee.
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term.
Regulations	The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)
UK-adopted international accounting standards	IAS that have been adopted for use within the UK in accordance with the International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019 (SI 2019/685).

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Chapter 3

Scope of FRS 102

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Overview

Section 1 *Scope of FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* sets out which entities required to prepare financial statements can apply FRS 102. FRS 102 is designed to apply to the general-purpose financial statements and financial reporting of entities, including those that are not companies or profit-oriented.

This chapter discusses some of the general requirements for UK entities preparing their financial statements in accordance with FRS 102. This chapter also covers the reduced disclosure framework applicable for qualifying entities. Note that this chapter does not intend to be a one-stop shop for all requirements of UK entities.

What you need to know

- FRS 102 is a single financial reporting standard for entities, in the UK and Republic of Ireland, that applies to the financial statements of entities that are not applying adopted IFRS, FRS 101 or FRS 105. If permitted by local laws and regulations, an entity outside the UK and Republic of Ireland, can choose to apply FRS 102.
- FRS 102 applies to general purpose financial statements of entities, including public benefit entities that are intended to give a true and fair view. FRS 102 can be applied in consolidated and individual financial statements.
- FRS 102 requires certain types of entities to directly apply particular IFRS Accounting Standards (as adopted in the relevant jurisdiction), namely IAS 33 *Earnings per Share*, IFRS 6 *Exploration for and Evaluation of Mineral Resources* and IFRS 8 *Operating Segments*. These standards apply to FRS 102 reporters that would fall within the scope of these standards if applying IFRS Accounting Standards.
- FRS 102 includes a reduced disclosure framework for qualifying entities, available in their individual financial statements only, where the criteria are met.

1 Introduction

Section 1 sets out which entities, required by Companies Act 2006 to prepare financial statements, can apply FRS 102. Its requirements are consistent with the general financial reporting framework set out in FRS 100 *Application of Financial Reporting Requirements*, discussed further at 2.1 below. FRS 102 applies to financial statements intended to give a true and fair view. As its application is not restricted to UK and Irish companies, all entities must ensure that preparation of their financial statements in accordance with FRS 102 is permitted by the legal framework in which they operate. The legal framework for UK companies is discussed in more detail in Chapter 1 at 6.

This chapter covers the following topics:

- Summary (see 1.1 below)
- Periodic Reviews (see 1.2 below)
- Effective date of FRS 102 and related standards (see 1.3 below)
- Structure of FRS 102 (see 1.4 below)
- Scope of FRS 102 (see 2 below)
- Reduced disclosure framework in FRS 102 (see 3 below)

And

- Companies Act 2006 ('CA 2006') requirements for FRS 102 reporting entities (see 4 below)

Except where otherwise stated, the rest of this chapter will refer to the requirements for companies and Limited Liability Partnerships (LLPs) in the UK.

FRS 103 *Insurance Contracts* (see Chapter 38) applies to financial statements prepared in accordance with FRS 102 by entities that issue insurance contracts (including reinsurance contracts), hold reinsurance contracts or issue financial instruments (other than insurance contracts) with discretionary participation features. [FRS 103.1.1, FRS 103.1.2, FRS 101.1.3].

FRS 104 *Interim Financial Reporting* is a voluntary standard that FRS 102 reporters can apply in preparing interim financial statements. This is discussed in Chapter 39.

1.1 Summary

This summary covers a number of areas relevant to the scope of FRS 102 and to its structure which are addressed more fully in the chapter, as indicated.

FRS 102 applies to the financial statements of entities preparing financial statements in accordance with legislation, regulation or accounting standards applicable in the UK and the Republic of Ireland that are not prepared in accordance with adopted IFRS, FRS 101 *Reduced Disclosure Framework*, or FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. See 2.1 below.

- FRS 102 does not set out which entities must prepare financial statements. This is governed by the legal framework (or other regulation or requirements), if any, relating to the preparation of the entity's financial statements. For example, statutory accounts prepared in accordance with FRS 102 by a UK company are Companies Act accounts. While FRS 102 has been developed with the requirements for Companies Act accounts primarily in mind, the standard is available for adoption by entities other than UK companies. An entity applying FRS 102 must ensure that it complies with any applicable legal requirements. See 2.1 below.
- FRS 102 was originally issued in March 2013 and subsequently amended several times. This book covers the requirements of the September 2024 version of the Standard, which include the Periodic Review 2024 amendments to FRS 102 as discussed in 1.2 below. For details of effective date of this version of the Standard, see 1.3 below.
- FRS 102 applies to general purpose financial statements of entities, including public benefit entities (see 2.5.2 below) that are intended to give a true and fair view. FRS 102 can be applied in consolidated and individual financial statements.
- FRS 102 is a single financial reporting standard based on the IFRS for SMEs Accounting Standard *International Financial Reporting Standard for Small and Medium-sized Entities* which itself generally includes simplified requirements and disclosures compared to full IFRS Accounting Standards. When drafting the standard, the FRC made a number of modifications to IFRS for SMEs, including the scope and requirements. While largely based on IFRS for SMEs, FRS 102 is not just a simplified version of IFRS Accounting Standards. In certain cases, the standard includes direct references to IFRS Accounting Standards.

- Since FRS 102 includes less guidance than IFRS Accounting Standards, judgement is likely to be required in applying the standard. Section 10 *Accounting Policies, Estimates and Errors* sets out a 'GAAP hierarchy' that management must refer to in developing and applying relevant and reliable accounting policies where the standard does not specifically address the issue. This hierarchy includes references to applicable Statement of Recommended Practice (SORP). See 2.3 below. In addition, management may but are not required to refer to IFRS Accounting Standards addressing similar and related issues.
- FRS 102 requires certain types of entities to directly apply particular IFRS Accounting Standards (as adopted in the relevant jurisdiction), namely IAS 33, IFRS 6 and IFRS 8. These standards apply to FRS 102 reporters that would fall within the scope of these standards if applying IFRS Accounting Standards. See 2.4 below.
- In addition, an entity applying FRS 102 has a choice of applying the recognition and measurement requirements for financial instruments in:
 - Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102
 - IAS 39 *Financial Instruments: Recognition and Measurement* (the version extant immediately prior to IFRS 9 *Financial Instruments* superseding IAS 39). The ability to newly apply the IAS 39 option is permitted only in situations where applying IAS 39 is necessary to achieve consistency with group financial statements. This is possible for example, an entity which had not previously applied the IAS 39 option is acquired by a group that already applies the IAS 39 option
 Or
 - IFRS 9 *Financial Instruments* and IAS 39 (as amended by IFRS 9).

Whichever policy choice for the recognition and measurement of financial instruments is followed, FRS 102 reporters must give the disclosures required by Sections 11 and 12 and follow the presentation requirements (on offset of financial assets and financial liabilities) in these sections, rather than those required by IFRS Accounting Standards. See Chapter 13 at 3.

- FRS 102 requires an entity to apply FRS 103 to insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds, and financial instruments (other than insurance contracts) with a discretionary participation feature that it issues. See Chapter 38.
- Since statutory accounts prepared by UK companies in accordance with FRS 102 are Companies Act accounts, these must comply with the requirements of the CA 2006 and *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410) ('the Regulations') or *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409) ('the Small Companies Regulations').

Statutory accounts prepared by LLPs in accordance with FRS 102 are non-IAS accounts and must comply with similar requirements under LLP law. Some of these requirements are included in *The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2009/1911), *The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008* (SI 2008/1913) and *The Small Limited Liability Partnerships (Accounts) Regulations 2008* (SI 2008/1912).

The CA 2006 and the relevant regulations set out the formats for the balance sheet and profit and loss account (see Chapter 6 at 3 to 5), recognition and measurement principles and further disclosures required in Companies Act accounts (or non-IAS accounts, for an LLP). Entities not subject to the Regulations (or LLP Regulations) must also use the statutory or, where permitted, adapted formats for the balance sheet and profit and loss account, set out in those regulations except to the extent that these requirements are not permitted by any statutory framework under which such entities report.

While FRS 102 (and Appendix III *Note on legal requirements* to the standard) highlight certain issues relevant to Companies Act accounts, the discussion is not comprehensive. See 4 below, Chapter 1 at 5 and Chapter 6 at 8.

- Section 34 *Specialised Activities* sets out specific accounting and disclosure requirements for agriculture, extractive activities, service concession arrangements, financial institutions, retirement benefit plans, heritage assets, funding commitments, and certain issues specific to public benefit entities. Paragraphs marked PBE throughout the standard are specific to public benefit entities, and not for general application. See 2.5 below.

Section 34, in particular, sets out additional disclosure requirements for the financial statements of a financial institution (and for the consolidated financial statements of a group containing a financial institution) and for the financial statements of a retirement benefit plan. The definition of a 'financial institution' and the required disclosures are discussed at 2.5.1 below.

- FRS 102 includes a reduced disclosure framework for qualifying entities, available in their individual financial statements only, where the criteria are met.

A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view and that member is included in the consolidation. Some of the disclosure exemptions available under the reduced disclosure framework are conditional on equivalent disclosures being included in the consolidated financial statements of the group in which the entity is consolidated. In addition, a financial institution has fewer exemptions than an entity that is not a financial institution. See 3 below.

- Section 35 *Transition to this FRS* addresses transition to FRS 102. Section 35 is based on a simplified version of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, but with significant modifications. See Chapter 37.

1.2 Periodic Reviews of FRS 102

FRSs are subject to periodic reviews. This is an opportunity for the FRC to update and amend the standards, considering the feedback from stakeholders, developments in IFRS Accounting Standards and the IFRS for SME's Accounting Standard, and other emerging issues. These periodic reviews are performed approximately every five years. This allows experience of the most recent version of FRS 102 to develop, and also provides a period of stability between substantial changes. [FRS 102.BC.A.65]. When FRS 102 was first issued, it was envisaged previously that these reviews would take place every three years.

[FRS 102.BC.A.33]. The FRC assesses issues as they arise to determine whether action needs to be taken. When necessary this might involve introducing amendments to standards outside regular review cycles. [FRS 102.BC.A.45].

FRS 102 and FRS 105 are the primary focus of periodic reviews. However, proposed amendments to other FRSs may also arise from these reviews. On a similar note, an annual review of FRS 101 is carried out as IFRS Accounting Standards evolve, and to respond to stakeholder feedback about other possible improvements. These annual FRS 101 reviews are separate and independent from periodic reviews.

[FRS 102.BC.A.66].

Any amendments to FRS 102 to reflect major changes in IFRS Accounting Standards will be considered on a case-by-case basis, including the appropriate timing of adoption. The FRC agrees that, in most cases, it will be preferable to learn from IFRS implementation experience in determining whether, and if so how and when, FRS 102 needs to be amended. [FRS 102.BC.A.44].

1.2.1 Periodic Review 2024

In March 2024, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs - Periodic Review 2024*. In February 2026 the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* which amended paragraphs 9.2, 9.3, 9.11, 9.26A and 9.27A, inserted paragraphs 9.3A and 9.3B and deleted paragraph 13.14 (together, *The Periodic Review 2024 amendments*). [FRS 102.1.36]. The Periodic Review 2024 amendments apply for accounting periods beginning or after 1 January 2026.

This is the second periodic review completed by the FRC since the initial implementation of FRS 102.

[FRS 102.BC.A.67]. The Periodic Review 2024 amendments arose from proposals exposed in FRED 82 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland - Periodic Review* in December 2022, and FRED 84 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland - Supplier finance arrangements* in September 2023. [FRS 102.BC.A.69].

In February 2026, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats*. These amendments introduce requirements which enable FRS 102 preparers applying the adapted formats to align with the statement of financial position and profit and loss presentation requirements of IFRS 18, clarify the definition of current liabilities and align requirements for the classification of loan arrangements with covenants to those in IAS 1 and IFRS 18. [FRS 102.1.71, FRS 102.1.72, FRS 102.1.73]. These amendments apply for accounting periods beginning on or after 1 January 2027 but can be early-applied (see 1.3.2 below).

The Periodic Review amendments, except for those issued in February 2026 discussed above, form part of the September 2024 version of FRS 102, the effective date of which is discussed in 1.3 below.

In developing these amendments, the FRC considered all the changes in the IFRS Accounting Standards, proposed changes in developing an updated version of IFRS for SMEs Accounting Standard, stakeholder feedback and other developments in corporate reporting.

As noted above, the Periodic Review 2024 amendments result in a number of changes, primarily to FRS 102 (and FRS 105). [FRS 102.BC.A.68, FRS 102(2026).BC.A.85-A.87]. The most significant changes in FRS 102 are the following:

- New accounting requirements for revenue in Section 23 *Revenue from Contracts with Customers* based on the five-step model for revenue recognition built on the requirements of IFRS 15 *Revenue from Contracts with Customers*, with appropriate simplifications. See Chapter 25. [FRS 102.1.61, FRS 102.1.62, FRS 102.1.63, FRS 102.1.64, FRS 102.1.65, FRS 102.1.66, FRS 102.1.67].
- New accounting requirements for leases in Section 20 *Leases* based on the on-balance sheet model from IFRS 16 *Leases*, with appropriate simplifications. See Chapter 23. [FRS 102.1.54, FRS 102.1.55, FRS 102.1.56, FRS 102.1.57, FRS 102.1.58, FRS 102.1.59, FRS 102.1.60].
- Updated requirements relating to fair value measurement in Section 2A *Fair Value Measurement* to align with the principles of IFRS 13 *Fair Value Measurement*. Fair Value Measurement was previously an appendix to Section 2 *Concepts and Pervasive Principles*. See Chapter 10. [FRS 102.1.41].
- Section 7 *Statement of Cash Flows* updated to reflect the disclosure requirements for supplier finance arrangements. See Chapter 7. [FRS 102.1.42].
- Section 29 *Income Tax* updated to reflect requirements relating to uncertain tax positions. See Chapter 31. [FRS 102.1.68].
- With respect to the amendments issued by the FRC in February 2026, the following requirements were updated in relation to entities adapting the balance sheet and profit or loss formats (See Chapter 6 at 9 for more details),
 - Section 4 *Statement of Financial Position* amended to introduce the guidance on classifying liabilities as current or non-current. The amendments align with the revisions made to IAS 1 during the period from 2020 to 2022, which was effective for IFRS Accounting Standards reporters for periods on or after 1 January 2024. [FRS 102(2026).1.72].
 - Section 4 and Section 5 *Statement of Comprehensive Income and Income Statement* updated the minimum required line items to align with the requirements in IFRS 18, which was effective for IFRS Accounting Standards reporters, for periods on or after 1 January 2027. [FRS 102(2026).1.73].

In addition to the above, Section 2 was updated to reflect IASB's *Conceptual Framework for Financial Reporting*, issued in 2018.

For entities applying the small companies regime and Section 1A *Small Entities* of FRS 102 in the preparation of the financial statements, Section 1A was updated to reduce the judgement applied by small entities in determining which additional disclosures are required in order for financial statements to give a true and fair view. Before the Periodic Review 2024 amendments, Section 1A reflected the requirements of the EU Accounting Directive which precluded Member States from imposing specific disclosure requirements on small entities, except those limited disclosures set out in CA 2006. Those requirements of the EU Accounting Directive had not been written into CA 2006, but had acted as a constraint in developing Section 1A. As a result of the UK's exit from the European Union, the FRC has taken the opportunity in the Periodic Review 2024 to update FRS 102 so that Section 1A now specifies required disclosures for small entities, thereby reducing the judgement applied by small entities. For more details on disclosure requirements for small entities, see Chapter 5 at 5. With respect to the amendments issued by the FRC in February 2026, Section 1A was also updated to align with the changes to Section 4 and 5 relating to requirements for entities adapting the balance sheet and profit or loss formats. See Chapter 5 at 7.

As noted above, some requirements in the FRSs have been aligned to IFRS Accounting Standards. However, there are principles in the IFRS Accounting Standards that the FRC decided not to incorporate in the Periodic Review 2024 amendments. These include the following:

- Expected credit loss model in IFRS 9. As part of the Periodic Review 2024, the FRC made no amendment to incorporate the expected credit loss model of IFRS 9 into FRS 102. Therefore, only entities applying IFRS 9 as an accounting policy choice under Sections 11 and 12 use the expected credit loss model. The FRC intends to reconsider this matter in the future, taking into account the IASB's third edition of the IFRS for SMEs Accounting Standard. For entities applying IFRS 9 and therefore using the expected credit loss model, new disclosure requirements were introduced in paragraphs 11.48ZA and 11.48ZB of FRS 102. Please see Chapter 15 for details of the new disclosures. [FRS 102.BC.B11.49ZA].
- Control model in IFRS 10 *Consolidated Financial Statements*. This was considered in the Triennial Review 2017. Although there were no amendments made to FRS 102 to incorporate the control model in IFRS 10, disclosures regarding unconsolidated structured entities (such as special purpose entities) were introduced. This principles-based disclosure was derived from IFRS 12 *Disclosure of Interests in Other Entities*. [FRS 102.BC.B9.3]. See Chapter 8 for details of required disclosures. Currently, there is no indication that this will be reconsidered in future periodic reviews.
- IFRS 17 *Insurance Contracts*. The FRC did not consider whether and how to align its FRSs with IFRS 17 in the Periodic Review 2024. The FRC is likely to wait for several years' implementation experience of IFRS 17 before considering alignment. The FRC also observed that conflicts arise between IFRS 17 and CA 2006. Therefore, it was concluded that it is not currently possible to apply IFRS 17 in Companies Act accounts. [FRS 103.BC57A].

1.3 Effective date of FRS 102 and related standards

For accounting periods beginning on or after 1 January 2026, the September 2024 version of FRS 102 is applicable to preparers. This version of FRS 102 incorporates all amendments issued up to September 2024, including those introduced by the amendments issued by the FRC in March 2024 and the amendments to Section 9 *Consolidated and Separate Financial Statements* and Section 13 *Inventories in Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* issued in February 2026. [FRS 102(2026).1.36, FRS 102.1.37, FRS 102(2026).72-73].

For accounting periods beginning on or after 1 January 2027, an entity must apply the amendments relating to adapted formats in *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* issued in February 2026. [FRS 102.1.37, FRS 102(2026).72-73]

1.3.1 Accounting periods beginning on or after 1 January 2026 but before 1 January 2027

For accounting periods beginning on or after 1 January 2026, the following apply:

- The September 2024 version of FRS 102 and the clarifications and amendments to Section 9 *Consolidated and Separate Financial Statements* and Section 13 *Inventories in Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* issued in February 2026. [FRS 102(2026).1.36, FRS 102.1.37, FRS 102(2026).72-73]
- The September 2024 version of FRS 103 (if an entity is in scope of FRS 103) [FRS 103.1.11D]
And
- The September 2024 version of FRS 104 (if an entity is applying this standard to its interim reporting). [FRS 104.56D]

As discussed above, FRS 100 (September 2024) must be applied from the same date that the September 2024 version of FRS 102 is applied.

When an entity first applies the Periodic Review 2024 amendments, it applies the amendments retrospectively, in accordance with Section 10, except as specified in Section 1. [FRS 102.1.39]. The details of these transitional arrangements are discussed in this book and referred to as 'Periodic Review 2024 amendments' in each of the relevant chapters.

1.3.2 Accounting periods beginning on or after 1 January 2027

For accounting periods beginning on or after 1 January 2027, an entity must apply the amendments relating to adapted formats in *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* issued in February 2026. [FRS 102.1.37, FRS 102(2026).72-73]

Early application of these amendments relating to adapted formats in the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-Entities Regime - Adapted formats* issued in February 2026 is permitted, provided that:

- All amendments are applied at the same time
- Or
- Only the amendments relating to the classification of current and non-current assets and liabilities are applied at the same time [FRS 102(2026).A.87]

If an entity does early adopt the amendments, it must disclose that fact. [FRS 102(2026).1.72, FRS 102(2026).1.73].

1.3.3 Effective date for entities subject to SORP

Following the issuance of FRS 102, some SORPs are being updated for consistency with the September 2024 version of FRS 102. See Chapter 1 at 3.6.1 for a list of the extant SORPs. However, some SORPs have not been updated. This results to an inconsistency in the extant SORPs and the current version of FRS 102.

Amendments to the relevant SORPs are not necessary before any changes to FRS 102 take effect because a change in accounting standards after a SORP has been issued means any conflicting provisions of a SORP cease to have effect. [FRS 100.6]. However, where there is lag between amendments made to FRS 102 are introduced and the SORPs are reviewed, there may be uncertainty as to which parts of a SORP are considered in conflict with the amended version of FRS 102 and over what, if any, changes to a SORP may subsequently be made. Consequently, an entity may be wary of early applying amendments to FRS 102 until the relevant SORP (which will generally include additional guidance and disclosures) has been reviewed. For example, the *Charities SORP (FRS 102) (second edition - October 2019)* includes additional disclosures for charities beyond those required by FRS 102, which would apply to small charities (unless specifically exempted by the SORP).

Certain entities may also be subject to legal requirements relating to the application of SORPs which may restrict the ability of an entity to early apply an amendment to FRS 102 (or related SORP). It is therefore always important for entities to understand the legislative or other regulatory requirements governing the preparation of their financial statements. This book does not discuss these requirements.

1.4 Structure of FRS 102

FRS 102 includes Section 1 which addresses the scope of FRS 102, Section 1A, Section 2, Section 2A, Sections 3 to 33 each addressing a separate accounting topic, Section 34 on specialised activities (see 2.5 below) and Section 35 on transition to FRS 102.

All paragraphs have equal authority. Some sections include appendices of implementation guidance or examples. Some of these are an integral part of FRS 102, whereas others provide guidance, but each specifies its status. Terms defined in the Glossary (included in Appendix I to FRS 102) are in bold type the first time they appear in each section of FRS 102 and in each sub-section of Section 34. [FRS 102 Overview (vi), FRS 102 Overview (vii)].

Appendix II *Table of equivalence for company law terminology* compares UK and Irish Company Law terminology with that used in FRS 102. Appendix III *Note on legal requirements* provides an overview of how the requirements in FRS 102 address the requirements of CA 2006. Appendix IV *Republic of Ireland legal references* outlines the provisions in Irish law (Companies Act 2014) (CA 2014) corresponding to the provisions of CA 2006 and the Regulations.

The Basis for Conclusions summarises the main issues considered by the FRC in developing FRS 102. Section 1 of FRS 102 is addressed in this chapter.

2 Scope of FRS 102

Extract from FRS 102

- 1.1 This FRS applies to financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. *[FRS 102.1.1].*

The application of FRS 102 is intended to give a true and fair view of an entity's financial position and performance for a period.

FRS 102 is designed to apply to general purpose financial statements and financial reporting, intended to focus on the common information needs of a wide range of users (such as shareholders, lenders, other creditors, employees and members of the public), of entities including those that are not constituted as companies and those that are not profit-oriented. *[FRS 102 Overview(v)].*

FRS 102 applies to public benefit entities (PBEs) and other entities, not just to companies. *[FRS 102.1.2].* Paragraph numbers in the standard prefixed with a 'PBE' are applicable to public benefit entities and are not applied directly or by analogy to entities that are not public benefit entities (other than, where specifically directed, entities within a public benefit entity group). A public benefit entity must apply all paragraphs prefixed with a 'PBE' to the extent that they are relevant, provided that any SORP relating to that public benefit entity permits it. *[FRS 102.1.2].* These paragraphs are generally found in Section 34 but are not restricted to that section. See Chapter 36 at 6 and 2.5.2 below.

An entity applying FRS 102 must ensure it complies with any relevant legal requirements applicable to it. FRS 102 does not necessarily contain all legal disclosure requirements. FRS 102 Section 1A includes most legal disclosures for small companies but, for example, those only relevant when the financial statements have been audited are not included. *[FRS 102.1.2A].* See Chapter 5 at 5 for disclosures required for small companies (and LLPs), including those not included in FRS 102 Section 1A. For CA 2006 disclosure requirements for entities other than small entities, see Chapter 1 at 5.

2.1 Basis of preparation of financial statements

FRS 102 states that a UK entity required by the CA 2006 (or other legislation or regulation) to prepare consolidated financial statements in accordance with adopted IFRS must do so. Adopted IFRS refers to the IFRS Accounting Standards that have been adopted in the relevant jurisdiction. *[FRS 102.1.3].* In the UK, this is referred to as UK-Adopted International Accounting Standards. *[FRS 102 Appendix I].* The individual financial statements of such UK entity, or the individual financial statements or consolidated financial statements of any other UK entity, must be prepared in accordance with the following requirements:

- If the financial statements are the individual financial statements of an entity that is eligible to apply FRS 105 (and the entity chooses to do so), FRS 105
- Or
- If the financial statements are those of an entity that is not eligible to (or is eligible to but chooses not to) apply FRS 105, the financial statements must be prepared in accordance with:
 - (a) FRS 102
 - (b) UK-Adopted International Accounting Standards
- Or
- (c) FRS 101 (if the financial statements are individual financial statements of a qualifying entity) (see Chapter 2). *[FRS 102.1.3].*

The above requirements in Section 1 largely reinforce and are consistent with the general requirements on basis of preparation of financial statements in FRS 100. FRS 100 sets out the applicable financial reporting framework for entities preparing financial statements, intended to give a true and fair view, in accordance with legislation, regulations or accounting standards applicable in the UK and the Republic of Ireland. *[FRS 100.1, FRS 100.2].* However, FRS 100 sets out the choices available slightly different to Section 1 (see Chapter 1 at 3.3). FRS 100 states that the choice in (a) and (b) above relates to financial statements, whether consolidated or individual financial statements, that are not required by the CA 2006 (or other legislation or regulation) to be prepared in accordance with UK-Adopted International Accounting Standards. *[FRS 100.4].* While the CA 2006 does not require individual financial statements of UK companies with securities admitted to trading on a regulated market to be prepared in accordance with UK-Adopted International Accounting Standards, some UK companies may be subject to other regulations that do require the application of UK-Adopted International Accounting Standards in individual financial statements.

FRS 105 can be applied by a UK company, qualifying partnership, or LLP that meets the eligibility conditions to apply, and is not excluded from, the micro-entities regime. See Chapter 1 at 3.3.5

FRS 102 can also be used by entities that are not subject to the CA 2006 (or the CA 2014 in the Republic of Ireland). An entity's choice of financial reporting framework must be permitted by the legal framework or other regulations or requirements that govern the preparation of the entity's financial statements. Other agreements or arrangements (such as shareholders' agreements or banking agreements) may restrict the choice of financial reporting framework.

The basis of preparation of financial statements in the UK is addressed in more detail in Chapter 1 at 3.3.

The requirements of the CA 2006 (and certain other regulatory rules) governing preparation of financial statements by UK companies are discussed in Chapter 1 at 5. The CA 2006 exemptions available to small companies, small LLPs and small qualifying partnerships are addressed in Chapter 5 at 6, which includes discussions on how FRS 102 interacts with the CA 2006 exemptions for small companies, LLPs and qualifying partnerships, where a small entity chooses not to apply FRS 102 Section 1A (see 2.2 below).

2.2 Basis of preparation of financial statements for small entities

Small entities (as defined in Chapter 5 at 2.1) are entitled to apply Section 1A of FRS 102. If a small entity chooses not to apply the small entities regime, the entity must prepare its financial statements in accordance with FRS 102, excluding Section 1A. [FRS 102.1A.2].

Small entities applying Section 1A follow the same recognition and measurement principles as full FRS 102 but the presentation and disclosure requirements in Section 1A, which are based on the statutory requirements applicable to companies subject to the small companies regime (and LLPs subject to the small LLPs regime), are somewhat lighter than those that apply in full FRS 102. See Chapter 5 for a full discussion of the requirements of Section 1A.

A small entity, whether or not applying Section 1A, also benefits from:

- An exemption from the preparation of a cash flow statement (see Chapter 7 at 2.1).
- And
- An exemption from the preparation of consolidated financial statements (see Chapter 8 at 3.1.1.D).

2.3 Application of SORPs

SORPs recommend accounting practices for specialised industries or sectors, and supplement accounting standards and other legal and regulatory requirements in light of the special factors prevailing or transactions undertaken in a particular industry or sector. [FRS 102 Appendix I].

FRS 102 makes reference to current SORPs (to the extent the provisions are in effect) as part of the hierarchy for management to consider when developing and applying accounting policies. [FRS 102.10.5]. See Chapter 9 at 3.1. The provisions of a SORP cease to apply, for instance, where they conflict with a more recent financial reporting standard. [FRS 100.6]. See 1.3.3 above.

Individual SORPs need to be referred to in order to understand the circumstances in which they apply. If a SORP does apply, the entity must state in its financial statements the title of the SORP and whether the financial statements have been prepared in accordance with the SORP's provisions that are currently in effect. If the provisions of the SORP have been departed from, the entity needs to provide a description of how the financial statements depart from the practice recommended by the SORP. In particular, for any treatment not in accordance with the SORP, the entity discloses why the chosen treatment is judged more appropriate to the entity's circumstances and in the case of any omitted disclosures recommended by the SORP, the reason for the omission. A small entity in the Republic of Ireland applying the small entities regime in FRS 102 is exempt from this requirement, but such an entity is encouraged to provide the disclosures. [FRS 102.1.7A, FRS 100.6]. No such exemption is available for small entities in the UK.

2.4 Extension of specific IFRSs to certain types of entities

As FRS 102 is accessible to a wider scope of entities than the IFRS for SMEs Accounting Standard, the FRC has extended its requirements (compared to the IFRS for SMEs Accounting Standard) to address specific issues by way of direct references to adopted IFRS. These IFRS Accounting Standards apply with the same scope as contained within the individual IFRS Accounting Standards, as follows:

- IAS 33. This standard applies to an entity whose ordinary shares or potential ordinary shares are publicly traded or that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market, or an entity that chooses to disclose earnings per share. *[FRS 102.1.4]*.
- IFRS 6. This standard applies to an entity that is engaged in the exploration for and/or evaluation of mineral resources (extractive activities). *[FRS 102.34.11]*.
- IFRS 8. This standard applies to an entity whose debt or equity instruments are publicly traded, or that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, or an entity that chooses to provide information described as segment information. If an entity discloses disaggregated information, but that information does not comply with IFRS 8's requirements, the information is not described as segment information. *[FRS 102.1.5]*. See Chapter 6 at 2.7.

References to other IFRS Accounting Standards made in IAS 33, IFRS 6 or IFRS 8 are taken to be references to the relevant section or paragraph made in FRS 102 (except that when applying paragraph 21 of IFRS 6, a cash generating unit or group of cash generating units must be no larger than an operating segment (as defined in FRS 102's Glossary) and the reference to IFRS 8 is ignored). *[FRS 102.1.7, FRS 102.34.11A, FRS 102.34.11B]*.

FRS 102 is not applicable to insurance contracts (including reinsurance contracts) issued or held by an entity, nor to financial instruments with a discretionary participation feature that an entity issues. Instead, an entity must apply FRS 103 to such contracts and instruments. *[FRS 102.1.6, FRS 103.1.2]*. This scope may be wider than entities that are legally insurers for legal or supervisory purposes. See Chapter 38 for information on FRS 103.

2.5 Specialised activities

Section 34 of FRS 102 is devoted to additional requirements specific to specialised activities. These address:

- Financial institutions (disclosures) (see 2.5.1 below)
 - Agricultural activities
 - Extractive activities
 - Service concession arrangements
 - Heritage assets
 - Funding commitments
 - Incoming resources from non-exchange transactions
 - Retirement benefit plans (accounting for retirement benefit plans and disclosures for such plans are not within the scope of this publication)
- And
- Public benefit entities (see 2.5.2 below)

Importantly, Section 34 sets out requirements on certain areas not addressed directly by previous UK accounting standards or IFRS Accounting Standards. FRS 102's requirements on specialised activities are addressed in Chapter 36.

2.5.1 Disclosure requirements for financial institutions required by Section 34

A financial institution that is a qualifying entity is not entitled to make use of the disclosure exemptions from Sections 11 and 12 when applying the reduced disclosure framework in its individual financial statements (see 3 below). *[FRS 102.1.9]*.

Section 34 of FRS 102 includes additional disclosure requirements for financial institutions (see definition at 2.5.1.A below) in financial statements prepared in accordance with FRS 102.

These disclosure requirements set out in paragraphs 19 to 33 of Section 34 must be provided in:

[FRS 102.34.17]

- The individual financial statements of a financial institution
- And
- The consolidated financial statements of a group containing a financial institution when the financial institution's financial instruments are material to the group.

Disclosures are required in the consolidated financial statements of a group containing a financial institution even if the principal activities of the group itself are not being a financial institution. This has an implication for group accounts where a group company is identified as a financial institution (see 2.5.1.A below). Disclosures will be required in the group accounts in relation to financial instruments of the group company (to the extent the transactions have not eliminated on consolidation), where these are material to the group.

The additional disclosures required by financial institutions are set out in Chapter 15 at 4.1.4.

2.5.1.A Definition of a financial institution

In broad terms, financial institutions are entities that hold assets in a fiduciary capacity or take deposits, including credit unions, building societies and investment entities. [FRS 102.BC.B34D.1]. However, the FRC has opted not to provide a generic definition of a financial institution. Instead, it has provided a list of entities that are financial institutions. A financial institution is stated to be any of the following: [FRS 102 Appendix I]

Extract from FRS 102

Appendix I Glossary

financial institution

Any of the following:

- (a) a bank which is:
 - (i) a with a Part4A permission which includes accepting deposits and:
 - (a) which is a credit institution; or
 - (b) whose Part 4A permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, a friendly society or a credit union;
 - (ii) an EEA bank which is a full credit institution;
- (b) a building society which is defined in section 119(1) of the Building Societies Act 1986 as a building society incorporated (or deemed to be incorporated) under that act;
- (c) a credit union, being a body corporate registered under the Co-operative and Community Benefit Societies Act 2014 as a credit union in accordance with the Credit Unions Act 1979, which is an authorised person;
- (d) a custodian bank or broker-dealer;
- (e) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities;
- (f) an incorporated under the Friendly Societies Act 1992 or a registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment which it replaced, including any registered branches;
- (g) an investment trust, Irish investment company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC); or
- (h) [Deleted]
- (i) any other entity whose principal activity is similar to those listed above but is not specifically included in that list.

A parent entity whose sole activity is to hold investments in other group entities is not a financial institution.

Retirement benefit plans are not financial institutions as they are not deemed to be similar to the other institutions in the list. Stockbrokers also are not considered to be financial institutions as they are considered to be generally dissimilar from other entities as they do not hold financial instruments on behalf of others. [FRS 102.BC.B34D.6, FRS 102.BC.B34D.7]

Whether or not a group treasury company is a financial institution will depend on the individual facts and circumstances. Judgement will need to be applied in determining whether a group treasury company is similar to the other entities listed in the definition of a financial institution. [FRS 102.BC.B34D.8].

If the risks arising from financial instruments are particularly significant to a business, additional disclosure may be required to enable users to evaluate the significance of those instruments, regardless of whether the entity meets the definition of a financial institution. If a group entity ceases to meet the definition of a financial institution, the disclosures relating to both the individual financial statements and the consolidated financial statements will no longer be required. [FRS 102.BC.B34D.9].

Identifying a group entity as a financial institution impacts both the disclosures that need to be given in the individual financial statements of that entity (prepared in accordance with FRS 102) and, where the financial instruments of the financial institution are material to the group, in the consolidated financial statements including the entity (where prepared in accordance with FRS 102) (see 2.5.1 above).

2.5.2 Public benefit entities

Paragraphs in FRS 102 that are prefixed by PBE are specific to public benefit entities (see definition in the Glossary to FRS 102 and discussed further in Chapter 36 at 6). These paragraphs must not be applied directly, or by analogy, to entities that are not public benefit entities (other than, where specifically directed, entities within a public benefit entity group, i.e., a public benefit entity parent and all its wholly-owned subsidiaries). [FRS 102.1.2].

Section 34 addresses incoming resources from non-exchange transactions, public benefit entity combinations, and public benefit entity concessionary loans. These parts of Section 34 include paragraphs prefixed by PBE and, therefore, apply only to public benefit entities. Other sections of FRS 102 also contain paragraphs prefixed by PBE. Section 34 also addresses other accounting topics such as heritage assets and funding commitments, which may be of particular relevance to some public benefit entities (as the paragraphs are not prefixed by PBE), but apply to all entities. See Chapter 36 at 6 and Chapter 24 at 3.10. Many public benefit entities may also be subject to the requirements of a SORP (see 1.3.3 and 2.3 above).

3 Reduced disclosure framework for qualifying entities

Extract from FRS 102

- 1.8** A qualifying entity (for the purposes of this FRS) which is not a financial institution may take advantage in its individual financial statements of the disclosure exemptions set out in paragraph 1.12.
- 1.9** A qualifying entity (for the purposes of this FRS) which is a financial institution may take advantage in its individual financial statements of the disclosure exemptions set out in paragraph 1.12, except for the disclosure exemptions from Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments Issues.

FRS 102 provides for a reduced disclosure framework available only in the individual financial statements of a 'qualifying entity' (see 3.1 below). [FRS 102.1.8, FRS 102.1.9]. A qualifying entity which is required to prepare consolidated financial statements (for example, it is a parent company required by section 399 of the CA 2006 to prepare group accounts and is not entitled to any of the exemptions in sections 400 to 402 of the CA 2006 or chooses not to take advantage of these exemptions) may not take advantage of the disclosure exemptions in its consolidated financial statements. [FRS 102.1.10]. This does not preclude the reduced disclosure framework being applied in the individual financial statements of a parent preparing consolidated financial statements.

Individual financial statements to which FRS 102 applies are the accounts that are required to be prepared by an entity in accordance with the CA 2006 or relevant legislation, for example: 'individual accounts' as set out in section 394 of the CA 2006, a 'statement of accounts' as set out in section 132 of the Charities Act 2011, or 'individual accounts' as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of the term 'individual financial statements'.

[FRS 102 Appendix I].

It is worth noting that FRS 102 uses the term 'separate financial statements' to mean those presented by a parent in which investments in subsidiaries, jointly controlled entities or associates are accounted for either at cost or fair value rather than on the basis of the reported results and net assets of the investees.

[FRS 102 Appendix I]. This differs to the definition of 'separate financial statements' in IFRSs. [IAS 27.4].

This means that FRS 102's reduced disclosure framework can be used in:

- Individual financial statements of subsidiary undertakings
 - Separate financial statements of an intermediate parent undertaking which does not prepare consolidated financial statements
- And
- Separate financial statements of a parent undertaking which does prepare consolidated financial statements.

However, the entity applying FRS 102's reduced disclosure framework must be included in a set of publicly available consolidated financial statements intended to give a true and fair view (see 3.1.6 below).

A parent company that prepares consolidated financial statements but applies FRS 102 in its individual financial statements can also use the exemption in section 408 of the CA 2006 from presenting a profit and loss account and related notes in the individual financial statements. This is the case whether or not it applies FRS 102's reduced disclosure framework.

3.1 Definition of a qualifying entity

Extract from FRS 102

Appendix I Glossary

qualifying entity (for the purposes of this FRS)

A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation.

A charity can be a qualifying entity under FRS 102, unlike under FRS 101. *[FRS 101 Appendix I, FRS 102 Appendix I]*.

There is no requirement that a qualifying entity is a member of the group in which it is consolidated for its entire reporting period. There is also no requirement that the financial statements of the qualifying entity and the consolidated financial statements of the parent of that group (which may be the reporting entity itself) must be coterminous (i.e., they have the same reporting periods).

How we see it

In our view, an entity meets the definition of a qualifying entity even if the entity is not included in the consolidated financial statements of the group for its entire reporting period, or that the financial statements of the parent of that group and the entity are not coterminous (i.e., have similar reporting periods). The use of the present tense in the definition of qualifying entity in the standard implies that the intention is only that the qualifying entity (where it does not prepare its own consolidated financial statements) is a subsidiary of the parent at its reporting date. This view is consistent with UK Company Law which requires that an entity which is a parent at the end of the financial year must prepare group accounts unless it is exempted from the requirement.

However, when the consolidated financial statements of the group and the qualifying entity's individual statements are not coterminous (i.e., they have different reporting periods), care must be applied in determining which exemptions a qualifying entity may be able to take. Some of the disclosure exemptions may not be available to the qualifying entity because the consolidated financial statements may not contain the 'equivalent' disclosures (see 3.5 below).

There is no requirement for the consolidated financial statements in which the qualifying entity is included to be prepared under FRS 102 nor that the parent that prepares the consolidated financial statements is a UK entity. However, the consolidated financial statements must be intended to give a true and fair view (see 3.1.6 below).

3.1.1 Publicly available consolidated financial statements

The definition of a qualifying entity (see 3.1 above) makes reference to a parent that prepares publicly available consolidated financial statements. FRS 102 requires that the consolidated financial statements of the parent can be accessed by the public as the use of FRS 102's reduced disclosure framework is conditional on a disclosure by the qualifying entity indicating from where those consolidated financial statements can be obtained (see 3.2 below). This does not mandate that the consolidated financial statements must be filed with a regulator. Therefore, for example, UK consolidated financial statements that have not been filed with the Registrar of Companies must be publicly available via some other medium.

3.1.2 Definition of 'group' and 'subsidiary'

The definition of a qualifying entity contains a footnote that refers to section 474(1) of the CA 2006 which defines a 'group' as a 'parent undertaking and its subsidiary undertakings'. *[s474(1)]*.

The CA 2006 states that an undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if:

- It holds a majority of the voting rights in the undertaking. *[s1162(2)]*.
- It is a member of the undertaking and has the right to appoint or remove a majority of its board of directors *[s1162(2)]*
- It has the right to exercise a dominant influence over the undertaking by virtue of provisions contained in the undertaking's articles or by virtue of a control contract *[s1162(2)]*
- It is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking *[s1162(2)]*
- It has the power to exercise, or actually exercises, dominant influence or control over it *[s1162(4)]*

Or

- It and the subsidiary undertaking are managed on a unified basis *[s1162(4)]*

An undertaking is treated as a member for the purposes above if any of its subsidiary undertakings is a member of that undertaking or if any shares in that other undertaking are held by a person acting on behalf of the undertaking or any of its subsidiary undertakings. *[s1162(3)]*.

A parent undertaking must be treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings, and references to its subsidiary undertakings are construed accordingly. [s1162(5)]. Schedule 7 to the CA 2006 provides interpretation to terms used in Section 1162 of CA 2006. [s1162(6)]. References to 'shares' in Section 1162 and in Schedule 7 are to 'allotted shares'. [s1162(7)].

FRS 102 defines a subsidiary as an entity, including an unincorporated entity such as a partnership, that is controlled by the parent. [FRS 102 Appendix I]. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [FRS 102 Appendix I]. FRS 102 goes on to explain in which circumstances control exists or can exist. [FRS 102.9.4, FRS 102.9.5, FRS 102.9.6, FRS 102.9.6A]. These circumstances are similar, but not identical to, those included in the definition of a subsidiary undertaking under Section 1162 of CA 2006.

Although there are slight differences in wording emphasis between the definition of a subsidiary undertaking in Section 1162 of CA 2006 and the requirements of Section 9 *Consolidated and Separate Financial Statements*, we would expect to see few conflicts arising in practice between Section 9 and the CA 2006 (see Chapter 8 at 3.2). The key issue for the application of FRS 102's reduced disclosure framework is whether the subsidiary is included in the parent's consolidated financial statements. A company that meets the definition of a subsidiary undertaking under the CA 2006 but is not included in the consolidated financial statements of its parent cannot apply FRS 102's reduced disclosure framework.

3.1.3 Entity included in the consolidation

The phrase 'included in the consolidation' (which may also be referred to as 'included in consolidated group accounts') is referenced to Section 474(1) of the CA 2006 which states that this means that 'the undertaking is included in the accounts by the method of full (and not proportional) consolidation and references to an undertaking excluded from consolidation must be construed accordingly'. Therefore, entities that are not fully consolidated in the consolidated financial statements, such as subsidiaries excluded from consolidation under FRS 102 [FRS 102.9.9, FRS 102.9.9A] or subsidiaries of investment entities that are accounted for at fair value through profit or loss under IFRS 10 *Consolidated Financial Statements*, cannot use FRS 102's reduced disclosure framework. Associates and jointly controlled entities are not qualifying entities since they are not members of a group (see 3.1.2 above).

3.1.4 Non-UK qualifying entities

There is no requirement that a qualifying entity is a UK entity. Non-UK entities can apply FRS 102's reduced disclosure framework in their individual or separate financial statements subject to meeting the criteria for its use, and provided FRS 102 is allowed for use in their own jurisdiction.

3.1.5 Non-controlling interests

There is no ownership threshold for a subsidiary to apply FRS 102's reduced disclosure framework. Therefore, a qualifying entity can apply the reduced disclosure framework even if its parent holds less than a majority of the voting rights, provided that the parent has control via other means (see Chapter 8 at 3.2).

3.1.6 Intended to give a true and fair view

The definition of a qualifying entity (see 3.1 above) does not require the consolidated financial statements in which the qualifying entity is included to give an explicit true and fair view of the assets, liabilities, financial position and profit or loss. Rather, the requirement is that the consolidated financial statements are 'intended to give a true and fair view'. This means that the consolidated financial statements in which the qualifying entity is consolidated need not contain an explicit opinion that they give a 'true and fair view' but, in substance, they are intended to give such a view. The FRC guidance *True and Fair* issued in June 2014 states that 'Fair presentation under IFRS (IFRS Accounting Standards) is equivalent to a true and fair view'¹⁵. It is therefore implied that financial statements prepared under equivalent standards to IFRS Accounting Standards can also give a true and fair view. See 3.1.6.A below for considerations in determining whether the financial reporting framework in which the consolidated financial statements are prepared, is 'intended to give a true and fair view'.

15 [True and Fair](#), Financial Reporting Council, page 1

3.1.6.A Considerations in determining whether preparing financial statements under a financial reporting framework is intended to give a true and fair view

This section discusses the considerations in determining whether preparing financial statements under a financial reporting framework is intended to give a true and fair view.

A UK parent company that wishes to claim an exemption from preparing group accounts under either Section 400 or Section 401 of the CA 2006 must be a subsidiary included in the consolidated accounts of a larger group. Those consolidated accounts (and where appropriate, the group's annual report) must be drawn up: [s400(2)(b), s401(2)(b)]

- In accordance with UK-adopted international accounting standards (for Sections 400 and 401).
- If the undertaking is a company, in accordance with the requirements of Part 15 of CA 2006, or if the undertaking is not a company, the legal requirements which apply to the drawing of consolidated accounts for that undertaking (for Section 400).
- In a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with the requirements of Part 15 of CA 2006 (for Section 401).

Or

- In accordance with accounting standards which are equivalent to UK-adopted international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 (for Section 401).

There are similar requirements for a parent LLP but for Section 401 of the LLP regulations, there is no reference to the basis on which the consolidated reports are drawn up. [s400(2)(b)(LLP), s401(2)(b)(LLP)].

How we see it

In our view, a set of consolidated financial statements that would meet the above criteria is intended to give a true and fair view.

The Application Guidance to FRS 100 states that consolidated financial statements of the higher parent will meet the condition that these are drawn up in a manner equivalent to consolidated accounts and consolidated reports drawn up in accordance with Part 15 of CA 2006, if they are intended to give a true and fair view and:

- Are prepared in accordance with FRS 102
- Or
- Are prepared using other Generally Accepted Accounting Principles (GAAPs) which are closely related to IFRS Accounting Standards, subject to consideration of the effect of any differences from UK-adopted international accounting standards.

Consolidated financial statements of the higher parent prepared in any other manner must be assessed for equivalence with Part 15 of CA 2006 based on the particular facts, including the similarities to and differences from the requirements of Part 15 of CA 2006. [FRS 100.AG14].

In determining whether the consolidated financial statements are drawn up in accordance with accounting standards equivalent to UK-adopted international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007, the UK government recognised the following GAAP of equivalence to UK-adopted international accounting standards. These include those GAAPs previously recognised by the European Commission as equivalent to EU-adopted IFRS: [FRS 100.AG9]

- GAAP of Canada
- GAAP of the People's Republic of China
- GAAP of Japan
- GAAP of the Republic of Korea
- GAAP of the United States of America
- EU-adopted IFRS
- IFRSs as issued by the IASB

As at the date of the publication of the September 2024 version of FRS 100, the UK has not formally granted the equivalence of any other country's accounting standards to UK-adopted international accounting standards. These include the national accounting standards of EEA states or the IFRS for SMEs Accounting Standard.

The concept of equivalence for the purposes of Section 401 is discussed further in Chapter 8 at 3.1.1.C.

If the group, in which an entity is a member, prepares consolidated financial statements under a GAAP that is not 'equivalent' to UK-adopted international accounting standards, it begs the question as to whether the member can be a qualifying entity.

How we see it

In our view, an entity is not automatically excluded from being a qualifying entity, and from taking exemptions from FRS 102's reduced disclosure framework in its individual financial statements if it is a member of a group where the parent prepares consolidated financial statements under a GAAP that is not 'equivalent' to UK-adopted international accounting standards, provided that, those consolidated financial statements in which the entity is included are publicly available and are intended to give a true and fair view. Care must be applied in determining which exemptions a qualifying entity may be able to take.

A number of the disclosure exemptions under FRS 102's reduced disclosure framework are conditional on 'equivalent' disclosures being made in those publicly available consolidated financial statements in which the qualifying entity is included. [FRS 102.1.13]. Where the equivalent disclosure is not made, the relevant disclosure exemptions cannot be applied in the qualifying entity's individual financial statements prepared under FRS 102 (see 3.5 below). A GAAP that is not 'equivalent' to the UK-adopted international accounting standards is less likely to have those 'equivalent' disclosures.

One issue not addressed by FRS 102 is the impact of a qualified audit opinion on the parent's consolidated financial statements. A Queen's Counsel's opinion, obtained by the FRC in 2008, stated that 'the scope for arguing that financial statements which do not comply with relevant accounting standards nevertheless give a true and fair view, or a fair presentation, is very limited'.¹⁶

3.2 Use of the disclosure exemptions

The use of the disclosure exemptions in FRS 102's reduced disclosure framework (see 3.3 below) is conditional on all of the following criteria being met:

- The reporting entity applies the recognition, measurement and disclosure requirements of FRS 102.
And
- The reporting entity discloses in the notes to its financial statements:
 - (a) A brief narrative summary of the disclosure exemptions adopted.
And
 - (b) The name of the parent of the group in whose consolidated financial statements its financial statements are consolidated (i.e., the parent identified in the definition of 'qualifying entity') and from where those financial statements may be obtained. [FRS 102.1.11].

There is no requirement to list all the disclosure exemptions in detail. Reporting entities can also choose to apply the disclosure exemptions on a selective basis. This may be necessary, for example, where not all the relevant 'equivalent disclosures' are made in the consolidated financial statements of the parent on the grounds of materiality (see 3.5 below).

FRS 102 did not clarify as to whether the consolidated financial statements must be prepared before the individual financial statements of the qualifying entity in order for a qualifying entity to take advantage of the exemptions available under the reduced disclosure framework.

3.3 Disclosure exemptions for qualifying entities

A qualifying entity may take advantage of the following disclosure exemptions in its individual financial statements: [FRS 102.1.12]

- The requirements of Section 7 *Statement of Cash Flows*, and Section 3 *Financial Statement Presentation*, paragraph 3.17(d) (see 3.3.1 below), provided that in the case of paragraph 7.20C, which relates to supplier finance disclosures, equivalent disclosures are included in the consolidated financial statement in which the qualifying entity is included

¹⁶ [The Financial Reporting Council: The True and Fair Requirement Revisited - Opinion by Martin Moore QC, May 2008](#), para. 4(F).

- The requirements of:
 - (a) Section 11, paragraphs 11.42, 11.44, 11.45, 11.47, 11.48(a)(iii), 11.48(a)(iv), 11.48(b) and 11.48(c).
 - And
 - (b) Section 12 paragraphs 12.26 (in relation to those cross-referenced paragraphs from which a disclosure exemption is available), 12.27, 12.29(a), 12.29(b), 12.29A and 12.30.

These disclosure exemptions are subject to certain conditions and exceptions. See 3.3.2 and 3.4 below.
- The requirements of Section 20 *Leases*, paragraphs 20.80(f) and 20.116 (see 3.3.3 below).
- The requirements of Section 23 *Revenue*, paragraphs 23.131, 23.132, 23.133(a), 23.135(a) to 23.135(c), 23.136, 23.137 and 23.139 (see 3.3.4 below).
- The requirements of Section 26 *Share-based Payment*, paragraphs 26.18(b), 26.19 to 26.21 and 26.23, provided that for a qualifying entity that is:
 - (a) A subsidiary, the share-based payment arrangement concerns equity instruments of another group entity.
 - (b) An ultimate parent, the share-based payment arrangement concerns its own equity instruments and its separate financial statements are presented alongside the consolidated financial statements of the group.

And, in both cases, provided that the equivalent disclosures required by FRS 102 are included in the consolidated financial statements of the group in which the entity is consolidated (see 3.3.5 below)

- The requirement of Section 29 *Income Tax*, paragraphs 29.28(b) and 29.29, provided that disclosures equivalent to those required by FRS 102 are included in the consolidated financial statements of the group in which the entity is consolidated (see 3.3.6 below).
- The requirement of Section 33 *Related Party Disclosures*, paragraph 33.7 (see 3.3.7 below).
- The requirements of paragraph 24(b) of IFRS 6 to disclose the operating and investing cash flows arising from the exploration for and evaluation of mineral resources (see 3.3.8 below).

Qualifying entities must still ensure that they comply with any relevant legal requirements. FRS 102 does not necessarily contain all legal disclosure requirements. [FRS 102.1.2A].

3.3.1 Statement of cash flows

The exemption removes the requirement for a cash flow statement for any qualifying entity in its individual financial statements. This also removes the following disclosure requirements for supplier finance arrangements, if the equivalent disclosures are made in the consolidated financial statements in which the qualifying entity is included: [FRS 102.1.12(b)]

- The key terms and conditions of the arrangements.
- As at the end of the reporting period, the carrying amounts and associated line items presented in the statement of financial position of the financial liabilities that are part of the supplier finance arrangement, and the range of payment due dates for both the financial liabilities that are part of the supplier finance arrangement, and comparable trade payables that are not part of the supplier finance arrangement.
- And
- The type and effect of non-cash changes in the carrying amounts of the financial liabilities that are part of a supplier finance arrangement. [FRS 102.7.20(c)]

3.3.2 Financial instruments

The exemption removes certain of the disclosure requirements of Sections 11 and 12 (see 3.3 above). [FRS 102.1.12(c)]. Financial institutions are not permitted to use this exemption.

The exemption depends on there being equivalent disclosures in the publicly available consolidated financial statements in which the qualifying entity is included. The guidance on 'equivalence' included in FRS 100 (see 3.5 below) is clear that the exemption can be taken in relation to intra-group balances that are eliminated on consolidation in these consolidated financial statements. [FRS 100.AG26]

Notwithstanding this exemption, when a qualifying entity that is not a financial institution has financial instruments held at fair value under UK-adopted international accounting standards, it must give the disclosures required by UK-adopted international accounting standards (see 3.4 below). [1 Sch 36(4), 1 Sch 36(4)(LLP)].

The reduction in disclosure exemptions in relation to Sections 11 and 12 applies even if the qualifying entity is not subject to UK company and LLP law. See Chapter 15 at 4 for details of disclosure requirements for financial instruments that apply to all entities, including qualifying entities.

3.3.2.A Other disclosures required by the Regulations for financial instruments

Qualifying entities must also ensure that they comply with any relevant legal requirements. FRS 102 does not necessarily contain all legal disclosure requirements. [FRS 102.1.2A].

FRS 102 financial statements prepared in accordance with Part 15 of the CA 2006 are Companies Act accounts. A UK company's statutory accounts prepared in accordance with FRS 102 must give the disclosures in respect of financial instruments required by the Regulations (or by the Small Companies Regulations) even if the company is a qualifying entity using the reduced disclosure framework. Similarly, a UK LLP must comply with the disclosure requirements of the LLP Regulations (or the Small LLP Regulations).

In particular, qualifying entities that are preparing Companies Act accounts must provide the disclosures required by paragraph 55 of Schedule 1 to the Regulations (and its equivalents in the Small Companies Regulations, LLP Regulations and Small LLP Regulations) which set out requirements relating to financial instruments at fair value. [1 Sch 55]. These disclosures relate to financial instruments held at fair value generally and not just to those financial instruments measured at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents). FRS 102 reporters applying IFRS 9 or IAS 39 to the recognition and measurement of financial instruments may have financial instruments measured at fair value, but with fair value changes outside profit and loss. Appendix III to FRS 102 states that most of these disclosures will be satisfied by equivalent requirements of FRS 102 but cautions that entities will need to take care to ensure appropriate disclosure of derivatives is provided. [FRS 102.A3.12D]. In addition, the Regulations contain disclosures that have not been included in FRS 102 concerning investments and loans. Care is needed to ensure compliance with the statutory requirements in addition to the disclosures listed in the standard. See Chapter 15 at 4 for details of statutory disclosures for financial instruments required in the accounts of UK entities. For further details on required disclosures for financial instruments held at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations, see 3.4 below.

The Regulations also require that the directors' report of a UK company must contain, in relation to the use of financial instruments, an indication of the financial risk management objectives, policies (including the policy for hedging each major type of forecasted transaction for which hedge accounting is used) and the exposure of the company to price risk, credit risk, liquidity risk and cash flow risk, unless not material. In respect of a group directors' report, this information is required for the company and its consolidated subsidiary undertakings. [7 Sch 6]. These requirements do not apply to LLPs.

3.3.3 Leases

For lessees, the exemption removes the requirement to disclose the total cash outflow for leases.

For lessors, the exemption removes the requirement to disclose:

- For finance leases, the selling profit or loss, finance income on the net investment in the lease, and income relating to variable lease payments which are not included in the measurement of the net investment in lease.
- For operating leases held by a lessor, a qualifying entity is not required to disclose lease income. [FRS 102.1.12(cA)]

3.3.4 Revenue from contracts with customers

This exemption removes most of the disclosure requirements in Section 23 (see Chapter 25 at 11.4). An entity, regardless of whether it is a qualifying entity or not, is required to disclose the following in its financial statements:

- Unless presented separately in the statement of comprehensive income (or income statement), the impairment losses recognised (applying Section 11) on receivables or contract assets from entity's contracts with customers. Any impairment losses on receivables or contract assets from other contracts must be separately disclosed. [FRS 102.23.133(b)]

- The opening and closing balances of receivables and contract balances (contract assets and liabilities), if they are not disclosed or presented separately. *[FRS 102.23.134(a)]*
- Revenue recognised in the current period that was included in the balance of the contract liability at the beginning of the period. *[FRS 102.23.134(b)]*
- The revenue recognised in the current period from performance obligations satisfied or partially satisfied in previous periods. An example of this is revenue recognised from changes in estimates of variable consideration. *[FRS 102.23.134(c)]*
- The description of obligations for returns, refunds and other similar obligations *[FRS 102.23.134(d)]*
- The description of types of warranties and related obligations *[FRS 102.23.134(e)]*
- The closing balances of assets recognised from the costs incurred to obtain or fulfil a contract, categorised appropriately (for example, by splitting amount to costs to obtain contracts with customers, pre-contract costs, and set-up costs). *[FRS 102.23.138(a)]*
- The amount of the amortisation and impairment losses in the period from assets recognised from costs incurred to obtain or fulfil a contract.

3.3.5 Share-based payment

The reduced disclosure framework in FRS 102 provides exemption for all the disclosure requirements of Section 26 (see Chapter 28 at 14) except for the following:

- A description of each type of share-based payment arrangements that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity). An entity with substantially similar types of share-based payment arrangement may aggregate this information. *[FRS 102.26.18(a)]*

And

- If the entity is part of a group share-based payment arrangement, and it measures its share-based payment expense on the basis of a reasonable allocation of the expense recognised for the group, it must disclose that fact and the basis for the allocation. *[FRS 102.26.22]*.

The exemption may only be taken by a subsidiary if the share-based payment arrangement concerns the equity instruments of another group entity, or by an ultimate parent entity if the share-based payment arrangement concerns its own equity instrument and its separate financial statements are presented alongside the consolidated financial statements. In addition to this, the exemption may only be taken if the disclosures equivalent to those required by FRS 102 are included in the consolidated financial statements in which the qualifying entity is included.

3.3.6 Income tax

Disclosure exemptions for qualifying entities in Section 29 apply only if an entity is in scope or is expected to be in scope of Pillar Two legislation. In this instance, a qualifying entity is only required to disclose the fact that it is, or it is expected to be within the scope of Pillar Two rules, provided that disclosures equivalent to those required by FRS 102 are included in the consolidated financial statements in which the qualifying entity is included. *[FRS 102.1.12(dA)]*.

3.3.7 Related party transactions

This exemption removes the requirement to disclose key management personnel compensation in total. *[FRS 102.1.12(e)]*.

3.3.8 Extractive activities

If an entity is engaged in the exploration for and/or evaluation of mineral resources, an entity applies the requirements of IFRS 6, as adopted in the relevant jurisdiction. *[FRS 102.34.11]*. A qualifying entity, applying IFRS 6, is not required to disclose the operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

3.4 Disclosures required by the Regulations in the financial statements for certain financial instruments held at fair value

The Regulations require several disclosures for financial instruments which are held at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 to the Regulations, the Small Companies Regulations, LLP Regulations and Small LLP Regulations). See 3.4.1 below for a discussion of financial instruments that are in scope of this paragraph. For disclosure requirements relating to these financial instruments, see 3.4.2 below.

3.4.1 Financial instruments at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations

Paragraph 36 of Schedule 1 to the Regulations (and its equivalents) allows financial instruments to be included in the financial statements at fair value, where their fair value can be measured reliably. Paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents) state that “financial instruments which under UK-adopted international accounting standards may be included in accounts at fair value, may be so included, provided that the disclosures required by such accounting standards are made.” [1 Sch 36(4), 1 Sch 36(4)(LLP)]. Following the adoption by the UK of IFRS 9, IFRS 9 is now the principal point of reference for which financial instruments may be included in the accounts at fair value when referring to paragraph 36(4) of Schedule 1 to the Regulations. The Regulations (and its equivalents) were written with the application of the previously extant IAS 39 in mind. Terms such as ‘loans and receivables’, ‘held to maturity’ and ‘held for trading’ are not defined in FRS 102. The Regulations indicate that these terms are defined in the Accounting Directive (Directive 2013/34/EC) and Directive 91/674/EEC (for insurance undertakings) and in paragraph 96 of Schedule 2 to the Regulations (for banking companies). [10 Sch 3(1), 4 Sch 2(1)(LLP)]. Some of these terms are no longer used in IFRS 9 and therefore it would be necessary to refer back to definitions under the version of IAS 39 extant immediately before the introduction of IFRS 9.

Paragraphs 36(2) and 36(3) of Schedule 1 to the Regulations (and their equivalents) exclude certain types of financial instruments from being measured at fair value, unless these are permitted to be held at fair value by paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents). [1 Sch 36, 2 Sch 44, 3 Sch 30, 1 Sch 36(SC), 1 Sch 36(LLP), 1 Sch 36(LLP SC)]. These financial instruments are as follows:

- Financial liabilities, unless they are held as part of a trading portfolio or are derivatives.
 - Financial instruments (other than derivatives) held to maturity.
 - Loans and receivables originated by the company (or the LLP) and not held for trading purposes.
 - Interests in subsidiary undertakings, associated undertakings and joint ventures.
 - Equity instruments issued by the company (or the LLP).
 - Contracts for contingent consideration in a business combination.
- And
- Other financial instruments with such special characteristics that the instruments according to generally accepted accounting principles or practice, are accounted for differently from other financial instruments. [1 Sch 36(2), 1 Sch 36(3), 1 Sch 36(2)(LLP), 1 Sch 36(3)(LLP)].

FRS 102 allows a choice of applying either IAS 39, IFRS 9, or Sections 11 and 12 in the recognition and measurement of financial instruments. [FRS 102.11.2, FRS 102.12.2]. Note that the ability to newly adopt the IAS 39 option is restricted to situations where adopting this option is necessary to achieve consistency with group financial statements. This is possible for example, an entity which had not previously applied the IAS 39 option is acquired by a group that already applies the IAS 39 option. See Chapter 11 at 4. The situations in which financial instruments are carried at fair value under FRS 102 will differ depending on the choice taken.

Sections 11 and 12, where applied to the recognition and measurement of financial instruments, distinguish between basic and other financial instruments. These requirements differ significantly to those of IAS 39 and IFRS 9. Most basic financial instruments (with certain exceptions) are carried at cost or amortised cost, whereas other financial instruments are carried at fair value through profit or loss. For other financial instruments, Section 12 does not permit measurement at fair value through profit or loss where this is not permitted by the Regulations (and its equivalents). [FRS 102.12.8(c)]. Hence the potential for conflict between Sections 11 and 12, and the Regulations (and its equivalents) over financial instruments permitted to be carried at fair value is expected to be limited. See Chapter 13 at 4 for a discussion of the classification and measurement of financial instruments and which financial instruments may be held at fair value under Sections 11 and 12.

Financial instruments that are held at fair value subject to paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents) in FRS 102 financial statements (under any of the accounting choices) therefore include:

- Financial liabilities, which are not held as part of a trading portfolio nor derivatives that:
 - (a) Are designated at fair value through profit or loss because this eliminates or significantly reduces an 'accounting mismatch' or a group of financial assets and/or financial liabilities is managed and its performance evaluated on a fair value basis (IAS 39, IFRS 9 and Section 11 have similar but not identically worded provisions). *[IAS 39.9, IFRS 9.4.2.2, FRS 102.11.14(b)].*
 - (b) Where Sections 11 and 12 are applied, do not qualify as basic financial instruments under Section 11, but would meet the conditions to be measured or designated at fair value through profit or loss under UK-adopted international accounting standards (i.e., under paragraphs 4.3.5 and 4.3.6 of IFRS 9). *[IFRS 9.4.3.5, IFRS 9.4.3.6].*
 - (c) Where IAS 39 or IFRS 9 is applied, are hybrid contracts, but are measured or designated at fair value through profit or loss. *[IAS 39.11A, IAS 39.12, IFRS 9.4.3.5, IFRS 9.4.3.6].*
- Financial assets, which could have been designated as held to maturity (which are not derivatives) or loans and receivables originated by the reporting entity (and which are not held for trading purposes) that:
 - (a) Where IAS 39 is applied, are designated at either available-for-sale or are measured or designated at fair value through profit or loss (i.e., under paragraphs 9, 11A or 12 of IAS 39) - but would meet the conditions to be measured or designated at fair value under UK-adopted international accounting standards (i.e., under paragraphs 4.1.2A, 4.1.4, 4.1.5, 4.3.5 and 4.3.6 of IFRS 9). *[IAS 39.9, IAS 39.11A, IAS 39.12, IFRS 9.4.1.2A, IFRS 9.4.1.4-5, IFRS 9.4.3.5-6].*
 - (b) Where Sections 11 and 12 are applied, are designated at fair value through profit or loss. *[FRS 102.11.14(b)].*
 - (c) Where Sections 11 and 12 are applied, do not qualify as basic financial instruments but would meet the conditions to be measured or designated at fair value through profit or loss under UK-adopted international accounting standards (i.e., under paragraphs of 4.1.4, 4.1.5, 4.3.5 and 4.3.6 of IFRS 9). *[FRS 102.11.14(b), FRS 102.12.8(c), IFRS 9.4.1.45, IFRS 9.4.3.5-6].*

And

 - (d) Are measured at fair value in accordance with IFRS 9 (which is extant UK-adopted international accounting standards). *[IFRS 9.4.1.2A, IFRS 9.4.1.4-5].*

And

- Investments in subsidiaries, associated undertakings and joint ventures measured at fair value through profit or loss in consolidated or individual financial statements. *[FRS 102.9.9, FRS 102.9.9B, FRS 102.9.9C, FRS 102.9.26(c), FRS 102.14.4(d), FRS 102.14.4B, FRS 102.15.9(d), FRS 102.15.9B].* See Chapter 8 at 3.4, 4.1 and 4.2, Chapter 17 at 3.2.1 and Chapter 18 at 3.5.2 and 3.5.3.

FRS 102 permits or requires investments in subsidiaries, associates and joint ventures to be measured at fair value in consolidated and/or individual financial statements in certain circumstances. However, where such investments are held at fair value through profit and loss, these fall within the scope of paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents). The interaction with company and LLP law is explained further in Chapter 13 at 4.4.

Contingent consideration arising in a business combination is not permitted to be held at fair value (whatever accounting policy choice is applied to the recognition and measurement of financial instruments). *[FRS 102.19.12, FRS 102.19.13, FRS 102.BC.A.28].* Equity instruments of the issuer are not held at fair value under Section 22 *Liabilities and Equity*.

3.4.2 Disclosures required for financial instruments at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations

Appendix III to FRS 102 comments that an entity applying FRS 102 and holding financial instruments measured at fair value may be required to provide the disclosures required by paragraph 36(4) of Schedule 1 to the Regulations. *[FRS 102.A3.13].*

As noted at 3.4.1 above, the disclosures required by paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents) are those in extant UK-adopted international accounting standards. The most logical interpretation of this is that an entity needs to make all material disclosures required by IFRS 7 *Financial Instruments: Disclosures* and IFRS 13, in respect of such financial instruments.

However, Appendix III to FRS 102 states that the disclosures required by paragraph 36(4) of Schedule 1 to the Regulations have been incorporated into Section 11. Some of the disclosure requirements of Section 11 apply to all financial instruments measured at fair value, whilst others (such as paragraph 11.48A) apply only to certain financial instruments (this does not include financial instruments held as part of a trading portfolio nor derivatives). The disclosure requirements of paragraph 11.48A will predominantly apply to certain financial liabilities, however, there may be instances where paragraph 36(3) of Schedule 1 to the Regulations requires that the disclosures must also be provided in relation to financial assets, e.g., investments in subsidiaries, associates or jointly controlled entities measured at fair value through profit or loss. [FRS 102.A3.13, FRS 102.9.27B].

How we see it

While the guidance in Appendix III above implies that FRS 102 reporters complying with the disclosures included in Sections 11 (and 12) will meet the disclosure requirements of paragraph 36(4) of Schedule 1 to the Regulations (and its equivalents), we consider that care needs to be taken with both the scope of the disclosures and disclosure requirements. In any event, FRS 102 reminds entities that they must ensure that they comply with any relevant legal requirements applicable to them and that the standard does not necessarily contain all legal disclosure requirements.

The disclosure requirements of Sections 11 and 12 apply to financial instruments within the scope of whichever accounting standard is applied for the recognition and measurement of financial instruments. [FRS 102.11.2, FRS 102.12.2].

Paragraph 11.48A, which is excluded from the disclosure exemptions in the reduced disclosure framework, has a more restricted scope for UK entities. It states that: “An entity in the UK, including an entity that is not a company, must provide the following disclosures for financial instruments measured at fair value through profit or loss in accordance with paragraph 36(4) of Schedule 1 to the Regulations. This does not include financial liabilities held as part of a trading portfolio nor financial liabilities that are derivatives.” Entities in the Republic of Ireland must provide the disclosures in paragraph 11.48A for financial instruments that are measured at fair value through profit or loss. [FRS 102.11.48A]

FRS 102 also requires a parent adopting a policy of accounting for its investments in subsidiaries, associates or jointly controlled entities at fair value through profit or loss in its separate financial statements to comply with the requirements of paragraph 36(4) of Schedule 1 to the Regulations by applying the disclosure requirements of Section 11 to those investments. [FRS 102.9.27B]. This means that all applicable disclosures in Section 11 must be given in respect of those investments.

How we see it

In our view, paragraph 36(4) of Schedule 1 to the Regulations also applies when investments in subsidiaries, associates or jointly controlled entities are held at fair value through profit or loss in the consolidated financial statements or in the individual financial statements of an investor or venturer, that is not a parent.

Care needs to be taken where IAS 39 or IFRS 9 is applied to the recognition and measurement of financial instruments, as financial instruments held at fair value (but not through profit or loss) may in principle be held at fair value subject to paragraph 36(4) of Schedule 1 to the Regulations (or its equivalents). Examples might include an available-for-sale financial asset or debt instrument at fair value through other comprehensive income. The disclosure requirements in Sections 11 and 12 for financial instruments at fair value, including paragraph 11.48A, are generally framed in respect of financial instruments at fair value through profit or loss, and therefore may not capture all financial instruments for which disclosures are required.

See Chapter 15 at 4 for details of disclosures for financial instruments, including those for financial instruments at fair value in accordance with paragraph 36(4) of Schedule 1 to the Regulations.

3.5 Equivalent disclosures

The disclosure exemptions in respect of cash flows, financial instruments, share-based payments and income tax set out in paragraphs 1.12(b), 1.12(c), 1.12(d), 1.12(dA), respectively of FRS 102 are dependent on the provision of ‘equivalent’ disclosures in the publicly available consolidated financial statements of the parent in which the qualifying entity is included.

FRS 102 refers to the Application Guidance in FRS 100 in deciding whether the consolidated financial statements of the group in which the reporting entity is included provides disclosures that are 'equivalent' to the requirements of FRS 102 from which relief is provided. [FRS 102.1.13].

The Application Guidance in FRS 100 states that:

- It is necessary to consider whether the consolidated financial statements of the parent provide disclosures that meet the basic disclosure requirements of FRS 102 without requiring strict conformity for each and every disclosure. This assessment must be based on the particular facts, including the similarities to and differences from the requirements of the relevant standard from which relief is provided. 'Equivalence' is intended to be aligned to that described in Section 401 of the CA 2006 (see Chapter 8 at 3.1.1.C and 3.1.6.A above). [FRS 100.AG25].

And

- Disclosure exemptions for subsidiaries are permitted where the relevant disclosure requirements are met in the consolidated financial statements, even where the disclosures are made in aggregate or in an abbreviated form, or in relation to intra-group balances, those intra-group balances have been eliminated on consolidation. If, however, no disclosure is made in the consolidated financial statements on the grounds of materiality, the relevant disclosures must be made at the subsidiary level if material in those financial statements. [FRS 100.AG26].

This means that a qualifying entity must review the consolidated financial statements of its parent to ensure that 'equivalent' disclosures have been made for each of the above exemptions that it intends to use. Where a particular 'equivalent' disclosure has not been made (unless the disclosure relates to an intra-group balance eliminated on consolidation) then the qualifying subsidiary cannot use the exemption in respect of that disclosure.

4 CA 2006 requirements for FRS 102 reporting entities

The requirements of the CA 2006 (and certain other regulatory rules) governing preparation of financial statements by UK companies are addressed in Chapter 1 at 5. See also 2.1 above for the requirements for which entities can apply FRS 102.

Statutory accounts prepared by a UK company in accordance with FRS 102 are Companies Act individual or group accounts and are therefore required to comply with the applicable provisions of Parts 15 and 16 of the CA 2006 and with the Regulations. [FRS 102.A3.7]. These requirements include the rules on recognition and measurement, the Companies Act accounts formats and note disclosures (see Chapter 6).

Appendix III *Note on legal requirements* to FRS 102 provides an overview of how the requirements in FRS 102 address UK law requirements. When discussing legal requirements relevant to FRS 102 financial statements, Appendix III generally refers to specific provisions of Schedule 1 to the Regulations. Entities applying Schedules 2, 3 or 6 to the Regulations must read such references as referring to the equivalent paragraph in those schedules. Small entities applying the Small Companies Regulation must read them as referring to the equivalent paragraph in Schedule 1 to the Small Companies Regulations. Similar provisions generally apply to LLPs in Schedule 1 to the LLP Regulations or Schedule 1 to the Small LLP Regulations. [FRS 102.A3.3].

Appendix III *Note on legal requirements* states that it does not list every legal requirement but instead focuses on those areas where greater judgement might be required in determining compliance with the law. [FRS 102.A3.11]. It notes that the standard 'is not intended to be a one-stop-shop for all accounting and legal requirements, and although the FRC believes the FRS 102 is not inconsistent with Company Law, compliance with FRS 102 alone will often be insufficient to ensure compliance with all the disclosure requirements set out in the Act and the Regulations. As a result, preparers will continue to be required to have regard to the requirements of Company Law in addition to accounting standards.' [FRS 102.A3.10].

4.1 Small and medium-sized entities

This section is relevant to small and medium-sized companies and LLPs that do not apply Section 1A of FRS 102. The requirements for entities applying Section 1A are covered in Chapter 5.

While this section refers to companies and LLPs, there are equivalent provisions for a qualifying partnership preparing the 'like annual accounts and reports', as if the partnership is a UK company, in accordance with the *Partnerships (Accounts) Regulations 2008*. See Chapter 6 at 3.1.4.

4.1.1 Small companies regime, small LLPs regime and small companies exemption

The criteria for use of the small companies regime and small LLPs regime, and the details of available exemptions for these entities, are discussed in Chapter 5 at 2 and 6.

A UK company subject to the small companies regime (or an LLP subject to the small LLPs regime) can apply the Small Companies Regulations (or the Small LLP Regulations) and is exempt from the requirement to prepare group accounts and from giving certain disclosures required in the notes to the financial statements by Part 15 of the CA 2006 (see Chapter 5 at 6).

In addition, FRS 102 Section 1A 'sets out the information that needs to be presented and disclosed in the financial statements of small entities that choose to apply the small entities regime' (see Chapter 5 at 2.1 for further information on entities eligible to apply the small entities' regime). [FRS 102.1A.1]. This paragraph implies that all eligible entities that choose to apply the small entities regime must apply the presentation and disclosure requirements in FRS 102 Section 1A. This includes the use of the formats included in Part 1 *General Rules and Formats* of Schedule 1 to the Small Companies Regulations or Part 1 *General Rules and Formats* of Schedule 1 to the Small LLP Regulations.

How we see it

In our view, entities may choose not to apply the requirements in FRS 102 Section 1A, and these entities will still be able to take advantage of other exemptions applicable to companies subject to the small companies regime or LLPs subject to the small LLPs regime. This is because paragraph 3(3) of the Small Companies Regulations specifically states that “accounts are treated as having complied with any provision of Schedule 1 to these Regulations if they comply instead with the corresponding provision of Schedule 1 to *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*.” Paragraph 8(2) of the Small Companies Regulations makes a similar statement in respect of the group accounts formats included in Schedule 6 to the Small Companies Regulations and Schedule 6 to the Regulations. For LLPs, the corresponding statements are made in paragraphs 3(1) and 6(1) of the Small LLP Regulations.

A UK company that takes advantage of the small companies exemption is not required to prepare a strategic report, [s414B]. In the directors’ report, this entity is exempted from disclosing the recommended dividend. [s415A].

On the basis that a strategic report is required for traded or a banking LLP only, which are both excluded from the small LLP regime, and that an LLP is not required to prepare a directors’ report, there is no small companies exemption equivalent for LLPs. Some LLPs choose to prepare a separate members’ report but this is not a statutory requirement. While the LLP SORP includes certain disclosures (such as principal activities, a list of designated members, etc.) that could be included in such a report, the disclosures may be presented anywhere in the annual report. [LLP SORP.30, LLP SORP.31].

A UK company subject to the small companies regime or taking advantage of the small companies exemption is entitled to certain filing exemptions. An LLP subject to the small LLPs regime is also entitled to filing exemptions.

4.1.2 Medium-sized companies and LLPs

The criteria in determining whether an entity (a company or an LLP) is medium-sized, together with the details of available exemptions, are discussed in Chapter 1 at 5.6. The exemptions for medium-sized companies impacting the strategic report (not to disclose non-financial KPIs) are not relevant for LLPs. Companies (or LLPs) applying FRS 102 can make use of these exemptions to the extent they do not conflict with accounting standards, e.g., medium-sized companies would need to give related party disclosures in individual financial statements because this is required by FRS 102 notwithstanding the exemption in the Regulations. [Regulations 4(2B), LLP Regulations 4(2B)].

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

adopted IFRS	IFRS Accounting Standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. In the Republic of Ireland, this refers to EU-adopted IFRS.
consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
financial institution	Any of the following: (a) a bank which is: (i) a with a Part4A permission which includes accepting deposits and: (a) which is a credit institution; or (b) whose Part 4A permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, a friendly society or a credit union; (ii) an EEA bank which is a full credit institution; (b) a building society which is defined in section 119(1) of the Building Societies Act 1986 as a building society incorporated (or deemed to be incorporated) under that act; (c) a credit union, being a body corporate registered under the Co-operative and Community Benefit Societies Act 2014 as a credit union in accordance with the Credit Unions Act 1979, which is an authorised person; (d) a custodian bank or broker-dealer; (e) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities; (f) an incorporated under the Friendly Societies Act 1992 or a registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment which it replaced, including any registered branches; (g) an investment trust, Irish investment company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC); or (h) [Deleted] (i) any other entity whose principal activity is similar to those listed above but is not specifically included in that list. A parent entity whose sole activity is to hold investments in other group entities is not a financial institution.
financial position	The relationship of the assets, liabilities and equity of an entity as reported in the statement of financial position.
financial statements	Structured representation of the financial position, financial performance and cash flows of an entity.
group	A parent and all its subsidiaries.

IAS / IFRS Accounting Standards	IFRS Accounting Standards and interpretations issued by the International Accounting Standards Board (IASB). They comprise: (a) International Financial Reporting Standards; (b) IAS® Standards; (c) IFRIC® Interpretations developed by the IFRS Interpretations Committee; and (d) SIC® Interpretations developed by the former Standing Interpretations Committee.
income and expenditure	The total of income less expenses, excluding the components of other comprehensive income. In the for-profit sector this is known as profit or loss.
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term.
parent	An entity that has one or more subsidiaries.
profit or loss	The total of income less expenses, excluding the components of other comprehensive income.
qualifying entity (for the purposes of this FRS)	A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation.
separate financial statements	Those presented by a parent in which the investments in subsidiaries, associates or jointly controlled entities are accounted for either at cost or fair value rather than on the basis of the reported results and net assets of the investees. Separate financial statements are included within the meaning of individual financial statements.
small entity	A small entity is: (a) a company meeting the definition of a small company as set out in section 382 or 383 of the Act and not excluded from the small companies regime by section 384; (b) an LLP qualifying as small and not excluded from the small LLPs regime, as set out in LLP Regulations; or (c) any other entity that would have met the criteria in (a) had it been a company incorporated under company law.
Statement of Recommended Practice (SORP)	An extant Statement of Recommended Practice developed in accordance with Policy on Developing Statements of Recommended Practice (SORPs). SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.
subsidiary	An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).
UK-adopted international accounting standards	IAS that have been adopted for use within the UK in accordance with the International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019 (SI 2019/685).
reporting period	The period covered by financial statements or by an interim financial report.

Chapter 4 Concepts and Pervasive Principles

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Overview

Section 2 *Concepts and Pervasive Principles* describes the objectives of the financial statements of entities within the scope of FRS 102 and sets out the concepts and basic principles underlying those financial statements. Financial statements prepared under FRS 102 by UK companies are subject to the requirements of the Companies Act 2006 and supporting regulations.

The Periodic Review 2024 amendments replaced the previous Section 2 in its entirety. The revised Section 2 is aligned with the concepts and principles contained within the Conceptual Framework which underpins the IFRS, though in the interests of brevity, Section 2 contains less discussion of the application of the principles.

What you need to know

- Section 2 explains the objective of general purpose financial statements, which is to provide financial information for the entity which is useful for decision-making by a wide range of users.
- If a particular transaction or event is not addressed by another section of FRS 102, the concepts and pervasive principles of Section 2 are applied to develop an accounting policy, using the hierarchy set out in Section 10 *Accounting Policies, Estimates and Errors*. If inconsistencies arise between Section 2 and another section of FRS 102, precedence is given to the requirements of the other section.
- Section 2 identifies:
 - Two fundamental qualitative characteristics of useful financial information: relevance and faithful representation.
 - Four enhancing qualitative characteristics: comparability, verifiability, timeliness, and understandability. These characteristics enhance the usefulness of information which is relevant and has been faithfully represented. The cost constraint on useful financial reporting is also addressed.
 - Materiality as an entity-specific aspect of relevance. Information will be material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of general purpose financial statements make on the basis of those statements.
 - Measurement bases, being historical cost and current value. Factors to consider when selecting a measurement base are outlined, giving guidance on how to apply both the fundamental qualitative characteristics and the enhancing characteristics to make the selection.
- Section 2 defines the elements of financial statements:
 - Assets, liabilities (including the unit of account) and equity which relate to a reporting entity's financial position.
 - Income and expenses, which relate to a reporting entity's financial performance.

And

 - Sets out the criteria for the recognition and derecognition of assets and liabilities.
- Section 2 addresses the concept of the reporting entity and the reporting period, the going concern assumption and includes principles for presentation and disclosure. It also addresses classification, offsetting and aggregation.
- Financial statements prepared by a UK company under FRS 102 are 'Companies Act accounts' and must apply the fundamental accounting principles set out in Company Law - going concern assumption, consistent accounting policies and measurement bases, prudence, accruals concept and separate determination (no offset). Section 2 addresses similar concepts.
- UK Company Law requires (with certain exceptions) that only realised profits are included in the income statement.

1 Introduction

Section 2 of FRS 102 is the equivalent of the IASB's Conceptual Framework for Financial Reporting ('the Conceptual Framework') which underpins IFRS. In the context of financial reporting, a conceptual framework is a statement of generally accepted principles that provide the basis for the evaluation of existing reporting practices and the development of new practices applicable to general purpose financial statements. It provides a conceptual basis for determining which events should be accounted for, how they should be measured and how they should be communicated. A conceptual framework is, therefore, used to inform standard setting, as well as being a point of reference for preparers of financial statements.

Similar to the Conceptual Framework, Section 2 is a statement of generally accepted theoretical principles which provide the basis for both the development of new reporting practices and the evaluation of existing ones. Since the financial reporting process is concerned with the provision of information that is useful in making business and economic decisions, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated. Therefore, although it is theoretical in nature, a conceptual framework for financial reporting has a highly practical end in view.

Unlike the Conceptual Framework (which is not an IFRS), Section 2 is an integral part of FRS 102, but its practical use is similar. Its purpose is to assist preparers in developing accounting policies for a transaction, other event or condition that is not specifically addressed by FRS 102. In the event of an inconsistency with another section of FRS 102, the latter takes precedence and, therefore, the changes to Section 2 are not expected to result in significant changes to existing practice. However, the updated concepts and pervasive principles will provide a basis for future standard-setting, and for the future development by preparers of accounting policies for a transaction, other event or condition that is not specifically addressed by FRS 102. [FRS 102.B2.2].

1.1 Key changes introduced by the Periodic Review 2024 amendments

Section 2 has been aligned with the Conceptual Framework published in 2018. Much of the detailed discussion of concepts and principles contained within the Conceptual Framework has not been brought into FRS 102, but given the close alignment, users of Section 2 are able to refer to that detailed discussion as required.

As less detail is contained in FRS 102 compared to IFRS, it is possible that an entity might need to apply the hierarchy permitted by Section 10 to refer to the Conceptual Framework to develop an accounting policy.

The definition of assets and liabilities has been aligned with the definitions in the Conceptual Framework and certain parts of the explanatory material from that framework have been introduced:

- An asset is a present economic resource (i.e., a right that has the potential to produce economic benefits) controlled by the entity as a result of past events.
- For a liability to exist, the entity must have a present obligation that exists as a result of past events to transfer an economic resource.

The previous definitions referred to an expectation of an inflow or outflow of economic benefits and that definition has been retained for certain sections, to avoid unintended consequences. These are set out below:

- Section 18 *Intangible assets other than Goodwill* - definition of an asset in respect of intangibles other than goodwill
- Section 20 *Leases* - definition of fair value in respect of lessor accounting
- Section 21 *Provisions and Contingencies* and Section 22 *Liabilities and Equity* - definition of liability in respect of provisions and contingencies, and liabilities and equity
- Section 26 *Share-based Payment* - definition of fair value in respect of share-based payments

This approach is considered consistent with that taken in the corresponding IFRS.¹⁷

¹⁷ At the date of writing, the IASB has proposed amendments to align the definition of a liability in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with the definition in the Conceptual Framework. See Exposure Draft, November 2024: *Provisions - Targeted Improvements*. Proposed Amendments to IAS 37. The next milestone is Decide Project Direction.

Section 2 explains the meaning of 'control' as follows: An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. An entity has the present ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities.

Given the previous lack of guidance on the definition of 'control', it is possible that some entities may have developed a different definition, based on risks and rewards, rather than on a present ability to direct the use of an economic resource. In such cases, those entities may need to revisit certain accounting policies. For example, an entity may need to assess whether costs related to customisation or configuration for cloud computing services represent an asset it controls or a service it purchases.

2 Comparison between Section 2 and Conceptual Framework

Section 2 has been revised to align with the concepts and principles expressed in the Conceptual Framework, published by the IASB in 2018. However, much of the detailed discussion and exposition of the principles contained in the Conceptual Framework has not been reproduced in Section 2. If more guidance in a particular area were needed, users could refer to the Conceptual Framework. The following is a non-exhaustive list of the main topics which are not directly addressed by Section 2:

- Executory contracts
- Substance of contractual rights and contractual obligations
- Factors specific to initial measurement
- More than one measurement basis
- Cash-flow-based measurement techniques
- Concepts of capital and capital maintenance

Statutory accounts prepared in accordance with FRS 102 by UK companies are subject to the requirements of the CA 2006 and its associated regulations. There are similar requirements under UK law for LLPs and other entities. For Irish entities, statutory accounts are subject to the requirements of the Companies Act 2014 and associated regulations. Section 2 does not address these legal requirements.

3 Concepts and Pervasive Principles

Section 2 contains the following topics which are aligned with the Conceptual Framework (except for the topics not covered in Section 2 as discussed in 2 above):

- Scope of this section (discussed in 3.1 below)
 - The objective of financial statements (discussed in 3.2 below)
 - Qualitative characteristics of useful financial information (discussed in 3.3 below)
 - Financial statements and the reporting entity (discussed in 3.4 below)
 - The elements of financial statements (discussed in 3.5 below)
 - Recognition and derecognition (discussed in 3.6 below)
 - Measurement (discussed in 3.7 below)
- And
- Presentation and disclosure (discussed in 3.8 below)

3.1 Scope of Section 2

Section 2 describes the objective of financial statements of entities within the scope of FRS 102 (see 3.2 below). It also sets out the concepts and basic principles underlying the financial statements of entities within the scope of FRS 102. [FRS 102.2.1].

When FRS 102 does not specifically address a transaction, other event or condition, the concepts and pervasive principles in Section 2 are applied in developing an accounting policy, using the hierarchy set out in Section 10 (and after considering the requirements and guidance dealing with similar and related issues in other sections of FRS 102 or if the entity is in scope of a Statement of Recommended Practice (SORP), in that SORP as described in paragraphs 4 and 5 of Section 10). [FRS 102.2.3, FRS 102.10.4, FRS 102.10.5].

In recognition of this hierarchy of sources, where inconsistencies arise between Section 2 and another section of FRS 102, precedence is given to the requirement of the other section. [FRS 102.2.2]. This clarifies that guidance in Section 2 is subordinate to specific requirements in the other sections of FRS 102.

3.2 The objective of financial statements

Section 2 defines the objective of general purpose financial reporting as being to provide financial information about the reporting entity that is useful for decision-making by a wide range of users who are not in a position to demand reports tailored to meet their particular information needs. Such general purpose financial statements allow users to make decisions and develop expectations based on their assessment of the amount, timing and uncertainty of future net cash inflows to the entity. [FRS 102.2.4].

Management is responsible for the use of an entity's economic resources - for example, by protecting those resources from the unfavourable effects of economic factors, such as price and technological changes. Information about how efficiently and effectively management has discharged this duty helps users to assess management's stewardship of those resources. It can also be useful for assessing how management may use the resources in future periods and thereby helps a user to assess the prospects for future cash inflows. [FRS 102.2.7].

To make these assessments, users need information about: [FRS 102.2.5]

- The economic resources of the entity, claims against the entity and changes in those resources and claims.
- And
- How efficiently and effectively the entity's management has discharged its responsibilities to use the entity's economic resources (management's stewardship).

Section 2 acknowledges that general purpose financial reports do not, and cannot, provide all the information needed by users. Users of financial reports need to consider other pertinent information, such as general economic and political conditions, and industry and company outlooks. [FRS 102.2.6].

General purpose financial reports are focused on meeting the needs of the largest number of users, who may have different, and possibly conflicting, needs for information. However, this does not preclude a reporting entity from including additional information that is useful to a particular subset of primary users. It should be noted, however, that Section 3 *Presentation of Financial Statements* states that the understandability of financial statements must not be reduced by obscuring material information with immaterial information. [FRS 102.3.16A].

3.3 Qualitative characteristics of useful financial information

Section 2 explains that the types of information likely to be most useful to users for the purposes of decision making are identified by various qualitative characteristics, [FRS 102.2.8], comprising:

- Two 'fundamental' qualitative characteristics (see 3.3.1 below):

- Relevance

And

- Faithful representation [FRS 102.2.9]

Supplemented by:

- Four 'enhancing' qualitative characteristics (see 3.3.2 below):

- Comparability

- Verifiability

- Timeliness

And

- Understandability [FRS 102.2.19]

Section 2 also notes the role of cost as a 'pervasive constraint' on a reporting entity's ability to provide useful financial information. [FRS 102.2.24]. This is discussed further in 3.3.3 below.

3.3.1 Fundamental qualitative characteristics

In order to be useful, financial information must be relevant (see 3.3.1.A below) and must faithfully represent what it purports to represent (see 3.3.1.C below). [FRS 102.2.9].

3.3.1.A Relevance

Extract from Section 2

2.10 Relevant financial information is capable of making a difference in the decisions made by users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. [FRS 102.2.10].

Financial information can have both confirmatory and predictive value. It has confirmatory value if it confirms or changes previous evaluations and it has predictive values if users can employ it, alongside other information, to predict future outcomes.

3.3.1.B Materiality

Materiality is an entity-specific aspect of relevance that depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole. In other words, information is material (and therefore relevant) if omitting it, misstating it, or obscuring it could reasonably be expected to influence the decisions of users of financial information about a specific reporting entity. Since materiality is specific to a particular reporting entity, it is not possible to specify a uniform quantitative threshold for materiality. [FRS 102.2.12, FRS 102.2.11].

Information is obscured if it is communicated in a way that would have a similar effect for users of general purpose financial statements to omitting or misstating that information. Examples of circumstances that may result in information being obscured could include usage of vague or unclear language, inappropriate aggregation of dissimilar information or disaggregation of similar information and hiding material information using immaterial information. [FRS 102.2.13].

Information is more useful if it is entity-specific, in other words, tailored to an entity's individual circumstances, rather than 'boilerplate' or standardised. See Chapter 6 at 8.4.

3.3.1.C Faithful representation

Section 2 observes that financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon.

[FRS 102.2.14].

Substance over form is a requirement of UK Company Law and is required by both *The Large and Medium-sized Companies and Groups (Accounts and reports) Regulations 2008 (SI 2008/410)* (the Regulations) and *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)* (the Small Companies' Regulations). [1 Sch 9, 2 Sch 10, 3 Sch 8, 1 Sch 9 (SC)].

A perfectly faithful representation would be:

- Complete
- Neutral
- And
- Free from error

Nonetheless, the standard acknowledges that while faithful representation involves maximising those qualities, it does not (and cannot) mean being accurate in all respects. [FRS 102.2.15].

A complete depiction includes all information, including all necessary descriptions and explanations, needed for a user to understand the phenomenon being depicted. [FRS 102.2.16]. Thus, a complete depiction of an asset might include not just a numerical depiction, but also a description of the nature of the assets and an explanation of what the numerical depiction means - for example, whether the asset is carried at historical cost or fair value.

A neutral depiction is one without bias in the selection or presentation of financial information. Section 2 discusses the word 'prudence', the exercise of which is considered to support neutrality. Prudence is defined as the exercise of caution, when making judgements under conditions of uncertainty. The outcome of the application of prudence is that:

- Assets and income are not overstated
- And
- Liabilities and expenses are not understated

However, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses, as there may be consequences related to this, such as the overstatement or understatement of income or expenses in future periods.

The standard is clear that the exercise of prudence does not imply a need for asymmetry. In other words, there is no systematic need for more persuasive evidence to support the recognition of assets or income than the recognition of liabilities or expenses. Nonetheless, individual sections may contain asymmetric requirements if these are a consequence of decisions intended to select the most relevant information that faithfully represents what it purports to represent. [FRS 102.2.17].

Finally, the term 'free from error' does not necessarily imply that information is perfectly accurate in all respects. The standard focusses on the selection of the information or the application of the process used to produce the information, with the result that information is deemed 'free from error' if there are no errors or omissions either in the description of the event or in the selection or process used to produce information. [FRS 102.2.18].

3.3.2 Enhancing qualitative characteristics

The usefulness of relevant and faithfully represented financial information is enhanced by the characteristics of comparability (see 3.3.2.A below), verifiability (see 3.3.2.B below), timeliness (see 3.3.2.C below) and understandability (see 3.3.2.D below). These enhancing characteristics may also help determine how to depict a phenomenon if there are multiple ways to provide equally relevant information and equally faithful representation of that phenomenon. [FRS 102.2.19].

Unlike the *Conceptual Framework*, FRS 102 does not provide guidance on how the enhancing qualitative characteristics should be applied. Nonetheless, the guidance in the 'Framework' may be helpful to entities, when considering what information to present and disclose and how to disclose it. The framework notes that while the enhancing qualitative characteristics must be maximised to the extent possible, they cannot, either individually or as a group, make information useful if that information is irrelevant or does not give a faithful representation. [CF 2.37].

3.3.2.A Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item, since, by definition, a comparison requires at least two items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Permitting alternative accounting methods for the same economic phenomenon diminishes comparability, while informing users of the accounting policies employed in the preparation of the financial statements, and of any changes in those policies and the effects of such changes, enhances it. [FRS 102.2.20].

There is detailed guidance on comparability in Section 10, which requires an entity to select and apply its accounting policies consistently for similar transactions, other events or obligations unless an FRS specifically requires or permits categorisation of items for which different policies may be appropriate. Section 10 also requires disclosures where there are changes in accounting policies. [FRS 102.10.7, FRS 102.10.13, FRS 102.10.14]. See Chapter 9 at 3.6.1. Section 8 *Notes to the Financial Statements* requires an entity to disclose a summary of material accounting policy information. [FRS 102.8.4(b)]. See Chapter 6 at 8.4.

3.3.2.B Verifiability

The purpose of the characteristic of verifiability is to assure users that information disclosed faithfully represents the economic event that it purports to depict. The consequence of information being verifiable is that different knowledgeable and independent observers could reach a consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. While the standard does not provide a direct definition of 'knowledgeable', it is listed as one of the characteristics which a market participant would possess and is described as "having a reasonable understanding about the asset or liability and the transaction using all available information". The standard explains that quantified information need not be a single point estimate to be verifiable, as a range of possible amounts and their related probabilities can also be verified. [FRS 102.2.21].

3.3.2.C Timeliness

For information to be capable of influencing decision-makers, it needs to be available to them in time. The standard observes that, generally, the older the information is, the less useful it is, but that some information may continue to be timely long after the end of a reporting period, for example because some users may need to identify and assess trends. [FRS 102.2.22].

UK companies are required by law to file accounts within specified time limits. For a private company, the period allowed by the CA 2006 for filing financial statements is nine months after the end of the relevant accounting reference period and, for a public company, the period allowed for filing is six months after the end of the relevant accounting reference period. [s442].

3.3.2.D Understandability

Information is made understandable by classifying, characterising and presenting it clearly and concisely. Section 2, however, notes that excluding information from financial statements about phenomena that are inherently complex and difficult to understand would make reports incomplete and therefore possibly misleading. The need for understandability does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand. [FRS 102.2.23].

3.3.3 The cost constraint

The standard asserts that cost is a pervasive constraint on the information provided by financial reporting, and that the cost of producing information must be justified by the benefits that it provides. It notes that while the evaluation of costs and benefits is substantially a judgemental process, the costs are not necessarily borne by those users who enjoy the benefits, and often the benefits are enjoyed by a broad range of external users. [FRS 102.2.24].

The standard identifies a number of benefits which may arise from the provision of relevant and faithfully representative financial information:

- Users are helped to make decisions with more confidence.
- Informed decisions may result in a more efficient functioning of capital markets and a lower cost of capital for the economy as a whole.
- An individual user may make more informed decisions.

- Management may make better decisions because financial information used internally is often based at least partly on information prepared for general purpose financial reporting purposes.

However, it is not possible for general purpose financial statements to provide all the information that every user finds relevant. [FRS 102.2.25].

3.4 Financial statements and the reporting entity

3.4.1 Reporting period and comparative information

A reporting period is defined as the period covered by financial statements or by an interim financial report. [FRS 102 Appendix I]. The period of time is specified, and those financial statements provide information about:

- Assets and liabilities (including unrecognised assets and liabilities) and equity that existed at the end of the reporting period, or during the reporting period.
- Income and expenses for the reporting period.

And

- At least one preceding reporting period, being the comparative period, except when FRS 102 permits or requires otherwise. [FRS 102.2.26, FRS 102.2.27].

Typically, information about future transactions is not included in financial statements, but in certain circumstances, it may constitute relevant information. In these cases, information about possible future transactions and other possible future events (forward-looking information) is included in financial statements if it:

- Relates to the entity's assets or liabilities (including unrecognised assets or liabilities) or equity that existed at the end of the reporting period, or during the reporting period, or to income or expenses for the reporting period.

And

- Is useful to users of financial statements.

This may arise if an asset or liability is measured by estimating future cash flows; information about those estimated future cash flows may help users of financial statements to understand the reported measures. Financial statements do not usually provide other types of forward-looking information, for example, explanatory material about management's expectations and strategies for the reporting entity, though this type of information may be provided in other reports which accompany the financial statements - for example, the strategic report. [FRS 102.2.28].

3.4.2 Perspective adopted in financial statements

Financial statements provide information about transactions and other events viewed from the perspective of the reporting entity as a whole. [FRS 102.2.29]. However, entities whose debt or equity instruments are publicly traded, or that files, or is in the process of filing its financial statements with a securities commission or regulator, is also required to provide information about its segments, following the requirements of IFRS 8 *Operating Segments*. This information may be given on a voluntary basis and in that case, the requirements of IFRS 8 must also be followed - see Chapter 3.

3.4.3 Going concern assumption

A fundamental principle is that financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future. However, there may be situations where management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. In such cases, the financial statements must be prepared on a different basis, and the financial statements must describe the basis used, as set out in paragraph 9 of Section 3 of the standard (see Chapter 6 at 8.3). [FRS 102.2.30, FRS 102.3.9].

3.4.4 The reporting entity

FRS 102 sets out what a reporting entity constitutes: it is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity and is not necessarily a legal entity. If a reporting entity comprises both the parent and its subsidiaries, the reporting entity's financial statements are referred to as 'consolidated financial statements'. [FRS 102.2.31].

3.5 The elements of financial statements

As discussed in 3.2 above, the central tenet of Section 2 is that users of financial information require information concerning:

- The economic resources of and claims against an entity.
- And

- Changes in those resources and claims.

These are described in Section 2 as being linked to the 'elements' of financial statements which are: assets, liabilities, equity, income and expense. The recognition and derecognition of elements are discussed in 3.6 below. Measurement of the elements is discussed in 3.7 below and presentation in 3.8 below.

Extract from Section 2

- 2.32** The elements of financial statements defined in this section are: *[FRS 102.2.32]*
- (a) assets, liabilities and equity, which relate to a reporting entity's financial position; and
 - (b) income and expenses, which relate to a reporting entity's financial performance.

3.5.1 Definition of an asset

'An asset' is defined as a present economic resource controlled by the entity as a result of past events and an economic resource is defined as a right that has the potential to produce economic benefits. The different aspects of the definition are discussed below. *[FRS 102.2.33]*.

3.5.1.A Economic resource as a right

It is observed that rights that have the potential to produce economic benefits take many forms, including:

- Rights that correspond to an obligation of another party (see 3.5.2.A below), for example, rights to:
 - Receive cash.
 - Receive goods or services.
 - Exchange economic resources with another party on favourable terms. Such rights include, for example, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource.
- And
- Benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs.
- Rights that do not correspond to an obligation of another party, for example, rights:
 - Over physical objects, such as property, plant and equipment or inventories. Examples of such rights are a right to use a physical object, such as an item of property, plant or equipment or a right to benefit from the residual value of a leased object.
 - To use intellectual property.
- And
- That create or enhance the service potential of physical objects or intellectual property.

[FRS 102.2.34].

Section 2 observes that there are different ways of acquiring rights: some rights are established by contract, legislation or similar means. This might include ownership rights over a physical object, debt or equity instrument or registered patent or rights arising from leasing a physical object or intangible item. An entity could also obtain rights in other ways, such as:

- By acquiring or creating know-how that is not in the public domain. An entity has the right if it can access the know-how and has the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent.
 - Or
 - Through a constructive obligation - an obligation of another party that arises because that party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statement. The definition of constructive obligation is further discussed in 3.5.2.A below.
- [FRS 102.2.35].*

It is worth noting that not all of an entity's rights are assets of that entity; to be assets the rights must also satisfy the criteria of potential to produce economic benefits and control.

3.5.1.B Potential to produce economic benefits

It is only necessary that the right already exists for an asset to have the potential to produce economic benefits. Section 2 clarifies that it does not need to be certain, or even likely, that the right will produce economic benefits. [FRS 102.2.36].

3.5.1.C Control

Control is the concept which links an economic resource to an entity. In cases where it is not clear, assessing whether control exists helps to identify the economic resource for which the entity accounts. An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. An entity has the present ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to permit another party to deploy the economic resource in that other party's activities. [FRS 102.2.37].

3.5.2 Definition of a liability

FRS 102 defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events. [FRS 102 Appendix I].

Extract from Section 2

- 2.38 For a liability to exist, three criteria must all be satisfied: [FRS 102.2.38]
- (a) the entity has an obligation;
 - (b) the obligation is to transfer an economic resource; and
 - (c) the obligation is a present obligation that exists as a result of past events.

These criteria are discussed in turn below.

3.5.2.A Obligation

Section 2 defines an obligation as a duty or responsibility that an entity has no practical ability to avoid. It is always owed to another party, but it is not necessary to know the identity of the party to whom the obligation is owed. Often, obligations are established by contract, legislation or similar means and are legally enforceable by the party to whom they are owed. They can also stem from an entity's customary practices, published policies or specific statements, but they only arise if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. An obligation arising in such a way is usually referred to as a 'constructive obligation'. [FRS 102.2.39].

3.5.2.B Transfer an economic resource

The second criterion for a liability is that the obligation is to transfer an economic resource. To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party. Likelihood is not a feature of the assessment of whether that potential exists, as it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource. For example, the transfer may be required only if a specified uncertain future event occurs. The only necessary condition is that the obligation already exists and that, in at least one circumstance, the entity would be required to transfer an economic resource. [FRS 102.2.40].

Section 2 provides a non-exhaustive list of examples of obligations to transfer an economic resource including:

- To pay cash.
 - To deliver goods or provide services.
 - To exchange economic resources with another party on unfavourable terms.
 - To transfer an economic resource if a specified uncertain future event occurs.
- And
- To issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource. [FRS 102.2.41].

Section 2 notes that there are other ways of settling an obligation to transfer an economic resource to the party that has a right to receive that resource. For example, in certain cases, an entity may decide to:

- Settle the obligation by negotiating a release from the obligation.
- Transfer the obligation to a third party.

Or

- Replace that obligation to transfer an economic resource with another obligation, by entering into a new transaction. [FRS 102.2.42].

3.5.2.C Present obligation existing as a result of past events

The third criterion for a liability is that the obligation is a present obligation that exists as a result of past events. This can only arise if two conditions exist:

- The entity has already obtained economic benefits or taken an action.
- And
- As a consequence, the entity will, or may have to, transfer an economic resource that it would not otherwise have had to transfer. [FRS 102.2.43].

Examples of economic benefits obtained might include goods or services. Examples of actions taken might include operating a particular business or operating in a particular market. If economic benefits are obtained, or an action is taken, over time, the resulting present obligation may accumulate over that time. [FRS 102.2.44].

3.5.3 Unit of account

Section 2 defines the unit of account as the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied. [FRS 102.2.45].

The unit of account is crucial to assess how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses. It can occasionally be appropriate to select one unit of account for recognition and a different unit of account for measurement. Section 2 provides an example of contracts which may sometimes be recognised individually but measured as part of a portfolio of contracts. For presentation and disclosure purposes, assets, liabilities, income and expenses may need to be aggregated or separated into components. [FRS 102.2.46].

If an entity transfers part of an asset or part of a liability, the unit of account may change at that time, so that the transferred component and the retained component become separate units of account (derecognition is discussed in 3.6.4 below).

3.5.4 Income and expenses

Income and expenses are the elements of financial statements that relate to an entity's financial performance. To be able to understand management's stewardship of the entity's resources, users of financial statements need information about both an entity's financial position and its financial performance. The standard points out that although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities. [FRS 102.2.47].

Those terms are defined as follows: [FRS 102 Appendix I]

- Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity investors.
- Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity investors.

A consequence of these definitions is that:

- Contributions from holders of equity claims are not income.
- And
- Distributions to holders of equity claims are not expenses.

Different transactions and other events generate income and expenses with different characteristics. Providing information separately about income and expenses with different characteristics can help users of financial statements to understand the entity's financial performance.

3.5.4.A The accrual basis

Section 2 requires an entity to prepare its financial statements using the accrual basis of accounting. This does not apply to cash flow information. The result of using the accrual basis is that items are recognised as assets, liabilities, equity, income or expenses when they satisfy the definitions and recognition criteria for those items. [FRS 102.2.48].

The principle of the accrual basis is that the effects of transactions (and other events) are recognised when they occur and not when cash or its equivalent is paid or received, and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. [FRS 102 Appendix I]. The definition is somewhat circular as it means that an item is recognised as income when it meets the definition and recognition criteria of income. The Regulations require that all income and charges relating to the financial year to which the accounts relate must be taken into account, without regard to the date or receipt of payment. [1 Sch 14, 2 Sch 20, 3 Sch 19, 1 Sch 14 (SC)]. Though the wording of the definition differs slightly between the standard and the Regulations, the meaning is very similar and is not expected to lead to differences of application.

3.6 Recognition and derecognition

Recognition is described in FRS 102 as the process of capturing for inclusion in the statement of financial position or statement of comprehensive income an item that meets the definition of one of the elements of financial statements: that is, an asset, a liability, equity, income or expenses. [FRS 102 Appendix I].

3.6.1 The recognition process

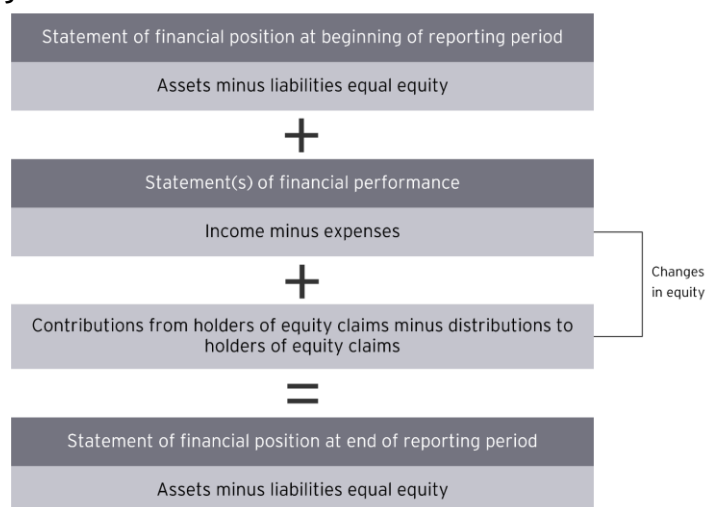
Recognition involves depicting the item in one of those statements (either alone or in aggregation with other items) in words and by a monetary amount and including that amount in one or more totals in that statement. The amount at which an asset, a liability or equity is recognised in the statement of financial position is referred to as its 'carrying amount'. [FRS 102 Appendix I].

Recognition provides the link between the elements of the financial statements - the statement of financial position and the statement(s) of financial performance - as follows:

- In the statement of financial position at the beginning and end of the reporting period, total assets minus total liabilities equal total equity
- And
- Recognised changes in equity during the reporting period comprise:
 - Income minus expenses recognised in the statement(s) of financial performance
 - Plus
 - Contributions from equity holders, minus distributions to equity holders. [FRS 102.2.49].

This is illustrated diagrammatically in Figure 3-1 below.

Figure 3-1: How recognition links the elements of financial statements



The statements of financial position and performance are linked because the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of one or more other items (or changes in the carrying amount of one or more other items). This is usually known as 'double-entry' bookkeeping.

3.6.2 Recognition criteria

Extract from Section 2

2.50 Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. *[FRS 102.2.50]*

However, not all items that meet the definition of one of those elements are recognised, for example, if doing so would not provide relevant information, or if the costs of doing so outweigh the benefits. *[FRS 102.2.51]*. Individual sections of the standard set out the recognition criteria for an item that meets the definition of one of the elements of financial statements. *[FRS 102.2.52]*.

If an item satisfies the recognition criteria and provides relevant information, it must be recognised - it is not possible to rectify an omission by disclosure of the accounting policies used or by notes or explanatory material. *[FRS 102.2.53]*.

An entity must not recognise items in the statement of financial position if they do not meet the definition of assets or of liabilities, unless the standard explicitly requires or permits this. The concept commonly referred to as 'matching' for measuring profit or loss is not to be applied. *[FRS 102.2.54]*.

Over time, the status of an item may change as a result of subsequent circumstances or events; consequently, an item that fails to meet the recognition criteria at a particular point in time may qualify for recognition at a later date. *[FRS 102.2.55]*.

3.6.2.A Relevance

Relevance is a key concept for assessing what information about assets, liabilities, equity, income and expenses must be provided to users of financial statements. In certain situations, recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That might arise when:

- It is uncertain whether an asset or liability exists (see 3.6.2.B below).
- Or
- An asset or liability exists, but the probability of an inflow or outflow of economic benefits is low (see 3.6.2.C below).

It is not sufficient to identify one or both of the factors described above, as other factors may need to be taken into account and may affect the conclusion. Thus, the combination of factors must be looked at as a whole and it cannot be automatically assumed that because one of the factors listed above is present, the information provided by recognition is not relevant. *[FRS 102.2.56]*.

3.6.2.B Existence uncertainty

Sometimes it is uncertain whether an asset or liability exists. In some cases, that uncertainty, possibly combined with factors such as a low probability of inflows or outflows of economic benefits and an extremely wide range of possible outcomes, may mean that the recognition of an asset or liability would not provide relevant information. This is because an asset or liability is, by necessity, measured at a single amount and cannot therefore reflect the wide range of possible outcomes. Whether or not the asset or liability is recognised, explanatory information about the uncertainties associated with it may need to be provided in the financial statements. *[FRS 102.2.57]*.

3.6.2.C Low probability of an inflow or outflow of economic benefits

As mentioned in 3.5.1.B and 3.5.2.B above, an asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low. If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability might be information about the magnitude of the possible inflows or outflows, their possible timing and the factors affecting the probability of their occurrence. Information of this type is typically located in the notes. However, it may be the case that the probability of an inflow or outflow of economic benefits is low, but recognition of the asset or liability might provide relevant further information. *[FRS 102.2.58]*. An example of the type of relevant information envisaged here is information about the cost of an asset acquired in an exchange transaction on market terms, which generally reflects the probability of an inflow of economic benefits.

3.6.3 Faithful representation

The standard explains that in addition to providing relevant information, recognition of a particular asset or liability is appropriate if it provides a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. The level of measurement uncertainty associated with the asset or liability, amongst other factors, could affect whether a faithful representation can be provided.

[FRS 102.2.59].

3.6.3.A Measurement uncertainty and outcome uncertainty

Measurement is essential for the recognition of an asset or liability, though often, measurement must be estimated and is therefore subject to uncertainty. The standard notes that using reasonable estimates are a necessary part of the preparation of financial information. There is no conflict with the usefulness of the information disclosed, provided that the estimates are clearly and accurately described and explained.

[FRS 102.2.60].

FRS 102 clarifies that additional explanatory information about the uncertainties associated with the asset or liability's existence or measurement may be needed to ensure a faithful representation. This may be the case, regardless of whether the asset is recognised or not. Such a representation might include information about the amount or timing of any inflow or outflow of economic benefits that will ultimately result from it.

[FRS 102.2.61].

3.6.4 Derecognition

Derecognition is defined as the removal of all or part of a recognised asset or liability from an entity's statement of financial position. [FRS 102 Appendix I].

Extract from Section 2

- 2.62 Derecognition normally occurs when that item no longer meets the definition of an asset or of a liability:
- (a) for an asset, derecognition normally occurs when the entity loses control of all or part of the recognised asset; and
 - (b) for a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

[FRS 102.2.62]. Accounting requirements for derecognition are designed to represent faithfully both:

- Any assets and liabilities retained after the transaction or other event that led to the derecognition.
- And
- The change in the entity's assets and liabilities as a result of that transaction or other event.

[FRS 102.2.63].

The standard explains that these aims are usually achieved by:

- Derecognising any assets or liabilities (components) that have either: expired, been consumed, collected, fulfilled or transferred (collectively referred to as the transferred components).
- Recognising, and presenting separately in the statement of financial performance, any resulting income and expenses.
- Continuing to recognise, and presenting separately in the statement of financial position, any retained assets or liabilities retained (the retained component).
- And
- Providing explanatory information. [FRS 102.2.64].

3.7 Measurement

As discussed in 3.6.1 above, elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis, which is defined in Section 2 as an identified feature (for example, historical cost, fair value or fulfilment value) of the item being measured. Applying a measurement basis to an asset or liability creates a measure for that asset or liability and for related income and expenses. [FRS 102.2.65, FRS 102.2.66].

The standard observes, perhaps somewhat unnecessarily, that different measurement bases may be appropriate for different assets, liabilities, income and expenses. [FRS 102.2.67].

3.7.1 Measurement bases

3.7.1.A Historical cost

Historical cost measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them. [FRS 102.2.68]. Unlike current value, historical cost does not reflect changes in values, except to the extent that those changes relate to impairment of an asset or a liability becoming onerous.

The historical cost of an asset is the value of the costs incurred in acquiring or creating the asset. This comprises the consideration paid to acquire or create the asset plus transaction costs. The historical cost of a liability when it is incurred or assumed is the value of the consideration received to incur or take on the liability, minus transaction costs. [FRS 102.2.69].

As noted above, the historical cost of an asset is updated over time to reflect certain changes to the asset, as follows:

- Consumption of part, or all, of the economic resource that constitutes the asset in the form of depreciation or amortisation.
 - Extinguishment of part, or all, of the asset by payments received.
 - Lack of recoverability of the asset (impairment).
- And
- Accrual of interest to reflect any financing component of the asset. [FRS 102.2.70].

Similarly, the historical cost of a liability is updated over time to reflect applicable changes, as follows:

- Fulfilment of part, or all, of the liability. This might be by making payments that extinguish part, or all, of the liability or by satisfying an obligation to deliver goods.
 - The effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous. A liability is onerous if the historical cost is no longer sufficient to depict the obligation to fulfil the liability.
- And
- Reflection of any financing component of the liability, for example, the accrual of interest. [FRS 102.2.71].

The standard explains that amortised cost is one method of applying a historical cost measurement basis to financial assets and financial liabilities. If a financial instrument has a variable rate, the discount rate used in applying amortised cost is updated to reflect changes in the variable rate. [FRS 102.2.72].

3.7.1.B Current value

Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Current value measurement bases include: [FRS 102.2.73]

- Fair value
 - Value in use for assets and fulfilment value for liabilities
- And
- Current cost

Fair value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [FRS 102 Appendix I]. It reflects the perspective of market participants; that is, participants in a market to which the entity has access. The asset or liability is measured using the same assumptions that market participants would use when pricing the asset or liability if those market participants act in their economic best interest.

The standard makes a distinction between the fair value of an asset or liability and the transaction price; it observes that fair value is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or liability. This has an impact on the treatment of transaction costs; the latter are a characteristic of a transaction rather than of an asset or liability. Consequently, a fair value measurement is not increased by any transaction costs incurred when acquiring the asset and is not decreased by any transaction costs incurred when the liability is incurred. [FRS 102.2.73(a)].

Value in use for assets and fulfilment value for liabilities

Value in use is defined as the present value of the cash flows, or other economic benefits, that an entity expects to 'derive' from an asset or cash-generating unit. [FRS 102 Appendix I]. Fulfilment value is the converse, or the present value of the cash, or other economic resources, that an entity expects to be obliged to 'transfer' as it fulfils a liability. Because value in use and fulfilment value are both based on future cash flows, they do not include transaction costs incurred on acquiring an asset or taking on a liability. [FRS 102.2.73(b)]. However, both measurement techniques include the present value of any transaction costs an entity expects to incur on the ultimate disposal of the asset or on fulfilling the liability.

Current cost

Section 2 defines the current cost of an asset as the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date. [FRS 102.2.73(c)].

3.7.2 Factors to consider in selecting measurement bases

The information provided by a measurement basis must, by necessity, be useful to users of financial statements. To achieve this, the information must be relevant, and it must faithfully represent what it purports to represent. In addition, the information provided must be, as far as possible, comparable, verifiable, timely and understandable. It follows that it is important to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance. Other factors, including the qualitative characteristics discussed in 3.3.2 above, should also be considered - see 3.7.2.C below. In most cases, no single factor will determine which measurement basis should be selected. The relative importance of each factor will depend on facts and circumstances. [FRS 102.2.74, FRS 102.2.75].

3.7.2.A Relevance

The standard explains that a measurement basis affects the relevance of information provided in two ways and these apply to both an asset or liability and to the related income and expenses:

- The characteristics of the asset or liability, including the variability of cash flows and whether the value of the asset or liability is sensitive to market factors or other risks.

And

- How that asset or liability contributes to future cash flows. [FRS 102.2.76].

If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value. As a result, users of financial statements may find information about historical cost to be irrelevant, if information about changes in value is important to them. [FRS 102.2.77]. For example, amortised cost cannot provide relevant information about a financial asset or financial liability that is a derivative.

Some economic resources produce cash flows directly; in other cases, economic resources are used in combination to produce cash flows indirectly. How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity.

Typically, for assets that can be sold independently and without a significant economic penalty, a current value measurement basis will provide the most relevant information, as it incorporates current estimates of the amount, timing and uncertainty of the future cash flows. For assets and liabilities that are used in combination, it is necessary to consider the principles of relevance and faithful representation, to the extent that they apply to the facts and circumstances. [FRS 102.2.78].

3.7.2.B Faithful representation

When assets and liabilities are related in some way, using different measurement bases for those assets and liabilities can create a measurement inconsistency; this is commonly referred to as an accounting mismatch. If financial statements contain measurement inconsistencies, those financial statements may not faithfully represent some aspects of the entity's financial position and financial performance.

Where cash flows from one asset or liability are directly linked to the cash flows from another asset or liability, avoiding an accounting mismatch by using the same measurement basis for related assets and liabilities may provide users of financial statements with information that is more useful than the information that would result from using different measurement bases. [FRS 102.2.79].

As noted in 3.3.1.C above, although a perfectly faithful representation is free from error, this does not mean that measures must be perfectly accurate in all respects. [FRS 102.2.15].

Measurement uncertainty arises when a measure cannot be determined directly by observing prices in an active market and must instead be estimated. This may affect whether information provided by that measurement basis provides a faithful representation of an entity's financial position and financial performance, though the effect may differ depending on the level of uncertainty. The standard explains that a high level of measurement uncertainty does not necessarily prevent the use of a measurement basis, if that basis provides relevant information. However, occasionally the level of measurement uncertainty is so high that information provided by a measurement basis might not provide a sufficiently faithful representation. In such cases, a different measurement basis that would result in relevant information must be considered. [FRS 102.2.80].

Section 2 draws a distinction between measurement uncertainty, outcome uncertainty and existence uncertainty:

- Outcome uncertainty is uncertainty about the amount or timing of any inflow or outflow of economic benefits that will result from an asset or liability.
- And
- Existence uncertainty is uncertainty about whether an asset or a liability exists (see 3.6.2.B above).
- [FRS 102.2.81].

The presence of outcome uncertainty or existence uncertainty may sometimes contribute to measurement uncertainty. However, outcome uncertainty or existence uncertainty does not necessarily result in measurement uncertainty. For example, if the fair value of an asset can be determined directly by observing prices in an active market, no measurement uncertainty is associated with the measurement of that fair value, even if it is uncertain how much cash the asset will ultimately produce and hence there is outcome uncertainty.

3.7.2.C Enhancing qualitative characteristics

The enhancing qualitative characteristics of comparability, understandability and verifiability all have implications for the selection of a measurement basis (discussed in 3.3.2 above), but that of timeliness has no specific implications. As well as the enhancing qualitative characteristics, the standard acknowledges that the cost constraint may have implications and hence consideration of whether the benefits justify the cost of providing and using that information is required. [FRS 102.2.82].

Consistently using the same measurement bases for the same items, either from period to period within a reporting entity or in a single period across entities, can help make financial statements more comparable and conversely, a change in measurement basis can make financial statements less understandable. Nonetheless, other factors may outweigh the reduction in understandability and in these cases a change may be justified. This may be the case if the change results in more relevant information. If any change is made, explanatory information is likely to be required to enable users of the financial statements to understand the effect of the change. [FRS 102.2.83, FRS 102.2.84].

As a general rule, the more measurement bases are used in a set of financial statements, the more complex the resulting information becomes and there is a risk that the information may become less understandable. This may also result in the totals or subtotals presented in the statement of financial position and the statement(s) of financial performance becoming less informative. It can therefore be seen that the characteristic of understandability depends partly on how many different measurement bases are used and on whether those bases are consistent over time. However, the provision of useful information is essential and thus it may be appropriate to use more measurement bases if that is necessary for that purpose. [FRS 102.2.85].

The characteristic of verifiability is enhanced when a user of the financial statements can independently corroborate the measurement basis, either directly, or indirectly. An example of direct corroboration is observing prices, whereas an example of indirect corroboration is checking inputs to a model. If it is not possible to verify a particular measure, explanatory information may be needed to enable users to understand how the measure was determined. In some cases, it may be necessary to specify the use of a different measurement basis. [FRS 102.2.86].

3.7.3 Measurement of equity

Extract from Section 2

2.87 The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities. [FRS 102.2.87].

The standard observes that although total equity is not measured directly, it may be appropriate to measure directly the carrying amount of some individual classes of equity and some components of equity. [FRS 102.2.88]. For a discussion on the presentation and reconciliation of components of equity, see Chapter 6.

3.8 Presentation and disclosure

The presentation and disclosure requirements cover three topics: classification, offsetting and aggregation, each of which are discussed in turn below.

3.8.1 Classification

Classification is defined as the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Examples of characteristics are given, such as the nature of the item, its role (or function) within the business activities conducted by the entity, and how it is measured, though this is not an exhaustive list. [FRS 102.2.89].

The standard points out that classifying together items which do not share characteristics, so dissimilar assets, liabilities, equity, income or expenses, can obscure relevant information and can reduce understandability and comparability, resulting in a failure to provide a faithful representation. [FRS 102.2.90].

Classification is applied to the unit of account selected for an asset or liability (see 3.5.3 above). However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately. Situations where that is appropriate are when separate classification would enhance the usefulness of the resulting financial information. [FRS 102.2.91]. An example of this is the separation of an asset or liability into current and non-current components.

3.8.1.A Classification of income and expenses

Section 2 requires all income and expenses to be classified and included either in profit or loss, or in other comprehensive income. [FRS 102.2.92]. As the income statement is the primary source of information about an entity's financial performance for the reporting period, all income and expenses are, in principle, included in that statement, unless FRS 102 requires or permits otherwise, or unless prohibited by the Act. [FRS 102.2.93]. This refers to the requirement for a UK company preparing Companies Act accounts to determine amounts included in the profit and loss account section of the statement of comprehensive income on a prudent basis, which results in only profits realised at the balance sheet date being included in profit or loss, with certain exceptions for fair value measurement. See 4.1 below and Chapter 6 at 5.2.

3.8.1.B Reclassification adjustments

Other comprehensive income includes income and expenses which are either required or permitted to be included in that statement; the question arises as to whether these items should be reclassified into profit and loss in a future period. This type of reclassification adjustment is sometimes referred to as 'recycling'. The standard clarifies that this is done when doing so results in the income statement providing more relevant information or providing a more faithful representation of the entity's financial performance for that future period. As a result, income and expenses included in other comprehensive income will not necessarily be reclassified into profit or loss. The reclassification requirements relating to specific items are set out in the relevant section of FRS 102. [FRS 102.2.94].

Reclassification is permitted for the following:

- Financial instruments held at available for sale, under the provisions of IAS 39 *Financial Instruments: Recognition and Measurement* that can be applied under Section 12 *Other Financial Instruments Issues* of FRS 102 (see Chapter 13 at 2.1). [FRS 102.12.2].
- Debt instruments carried at fair value through other comprehensive income, under the provisions of IFRS 9 *Financial Instruments*, that can be applied under Section 12 of FRS 102 (see Chapter 13 at 2.1). [FRS 102.12.2].

And

- The effective portion of gains and losses on hedging instruments in a cash flow hedge (see Chapter 14 at 4.8.3). *[FRS 102.12.23, IFRS 9.6.5.11]*.

Recycling of unrealised gains from a revaluation reserve within equity to profit and loss is generally not permitted by FRS 102, though the gain becomes realised at the point of disposal. A transfer of reserves from the revaluation reserve to retained earnings within the statement of changes in equity may be recorded.

3.8.1.C Classification of equity

Some components of equity may be subject to particular legal, regulatory or other requirements. Therefore, to achieve the objective of providing useful information, it may be necessary to classify equity claims separately. *[FRS 102.2.99]*.

3.8.2 Offsetting

The concept of offsetting refers to the process of grouping assets and liabilities, or income and expenses, which are recognised and measured as separate units of account and presenting them as single net amount in the statement of financial position. As a general rule, offsetting is not permitted, as it means that dissimilar items are classified together. *[FRS 102.2.95]*. However, there are limited circumstances in which offsetting is required or permitted by the standard. For example, in cases where it is not the normal operating activity of the entity, gains and losses on disposal of fixed assets (including investments and operating assets) are reported net by deducting from the proceeds on disposal the carrying amount of the asset and related selling expenses. *[FRS 102.2.98]*. Section 2 clarifies that measuring assets net of valuation allowances (for example, allowances for inventory obsolescence and allowances for uncollectible receivables) is not offsetting. *[FRS 102.2.96, FRS 102.2.97]*.

3.8.3 Aggregation

Section 2 defines aggregation as the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification. *[FRS 102.2.100]*.

The role of aggregation is to make information more useful by summarising a large volume of detail. Inevitably, aggregation conceals some of that detail and thus a risk of obscuring important information arises. Therefore, it is important to find a balance so that relevant information is not obscured by excessive aggregation or the inclusion of a large amount of insignificant detail. *[FRS 102.2.101]*.

4 Company Law principles

FRS 102 financial statements prepared by a UK company are 'Companies Act accounts' and must apply the fundamental accounting principles set out in Company Law - the going concern assumption, consistent accounting policies and measurement bases, prudence, the accruals concept and separate determination (no offset). Section 2 addresses similar concepts, as discussed at 3 above.

4.1 Application of prudence - realised profits

For UK companies, the Regulations also require that the amount of any item must be determined on a prudent basis. In particular, only profits realised at the balance sheet date are to be included in the profit and loss account and all liabilities which have arisen in respect of the financial year in which the accounts relate or a previous financial year must be taken into account, including those which only become apparent between the balance sheet date and the date on which it is signed by a director on behalf of the board in accordance with Section 414 of the CA 2006. [*1 Sch 13, 2 Sch 19, 3 Sch 18, 1 Sch 13 (SC), s414*]. See Chapter 6 at 8.1.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

accrual basis (of accounting)	The effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
Act	The Companies Act 2006
asset	A present economic resource controlled by the entity as a result of past events.
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.
consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position.
economic resource	A right that has the potential to produce economic benefits.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
expenses	Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to equity investors.
financial statements	
general purpose financial report	A report that provides financial information about the reporting entity's economic resources, claims against the entity and changes in those economic resources and claims that is useful to primary users in making decisions relating to providing resources to the entity.
general purpose financial statements (generally referred to simply as financial statements)	Financial statements directed to the general financial information needs of a wide range of users who are not in a position to demand reports tailored to meet their particular information needs.
going concern	An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.
income	Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from equity investors.
liability	A present obligation of the entity to transfer an economic resource as a result of past events.
material	Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions that the users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.
measurement	The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.
objective of financial statements	To provide information about the financial position, performance and, when required to be presented, cash flows of an entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

recognition	The process of capturing for inclusion in the statement of financial position or statement of comprehensive income an item that meets the definition of one of the elements of financial statements: (a) assets; (b) liabilities; (c) equity; (d) income; or (e) expenses. Recognition involves depicting the item in one of those statements - either alone or in aggregation with other items - in words and by a monetary amount, and including that amount in one or more totals in that statement.
reporting period	The period covered by financial statements or by an interim financial report.

Chapter 5

FRS 102 - Small entities

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Overview

This chapter deals with the requirements of Section 1A *Small Entities*.

What you need to know

- A small entity is: (1) a company qualifying for the small companies regime, (2) an LLP qualifying for the small LLPs regime, or (3) an entity that would have qualified for the small companies regime had it been a company incorporated under company law.
- Small entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* can choose to apply the small entities regime (i.e., Section 1A) or the full requirements of FRS 102 (excluding Section 1A). Therefore, Section 1A is optional for small entities to apply.
- Small entities other than UK companies or LLPs applying Section 1A must comply with the requirements of Section 1A (including those deriving from UK company and LLP law), except to the extent that these requirements are not permitted by its statutory framework.
- FRS 102 requires small entities to apply the recognition and measurement requirements of FRS 102 in full, with the exception of loans from a director or a director's close family member(s) where at least one of those individuals is a shareholder where a simpler accounting treatment is permitted.
- Section 1A addresses the presentation and disclosure requirements that apply to a small entity that chooses to apply the small entities regime, although a small entity applying Section 1A must still comply with most of the general principles in Section 3 *Financial Statement Presentation* of FRS 102.
- Small entities are not required to apply Sections 4 to 7 of FRS 102 (which cover the primary statements) nor other disclosure requirements of Sections 3, 8 to 35 of FRS 102 (unless specifically included in Section 1A). However, small entity financial statements are required to give a true and fair view, and this could necessitate the presentation of further primary statements or additional disclosures.
- Small entities must give an explicit and unreserved statement of compliance with FRS 102 in the notes to the financial statements, stating (where this is the case) that Section 1A has been applied. A statement (where applicable) that the financial statements are prepared in accordance with the provisions applicable to companies subject to the small companies regime (or the small LLPs regime, or small entities regime) is also given on the statement of financial position above the approval signature.
- A complete set of financial statements for a small entity applying Section 1A includes a statement of financial position, an income statement and notes (with comparatives). A cash flow statement is not required (even if Section 1A is not applied).
- Appendices A and B to Section 1A set out the permitted balance sheet and profit and loss account formats, which are aligned with those required by UK company law for companies applying the small companies regime (and the formats for LLPs applying the small LLPs regime). From April 2027, small entities only have a choice between adapted formats and statutory formats.
- Appendix C to Section 1A sets out the disclosure requirements for small entities. This appendix also sets out the disclosure requirements for small entities based on the requirements of UK company law, which are based closely on the requirements in the small companies regime. The Periodic Review 2024 Amendments increased the disclosures in Appendix C with the aim of reducing the amount of judgement required in determining what disclosures are needed for financial statements to give a true and fair view. Small entities subject to a Statement of Recommended Practice (SORP) could also be required by the SORP to present additional disclosures.
- Most small entities are exempt from the preparation of consolidated financial statements (whether or not they apply Section 1A), although some UK small companies and LLPs are not exempt.
- For financial years beginning on or after 6 April 2025, the size thresholds for a small company or LLP are £15 million turnover, a balance sheet total (total assets) of £7.5 million, and 50 employees. For a small company or LLP that is a parent, the corresponding size thresholds applied to the group it heads are £15 million turnover (£18 million gross of consolidation adjustments) and £7.5 million balance sheet total (£9 million gross of consolidation adjustments) and 50 employees.

1 Introduction

1.1 Background

In July 2015, the Financial Reporting Council (FRC) created a new small entities regime, Section 1A, within FRS 102. Section 1A allows small entities applying the small entities regime to follow simpler presentation and disclosure requirements than full FRS 102. The recognition and measurement principles of FRS 102 continue to apply (with very limited exceptions) to small entities. In addition, the FRC issued FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*. FRS 105 is outside the scope of this publication.

FRS 100 *Application of Financial Reporting Requirements* and FRS 102 (see Chapter 1 at 3.3 and Chapter 3 at 2.1) set out the accounting framework for preparation of an entity's financial statements, as follows:

- Certain entities are required by the CA 2006 or other legislation or regulation to apply adopted IFRS.
 - Entities preparing individual financial statements only that are eligible to apply the micro-entities regime may apply FRS 105.
 - Entities that are not eligible to or choose not to apply FRS 105 have a choice of applying: (1) adopted IFRS, (2) FRS 101 *Reduced Disclosure Framework - Disclosure exemptions from adopted IFRS for qualifying entities* (individual financial statements of a qualifying entity only), or (3) FRS 102
- And
- Entities qualifying for the small entities regime that adopt FRS 102 can choose to apply Section 1A or the full standard. [FRS 100.4, FRS 102.1A.1, FRS 102.1A.2, FRS 102.1.3].

Under the CA 2006, financial statements of a UK company prepared in accordance with FRS 101, FRS 102 or FRS 105 are Companies Act accounts (non-IAS accounts for an LLP). Financial statements of a UK company or LLP preparing financial statements in accordance with UK-adopted international accounting standards ('adopted IFRS') are IAS accounts.

When Section 1A was first introduced into FRS 102, the FRC concluded that it could not impose specific disclosure requirements for small entities that went beyond the statutory requirements. [FRS 102.BC.A.78]. Accordingly, the presentation and disclosure requirements of the original Section 1A were based on the requirements of the CA 2006 and The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409), as amended ('the Small Companies Regulations') for companies subject to the small companies regime. LLPs subject to the small LLPs regime have similar disclosures, as set out in The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911) and The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912), as amended ('the Small LLP Regulations').

Following the UK's exit from the European Union, the FRC concluded that it was able to specify additional disclosures for small UK entities in Appendix C of Section 1A that are expected to be required for the financial statements to give a true and fair view, reducing the amount of judgement required by preparers. [FRS 102.BC.A.79, FRS 102.BC.B1A.3B]. In practice, since the true and fair view requirement is unchanged, the FRC notes that it expects that this will simplify the process of deciding which disclosures are given, although the disclosures given might not change. [FRS 102.BC.A.80].

In December 2024, The Companies (Accounts and Reports) (Amendment and Transitional Provision) Regulations 2024 (SI 2024/1303) raised the size thresholds for micro, small and medium-sized companies and LLPs, effective for financial years beginning on or after 6 April 2025 (see 2.2 and 2.3 below). In March 2025, the FRC issued Amendments to FRS 102 and FRS 105 to reflect the new size thresholds in Appendix III Note on Legal Requirements of those standards.

1.2 Scope of this chapter

A company subject to the small companies regime (in the UK), an LLP subject to the small LLPs regime, and an entity that would have qualified for the small companies regime had it been a company, is a 'small entity' permitted to use the small entities regime in FRS 102, i.e., to apply Section 1A of FRS 102. [s382, s383, s384, s382 (LLP), s383(LLP), s384 (LLP), FRS 102 Appendix I].

Section 1A sets out the information to be presented and disclosed in the financial statements of a small entity choosing to apply the small entities regime. Unless specifically excluded, all the recognition and measurement requirements of the full standard continue to apply. [FRS 102.1A.1]. These are discussed in other chapters of this book. FRS 102 exempts small entities from preparing a cash flow statement (see 3.3.3 below) and provides an optional alternative for accounting for loans from a director or a director's close family member(s), where at least one of those individuals is a shareholder (see 3.1 below). The cash flow statement and directors' loan exemptions are available to a small entity whether or not Section 1A is applied. In addition, most small entities are exempt from preparation of consolidated financial statements (see 3.2 below).

This chapter principally addresses which entities qualify as 'small entities', the requirements of Section 1A, and the related statutory requirements (for UK companies subject to the small companies regime and LLPs subject to the small LLPs regime). A summary of Section 1A is included in the Overview above. Key changes made by the Periodic Review 2024 amendments are noted at 1.3 below. Key definitions used in this chapter are included in Appendix A below.

The definition and qualifying criteria for a small entity, the small companies regime and small LLPs regime are discussed at 2 below. This chapter has been cross referred from Chapter 1 (which discusses FRS 100) because it includes the qualifying criteria for the small companies regime and the small LLPs regime. These qualifying criteria apply both to small companies and LLPs preparing Companies Act accounts (non-IAS accounts, for an LLP) – such as financial statements prepared in accordance with FRS 101 and FRS 102 – and to those preparing IAS accounts, i.e., financial statements prepared in accordance with UK-adopted international accounting standards (see 1.1 above).

The presentation requirements of full FRS 102 that are mandatory for entities applying Section 1A are covered at 3 below. These include the overriding requirement for the financial statements to give a true and fair view. If a small entity chooses not to apply Section 1A (or presents additional primary statements), Chapter 6 addresses the presentation requirements of full FRS 102.

UK companies subject to the small companies regime apply the Small Companies Regulations (and LLPs subject to the small LLPs regime apply the Small LLP Regulations). These regulations set out simpler formats for the balance sheet and profit and loss account, and fewer notes disclosures for companies applying the small companies regime in Companies Act accounts (and LLPs applying the small LLPs regime in non-IAS accounts).

The formats for the balance sheet and profit and loss account included in Section 1A are consistent with the formats for Companies Act accounts (non-IAS accounts for an LLP) included in the Small Companies Regulations and Small LLP Regulations. These are discussed at 4 below.

The notes disclosures required by Section 1A, the Small Companies Regulations and the Small LLP Regulations in Companies Act accounts (non-IAS accounts for an LLP) are largely replicated in the notes disclosures set out in Appendix C of Section 1A and addressed at 5 below.

The requirements for the preparation and filing of small company and small LLP financial statements are set out in the CA 2006 as well as in the relevant financial reporting framework.

The disclosure exemptions in the CA 2006 (and the related requirements for LLPs) for:

- The financial statements of UK companies and LLPs, prepared in accordance with the small companies regime and small LLPs regime respectively
- And
- The annual reports of UK companies taking advantage of the small companies exemption, are discussed at 6 below.

The commentary on the scope of the small companies regime, small LLPs regime and the disclosure exemptions in 2 and 6 below, covers both Companies Act and IAS accounts. This is because these requirements derive from the Companies Act 2006, Small Companies Regulations and Small LLP Regulations.

1.3 Changes made by the Periodic Review 2024

The Periodic Review 2024 amendments stress the requirement in paragraph 1A.5 of FRS 102 for small entity financial statements to give a true and fair view. The language in Section 1A has been strengthened stating that "In order to comply with the requirement of paragraph 1A.5, a small entity may need to provide disclosures in addition to those set out in this section". Therefore, a small entity may need to present additional primary statements, shall present sufficient information in the notes to the financial statements and may need to provide any of those disclosures that are relevant to material transactions, other events or conditions of the small entity that are in other sections of FRS 102 in order for its financial statements to meet the true and fair requirement. [FRS 102.1A.5, FRS 102.1A.6, FRS 102.1A.9, FRS 102.1A.16, FRS 102.1A.17].

The FRC has included additional disclosures for UK small entities in Appendix C of Section 1A, taken from full FRS 102, that the FRC considers necessary for financial statements to give a true and fair view. Some but not all of these were previously encouraged disclosures in Appendix E of Section 1A (which now applies only to Irish small entities). These are described further below.

Other requirements have been restated and clarified. These include the following:

- Clarification of which parts of Section 3 of FRS 102 do not apply to a small entity. All of Section 3 now applies except for paragraphs 3.12 and 3.13 (which address changes in presentation – where the Small Companies Regulations have similar requirements), paragraphs 3.17 to 3.19 (which address a complete set of financial statements – where Section 1A has its own requirements) and paragraph 3.24(b) (description of the nature of the entity's operations and its principal activities). *[FRS 102.1A.7]*.
- In order for the financial statements to give a true and fair view, a small entity that recognises gains or losses in other comprehensive income may need to present (rather than, as previously, is encouraged to present) a statement of total comprehensive income. A small entity that has changes in equity, other than profit or loss may need to present a statement of changes in equity (or a statement of income and retained earnings). *[FRS 102.1A.9]*. Consequently, Section 1A more strongly emphasises that these are circumstances where the additional primary statements could be required if necessary for the financial statements to give a true and fair view.
- A UK small entity must include an explicit and unreserved statement of compliance with FRS 102, stating that Section 1A has been applied (where this is the case). The same applies to the statement, if applicable, that the small entity is a Public Benefit Entity (PBE) as well. These were previously encouraged disclosures in Appendix E for UK small entities. *[FRS 102.1A.7, FRS 102.1AC.2A, FRS 102.PBE1AC.2B]*.
- Certain disclosure requirements from other sections of FRS 102 have been added relating to:
 - Going concern (such as: use of the going concern basis (including significant judgements), material uncertainties over going concern, and use of a non-going concern basis). *[FRS 102.1AC.2C]*
 - Significant leasing arrangements. *[FRS 102.1AC.31A, FRS 102.1AC.31B]*
 - Provisions and contingencies. *[FRS 102.1AC.31C]*
 - Share-based payment transactions. *[FRS 102.1AC.31D]*
 - Short-term leases, leases of low value assets and variable lease payments. *[FRS 102.1AC.32A]*. Right-of-use assets will also now be subject to the usual disclosures for fixed assets, such as roll-forward reconciliations, disclosures for revalued assets, and impairments (and reversals).
 - Performance obligations in contracts with customers. *[FRS 102.1AC.32B]*
- And
- Current and deferred tax. *[FRS 102.1AC.11A, FRS 102.1AC.32C]*.
- A UK small entity must disclose all related party transactions covering the same categories of related parties as in full FRS 102 (rather than the restricted categories set out in the previous version of Section 1A and the Small Companies Regulations for transactions not concluded under normal market conditions, as previously), subject to the same exemptions available to all FRS 102 reporters. *[FRS 102.1AC.35]*. The FRC has clarified the scope of the new requirements and the interaction with the statutory requirements (see 5.1.19.B and 5.1.19.C below).
- A UK small entity must disclose dividends declared and paid or payable during the period (this was previously an encouraged disclosure in Appendix E for UK small entities). *[FRS 102.1AC.40]*.
- A UK small entity adopting FRS 102 for the first time must explain how the transition has affected its financial position and performance (this was previously an encouraged disclosure in Appendix E for UK small entities). *[FRS 102.1AC.41]*.

The requirements of SORPs are not generally addressed in this chapter (except in the context of the balance sheet and profit and loss account formats used in small LLP financial statements).

1.4 Abbreviations

'Small Companies Regulations' refers to The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) (as amended).

'Small LLP Regulations' refers to The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912) (as amended).

References to the 'General Rules to the formats' mean the 'General Rules', as included in Section A of Part 1 of Schedule 1 to the Small Companies Regulations or the equivalent requirements in the Small LLP Regulations.

The following statutory instruments are referred to by their statutory instrument number:

- The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (as amended) (SI 2008/1911). This statutory instrument sets out how Parts 15 and 16 of the Companies Act 2006 apply to LLPs and is also referred to as 'the CA 2006 as applied to LLPs' in this chapter.
- The Companies (Accounts and Reports) (Amendment and Transitional Provision) Regulations 2024 (SI 2024/1303).

'LLP SORP' refers to the Statement of Recommended Practice Accounting by Limited Liability Partnerships issued by CCAB in November 2025 ('LLP SORP'), which reflects the Periodic Review 2024 amendments.

2 Scope of small entities regime (Section 1A of FRS 102)

Section 1A sets out the information to be presented and disclosed in the financial statements of a small entity that chooses to apply the small entities regime (see 2.1 below). [FRS 102.1A.1].

2.1 Application of Section 1A

A small entity is defined as:

- (a) A company meeting the definition of a small company as set out in sections 382 or 383 of the CA 2006 and not excluded from the small companies regime by section 384 (see 2.2 below).
- (b) An LLP qualifying as small and not excluded from the small LLPs regime, as set out in sections 382 to 384 of the CA 2006 as applied to LLPs (see 2.3 below).

Or

- (c) Any other entity that would have met the criteria in (a) had it been a company incorporated under company law. [FRS 102 Appendix I].

Section 1A is optional for small entities to apply. A small entity that chooses not to apply the small entities regime is required to apply FRS 102, excluding Section 1A, unless the small entity chooses to apply UK-adopted international accounting standards (or, if eligible, FRS 101). [FRS 102.1A.2].

However, as noted in Chapter 1 at 3.3, an entity's choice of financial reporting framework must be permitted by the legal framework or other regulations or requirements that govern the preparation of the entity's financial statements. [FRS 100.4, FRS 102.1.3]. Other agreements or arrangements (such as shareholders' agreements, banking agreements) may restrict the choice of financial reporting framework.

Entities that are subject to a SORP must confirm the applicability of Section 1A. SORPs may restrict entities within their scope from taking advantage of certain exemptions within FRS 102 for small entities or require additional disclosures in order to comply with the SORP.

References to a 'small entity' in paragraphs 1A.4 to 1A.22 of Section 1A (and its appendices), i.e., in the rest of Section 1A, are to a small entity that chooses to apply the small entities regime. [FRS 102.1A.3].

Section 1A applies to all small entities applying the small entities regime, whether or not they report under the CA 2006. Small entities that do not report under the CA 2006 must comply with Section 1A and with the CA 2006 and the Small Companies Regulations (or, where applicable, the CA 2006 as applied to LLPs and the Small LLP Regulations) where referred to by Section 1A, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. [FRS 102.1A.4].

2.2 Small companies regime (UK)

The small companies regime applies to a company for a financial year in relation to which the company qualifies as small (see 2.2.1 and 2.2.2 below for the criteria for UK companies) and is not excluded from the regime (see 2.2.3 below for the types of excluded companies in the UK). [s381].

2.2.1 UK companies qualifying as small – company is not a parent undertaking (size criteria)

The discussion below addresses the qualifying conditions to be small for a company that is not a parent undertaking. See 2.2.2 below for the qualifying conditions for a company that is a parent undertaking.

A company qualifies as small in relation to its first financial year if the qualifying conditions (as set out below) are met in that year. [s382(1)].

A company qualifies as small in relation to a subsequent financial year if the qualifying conditions are met in that year except that in relation to a subsequent financial year, where on its balance sheet date a company meets or ceases to meet the qualifying conditions, then that will affect its qualification as a small company only if it occurs in two consecutive years. [s382(1A), s382(2)].

This provision is designed to assist companies which fluctuate in and out of the qualifying conditions. However, if a company fails to meet the criteria in two consecutive years, it will cease to qualify and then would need to meet the criteria in two later consecutive years to requalify for the exemptions. This is sometimes referred to as a 'year of grace'.

The qualifying conditions are met for a company in a year in which the company satisfies two or more of the following requirements: [s382(3)]

- Turnover is not more than £15 million.
- Balance sheet total (i.e., total assets shown in the balance sheet), [s382(5)], is not more than £7.5 million.

And

- Number of employees is not more than 50.

For financial years beginning prior to 6 April 2025, the turnover threshold was £10.2 million and the balance sheet total was £5.1 million.

If the company's financial year is not a full year, the maximum turnover figure is adjusted proportionately. [s382(4)].

The number of employees means the average number of persons employed under contracts of service by the company in the year (determining for each month, the number of such persons - whether employed throughout the month or not, adding together the monthly totals and dividing by the number of months in the financial year). [s382(6)].

As discussed in Chapter 6 at 7.7, 'contracts of service' with the company means an employment contract and therefore excludes people such as contractors or consultants. Executive directors generally have a contract of service, but non-executive directors may have contracts for services (rather than a contract of service) and if this is the case, would be excluded from the calculation of the number of employees. The calculation includes both part-time and full-time employees.

Although the small size criteria increased, effective for financial years beginning on or after 6 April 2025, the new size thresholds are applied to all preceding financial years in assessing whether a company is small in a particular financial year.¹⁸ This means the assessment is made as if the new small size criteria had always applied. For example, if a company with a calendar year end would qualify as small in 2026 and 2025 using the new small size criteria, it will be a small company in 2026 even if it had not qualified as small under the previous size criteria in 2025.

The Illustration below demonstrates the application of small size thresholds including application of the 'year of grace' rules.

Illustration 2-1: Applying the small size thresholds for UK companies and LLPs

Company A	20X5	20X4	20X3	20X2	20X1
	£'000	£'000	£'000	£'000	£'000
Turnover	17,000	16,200	16,000	11,000	10,800
Balance sheet total	6,000	6,500	6,000	5,650	5,500
Number of employees	49	55	51	45	45
Are at least two of the small size criteria met?	Yes	No	No	Yes	Yes
Is the company small?	No	No	Yes	Yes	Yes

In this Illustration, Company A, which is not a parent undertaking, prepares its financial statements for financial years that are calendar years. It is incorporated on 1 January 20X1 so 20X1 is its first financial year. The relevant size criteria applied in all years in the table above are those that apply for financial years beginning on or after 6 April 2025.

Does Company A qualify as small and in which years?

- Company A met at least two of the small size criteria, i.e., the qualifying conditions, in 20X1 and 20X2. It qualifies as small in those years.
- In 20X3, Company A does not meet two of the small size criteria but still qualifies as small because the qualifying conditions were met in the two preceding financial years (20X2 and 20X1).
- However, Company A ceases to qualify as small in 20X4, as it failed to meet two of the small size criteria for two financial years running.
- Although Company A again meets two of the small size criteria in 20X5, it does not qualify as small for its 20X5 financial statements, as it ceased to qualify as small in the prior year.

18 *The Companies (Accounts and Reports) (Amendment and Transitional Provision) Regulations 2024* (SI 2024/1303), paras. 2(2), 3 [The Companies \(Accounts and Reports\) \(Amendment and Transitional Provision\) Regulations 2024](#).

- If Company A meets two of the small size criteria again in 20X6, it will requalify as small for its 20X6 financial statements (as it would then meet the qualifying conditions for two years running).

However, had two of the small size criteria been met in 20X3 or 20X4, Company A would qualify as small in all the financial years shown above (on the basis that it had not failed the small size criteria for two financial years running).

2.2.2 UK companies qualifying as small – company is a parent undertaking (size criteria)

Where the company is itself a parent undertaking, it qualifies as small only if the group that it heads qualifies as a small group. [s382(7), s383(1)]. This is the case whether or not group accounts are prepared. Consequently, the assessment of whether a parent undertaking is small differs to that of a company that is not a parent undertaking, even if the entities are in the same group.

A group qualifies as small in relation to the parent's first financial year if the qualifying conditions (as set out below) are met in that year. [s383(2)].

A group qualifies as small in relation to a subsequent financial year if the qualifying conditions are met in that year except that in relation to a subsequent financial year, where on its balance sheet date the group meets or ceases to meet the qualifying conditions, then that will affect the group's qualification as a small group only if it occurs in two consecutive years. [s383(2A), s383(3)].

As discussed in 2.2.1 above, this provision, referred to as a 'year of grace', is designed to assist companies which fluctuate in and out of the qualifying conditions.

The qualifying conditions for a small group, including the separate financial statements of the parent undertaking, are met in a year in which the group headed by the company satisfies two or more of the following requirements: [s383(4)].

- Aggregate turnover must not exceed £15 million net (or £18 million gross).
- Aggregate balance sheet total (i.e., total assets shown in the balance sheet), [s382(5)], must not exceed £7.5 million (or £9 million gross).

And

- Aggregate number of employees must not exceed 50

For financial years beginning prior to 6 April 2025, the turnover threshold was £10.2 million net (£12.2 million gross), and the balance sheet total was £5.1 million net (£6.1 million gross). As discussed at 2.2.1 above, the assessment for financial years beginning on or after 6 April 2025 is made as if the new size criteria had always applied.

The aggregate figures are ascertained by aggregating the relevant figures determined in accordance with section 382 of CA 2006 for each member of the group (meaning the reporting company and its subsidiary undertakings). [s383(5), s474(1)]. The figures used for each subsidiary undertaking are those included in its individual accounts for the relevant financial year. Where the subsidiary undertaking's financial year is coterminous with that of the parent company, the relevant financial year ends at the same date as that of the parent company, or where it is not coterminous, the relevant financial year is the subsidiary undertaking's financial year ending last before the end of the financial year of the parent company. If those figures are not obtainable without disproportionate expense or undue delay, the latest available figures are used. [s383(7)].

The turnover and balance sheet total criteria can be satisfied on either the gross or net basis (with 'net' meaning after set-offs and other adjustments made to eliminate group transactions, and 'gross' meaning without those set-offs and other adjustments). It is permissible to satisfy turnover on the 'net' basis and the balance sheet total on the 'gross' basis (or vice versa). For Companies Act accounts (such as FRS 102 financial statements), the consolidation adjustments are determined in accordance with the Regulations or the Small Companies Regulations. For IAS accounts, the consolidation adjustments are determined in accordance with UK-adopted international accounting standards. [s383(6)].

Illustration 2-2: Applying the small size thresholds to a UK parent company/LLP

In this Illustration, Company B, which is a parent undertaking, prepares its financial statements for financial years that are calendar years. It is incorporated on 1 January 20X1 so 20X1 is its first financial year. The aggregate financial information of Company B and its subsidiary S (which also has a calendar year end) is presented below on a gross and a net (of consolidation adjustments) basis. The relevant size criteria applied to all years in the table are those that apply for financial years beginning on or after 6 April 2025.

Gross	20X5	20X4	20X3	20X2	20X1
	£'000	£'000	£'000	£'000	£'000
Turnover	21,000	20,500	19,000	18,500	16,000
Balance sheet total	11,000	10,000	10,000	8,900	8,500
Number of employees	55	55	49	51	45
Are at least two of the small size criteria met?	No	No	No	No	Yes

Net	20X5	20X4	20X3	20X2	20X1
	£'000	£'000	£'000	£'000	£'000
Turnover	18,100	16,200	14,800	14,400	11,500
Balance sheet total	9,200	8,500	8,000	7,600	6,000
Number of employees	55	55	49	51	45
Are at least two of the small size criteria met?	No	No	Yes	No	Yes

Does B qualify as small and in which years?

- In 20X1, B meets at least two of the small size criteria, i.e., the qualifying conditions (on either basis) and qualifies as small.
- In 20X2, B meets at least two of the small size criteria since it meets the turnover criterion on a net basis and the balance sheet total criterion on a gross basis. Therefore, B qualifies as small as it met the qualifying conditions in 20X2 and 20X1.
- In 20X3, B does not meet at least two of the small size criteria on a gross basis but it does so on a net basis and, therefore, meets the qualifying conditions. B qualifies as small as it meets the qualifying conditions in 20X3 and 20X2.
- In 20X4, B does not meet at least two of the small size criteria on either basis. Nevertheless, B qualifies as small because it met the qualifying conditions in 20X3 and 20X2.
- In 20X5, B no longer qualifies as small as it did not meet the qualifying conditions for two years running.
- Even if B meets two of the small size criteria again in 20X6, it will not requalify as small for its 20X6 financial statements.

The assessment is more complicated where a subsidiary does not have a coterminous year end. In such a case, the turnover and balance sheet total figures that are aggregated are based on the amounts shown in B's individual financial statements and those in S's individual financial statements for the relevant financial year (being the financial year end that ends last before B's financial year end).

2.2.3 Companies excluded from the small companies regime

A company is excluded from the small companies regime if it was at any time within the financial year to which the financial statements relate:

- A public company.
- A company that is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company.
- A company that carries on insurance market activity.
- A company that is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1).

Or

- A member of an ineligible group. [s384(1)].

A group is ineligible if any of its members is:

- A traded company.
- A body corporate (other than a company) whose shares are admitted to trading on a UK regulated market.
- A person (other than a small company) who has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on a regulated activity.
- An e-money issuer.
- A small company that is an authorised insurance company, a banking company, a MiFID investment firm or a UCITS management company.
- A person who carries on insurance market activity.

Or

- A scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1). [s384(2)].

A group means a parent undertaking and its subsidiary undertakings. [s474(1)]. Therefore, in determining whether a small company is excluded on the grounds that it is a member of an ineligible group, the term 'group' comprises the widest group of which the reporting company is a member. This differs from the scope of a 'group' used when evaluating whether the small size criteria are met, which is the group headed by the reporting company.

A company is a small company for the purposes of section 384(2) (the determination of whether a group is ineligible) if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the financial statements relate. [s384(3)].

2.2.3.A Relevant definitions for small companies regime

The reference to a 'company' above is to a company formed and registered (or treated as if formed and registered) under the CA 2006. This means a company formed and registered under the CA 2006, or prior to 1 October 2009 under the Companies Act 1985, Companies (Northern Ireland) Order 1986 (or was an existing company for the purposes of that Act and Order). [s1]. Sections 382 to 384 do apply also, with modifications, to unregistered companies via separate regulations (but such companies are outside the scope of this publication).¹⁹

A traded company (in this context) means a company which has transferable securities admitted to trading on a UK regulated market. [s474(1)]. Transferable securities are those classes of securities which are negotiable on the capital market (with the exception of instruments of payment). Common examples include shares, debt and depositary receipts in respect of such securities. [s1173(1)].

A UK regulated market is a regulated market which is a recognised investment exchange under section 285 of the Financial Services and Market Act 2000, but not an overseas investment exchange within the meaning of section 313 of that Act. [s1173(1)].

A list of UK regulated markets is obtainable from the Financial Conduct Authority (FCA) website and at the time of writing contains: The London Metal Exchange, ICE Futures Europe, London Stock Exchange, Aquis Stock Exchange Limited and Cboe Europe Equities Regulated Market.²⁰ However, certain segments of these exchanges are not UK regulated markets. For example, the Main Market of the London Stock Exchange (which includes issuers admitted to trading on the Official List and the Specialist Fund Segment) is a UK regulated market but the Alternative Investment Market (AIM), the International Securities Market, Professional Securities Market, and 'Admission to Trading Only' securities are not UK regulated markets.²¹ The Main Market of Aquis Stock Exchange is a UK regulated market for securities admitted to the Official List but the Growth Market for unlisted securities is not.²²

¹⁹ The Unregistered Companies Regulations 2009 (SI 2009/2436), Schedule 1, paras. 10(1), 10(2).

²⁰ The list of UK regulated markets is available from the FCA's Financial Services Register [Regulated Markets](#) (accessed 28 August 2025).

²¹ Admission and Disclosure Standards (effective July 2024), para. 1.2, London Stock Exchange [LSEG Admission and Disclosure Standards | Effective July 2024](#) (accessed 28 August 2025).

²² Overview, [Rules & Regulations - Aquis Stock Exchange](#) (accessed 28 August 2025).

A public company means a company limited by shares or limited by guarantee and having a share capital (a) whose certificate of incorporation states that it is a public company, and (b) in relation to which the requirements of the CA 2006 or the former Companies Acts as to registration or re-registration as a public company have been complied with (on or after the relevant date, being 22 December 1980 in Great Britain and 1 July 1983 in Northern Ireland). [s4]. Therefore, a public company means any UK-incorporated company that is a 'plc' or 'PLC' rather than a publicly traded company.

An authorised insurance company is defined in section 1165(2), a banking company in section 1164(2)-(3) and insurance market activity in section 1165(7) of the CA 2006. See Chapter 6 at 3.1.2 and 3.1.3.

The terms e-money issuer, MiFID investment firm, regulated activity, and UCITS management company are defined in section 474 of the CA 2006. [s474].

A body corporate includes a body incorporated outside the UK but does not include (a) a corporation sole, or (b) a partnership that, whether or not a legal person, is not regarded as a body corporate under the law by which it is governed. [s1173(1)]. Therefore, a body corporate would include an overseas company or a UK LLP.

2.3 Small LLPs regime (UK)

The small LLPs regime applies to an LLP for a financial year in relation to which the LLP qualifies as small (see 2.3.1 below for the size criteria for UK LLPs) and is not excluded from the regime (see 2.3.2 below for the types of excluded LLPs in the UK). [s381 (LLP)].

2.3.1 Size criteria

The small size criteria for an LLP that is not a parent and for an LLP that is a parent are the same as the small size criteria applied for a company that is not a parent (see 2.2.1 above) and a company that is a parent (see 2.2.2 above). These size criteria operate in the same way as described for UK companies above. [s382 (LLP), s383 (LLP)].

2.3.2 Excluded LLPs

An LLP is excluded from the small LLPs regime if it was at any time in the financial year to which the financial statements relate:

- A traded LLP (meaning an LLP any of whose transferable securities are admitted to trading on a UK regulated market).
 - An LLP that is an authorised insurance company, a banking LLP, an e-money issuer, a MiFID investment firm or a UCITS management company.
 - An LLP that carries on insurance market activity.
 - An LLP that is a scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1).
- Or
- A member of an ineligible group. [s384(1) (LLP), s474(1)].
 - A group (i.e., a parent undertaking and its subsidiary undertakings) is ineligible if any of its members is: A traded company.
 - A body corporate (other than a company) whose shares are admitted to trading on a UK regulated market.
 - A person (other than a small company or small LLP) who has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on a regulated activity.
 - An e-money issuer.
 - A small company or small LLP that is an authorised insurance company, a banking company or banking LLP, a MiFID investment firm or a UCITS management company.
 - A person who carries on insurance market activity.
- Or
- A scheme funder of a Master Trust scheme within the meanings given by section 39(1) of the Pension Schemes Act 2017 or section 39(1) of the Pension Schemes Act (Northern Ireland) 2021 (interpretation of Part 1). [s384(2) (LLP), s474(1) (LLP)].

A company or LLP is a small company or small LLP for the purposes of section 384(2) of the CA 2006 if it qualified as small in relation to its last financial year ending on or before the end of the financial year to which the financial statements relate. *[s384(3)(LLP)]*.

As discussed at 2.2.3 above, an LLP is a member of an ineligible group if the widest group to which the LLP belongs contains any excluded members.

The definition of an ineligible group for an LLP is similar but not identical to that used for a company (see 2.2.3 above). The relevant definitions for the exclusions are set out in the CA 2006 as applied to LLPs, *[s474(1)(LLP), s1173(1)(LLP)]*, and are similar to those discussed at 2.2.3.A above.

3 Requirements of Section 1A

Section 1A defines a small entity and sets out the financial statements requirements for small entities that are FRS 102 reporters and choose to apply Section 1A. Appendices A and B of Section 1A provide guidance on adapted and abridged balance sheet and profit and loss account formats. Appendix C of Section 1A sets out the disclosure requirements for small entities in the UK. Appendices D and E are only relevant for Republic of Ireland small entities.

Unless specifically excluded, all the requirements of FRS 102, including the recognition and measurement requirements, apply to a small entity applying Section 1A. [FRS 102.1A.1].

However, there is an optional relief (included in Section 11 *Basic Financial Instruments*) allowing small entities to measure loans from a director or a director's close family member(s) (where at least one of those individuals is a shareholder) at transaction price. This relief is available to a small entity, even if not applying Section 1A. [FRS 102.11.13A]. See 3.1 below.

A small entity applying Section 1A is not usually required to prepare consolidated financial statements (although some small entities might not fall within the statutory group accounts exemption). However, Section 1A addresses voluntary preparation of consolidated financial statements, including requiring the consolidation procedures in Section 9 *Consolidated and Separate Financial Statements* to be followed. [FRS 102.1A.21, FRS 102.1A.22, FRS 102.9.3(e)]. See 3.2 below.

Section 1A exempts small entities from most of the existing presentation and disclosure requirements of FRS 102. Accordingly, a small entity only needs to comply with certain parts of Section 3 of FRS 102 covering the general principles concerning presentation of financial statements (as set out in paragraph 1A.7 – see 3.3 below). [FRS 102.1A.7]. A small entity applying Section 1A is not required to comply with Section 4 *Statement of Financial Position*, Section 5 *Statement of Comprehensive Income and Income Statement*, Section 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings* or Section 7 *Statement of Cash Flows*. [FRS 102.1A.7A]. Small entities are not required to prepare a cash flow statement (even if not applying Section 1A) unless required to do so by a SORP or law or other relevant regulation. [FRS 102.3.1B, FRS 102.7.1B]. See 3.3 below. In addition, a small entity is not specifically required to comply with the other disclosure requirements of Sections 3, and 8 to 35 of FRS 102. [FRS 102.1A.17]. However, Appendix C of Section 1A, which applies to a small entity in the UK, does scope in certain disclosures included in other Sections of FRS 102. See 5.1 below.

3.1 Optional measurement exemption for certain loans from a director or a close member of their family

The FRC has concluded that, whilst a small entity may have fewer, or simpler transactions, the accounting for a given transaction by a small entity will not differ. However, occasional specific exemptions may be granted in order to provide proportionate and practical solutions. [FRS 102.BC.B1A.8, FRS 102.BC.B1A.9]. Currently there is only one such exemption offered in FRS 102 which is in respect of loans from a director or a director's close family members. Similar relief is available to small LLPs. This exemption is set out in Section 11 of FRS 102, in paragraphs 11.13A to 11.13C. The directors' loan exemption is not available to small entities applying IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*, to the recognition and measurement of financial instruments, as permitted as a policy choice under FRS 102. [FRS 102.11.2(b), FRS 102.11.2(c), FRS 102.12.2(b), FRS 102.12.2(c)].

3.1.1 Application of the exemption

FRS 102 generally requires that a financial asset or financial liability that is a financing transaction is measured at the present value of the future payments, discounted at a market rate of interest for a similar debt instrument as determined at initial recognition adjusted for transaction costs. [FRS 102.11.13]. There are limited optional exemptions from this requirement, where the initial measurement is at transaction price (see Chapter 13 at 5.2). [FRS 102.11.13A].

As an exception to this requirement, a basic financial liability of a small entity that is a loan from a person who is within a director's group of close family members, when that group contains at least one shareholder in the entity, is permitted to be measured initially at transaction price. [FRS 102.11.13A(a)]. The effective interest rate used when subsequently measuring the loan at amortised cost is the interest rate implicit in the contract, which may be zero. [FRS 102.11.14(a)(i)]. This relief is available to a small entity, whether or not Section 1A is applied.

'A director's group of close family members' means, in this context, the director and the close members of that director's family. This includes a person who is the sole director-shareholder of an entity. For an LLP, the reference to a 'shareholder' is read as 'a member who is a person'. [FRS 102.11.13A(a)]. A loan from a director, who is not a shareholder and has no close family members that are shareholders, will not qualify for the relief. [FRS 102.BC.B11.38].

How we see it

We believe the exemption is intended to be limited to a director (or member of an LLP) who is a natural person (individual) and would exclude a corporate director-shareholder or corporate member of an LLP.

The close members of the director's family are those family members who may be expected to influence, or be influenced by, that director in their dealings with the entity including:

- That director's children and spouse or domestic partner.
- Children of that director's spouse or domestic partner.

And

- Dependants of that director or that director's spouse or domestic partner. [FRS 102 Appendix I].

An example of a situation where the optional exemption to measure the loan initially at transaction price would be available is given in Illustration 3-1 below.

Illustration 3-1: Accounting for a loan from a director or a director's close family member(s) at transaction price using the exemption in paragraph 11.13A of FRS 102

A director's spouse makes an interest free loan to Entity A, which qualifies as a small entity. The director's adult son is a shareholder in Entity A.

The amount of the loan £200,000 is repayable after three years by the entity.

This situation would fall within the scope of paragraph 11.13A of FRS 102 since a loan is made by a director's close family member, and one of the director's close family members (the adult son) is a shareholder. There is no requirement for the shareholder to be the person making the loan.

Where the optional relief in paragraph 11.13A is used, Entity A records the loan liability initially at its transaction price of £200,000 and no interest is charged to profit or loss. The loan is then repaid at £200,000 in three years' time, extinguishing the liability.

3.1.2 Small entity becomes or ceases to be eligible for the exemption

An entity that was not a small entity when the transaction was entered into but subsequently becomes eligible to take advantage of the above exemption, and chooses to do so, applies the exemption retrospectively. [FRS 102.11.13C].

An entity that has taken advantage of the exemption but subsequently ceases to be a small entity is permitted, when remeasuring the financial liability to present value prospectively from the first reporting date after it ceases to be a small entity, to determine the present value either (1) on the basis of the facts and circumstances existing at that time or (2) at the date the financing arrangement was entered into. [FRS 102.11.13B].

This means that in the first reporting period in which the entity ceases to be a small entity, the financial liability is remeasured at its present value at the end of the reporting period - either at the present value required by paragraph 13 of Section 11 (using the market rates applicable to a similar transaction at the date the financing transaction was entered into) or on the basis of the facts and circumstances at the end of the reporting period. Interest would then be charged in subsequent reporting periods, applying the amortised cost method.

How we see it

While the adjustment is to be reflected prospectively, it is not specified where any catch up for any remeasurement required is reflected. However, in our view, the adjustment is most appropriately reflected in equity. This treatment is consistent with the accounting for any difference between the transaction price and the present value of such a loan on initial recognition, if the above exemption available for small entities had not been taken.

3.2 Preparation of consolidated financial statements under Section 1A

A small entity that is a parent entity is not required to prepare consolidated financial statements.

[FRS 102.1A.21]. The qualifying criteria for a small parent company and LLP in the UK are set out in 2.2 and 2.3 above. Note that the small size criteria are evaluated for the group headed by the small parent company or LLP and are set out in 2.2.1, 2.2.2 and 2.3.1 above.

The CA 2006 and related regulations use the term 'group accounts' and 'individual accounts' rather than 'consolidated financial statements' and 'individual financial statements'. The term 'group accounts' is used in this Chapter when discussing the statutory requirements for consolidated financial statements.

The exemption from preparation of group accounts set out in Section 9 of FRS 102 is more restrictive than that contained in section 399(2A) of the CA2006. [FRS 102.9.3(e)].

A parent company subject to the small companies regime, or a parent LLP subject to the small LLPs regime, that applies Section 1A and does not wish to prepare consolidated financial statements will also need to ensure that it meets the exemption in section 399(2A) of the CA 2006 from preparation of group accounts.

A company is exempt from the requirement to prepare group accounts if:

- (a) At the end of the financial year, the company is:
 - (i) Subject to the small companies regime (see 2.2 above).
 - Or
 - (ii) Would be subject to the small companies regime but for being a public company.
- And
- (b) Is not a member of a group (i.e., it is not a parent undertaking or subsidiary undertaking), [s474], which, at any time during the financial year, has an undertaking falling within section 399(2B) as a member. [s399(2A)].

An undertaking falls within section 399(2B) of the CA 2006 if:

- (a) It is established under the law of any part of the UK.
- (b) It has to prepare accounts in accordance with the requirements of Part 15 of the CA 2006.
- And
- (c) It:
 - (i) Is an undertaking whose transferable securities are admitted to trading on a UK regulated market.
 - (ii) Is a credit institution (within the meaning given by Article 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council, which is a CRR firm within the meaning of Article (4)(1)(2A) of Regulation (EU) No. 575/2013).
 - Or
 - (iii) Would be an insurance undertaking (within the meaning given by Article 2(1) of Council Directive 91/674/EEC of the European Parliament and of the Council, were the UK a member State).

Relevant definitions are at 2.2.3.A above.

Similarly, an LLP is exempt from the requirement to prepare group accounts if:

- (a) At the end of the financial year, the LLP is subject to the small LLPs regime (see 2.3 above).
- And
- (b) Is not a member of a group which, at any time during the financial year, has an undertaking falling within section 399(2B) of the CA 2006 as applied to LLPs (i.e., the same list as for companies above) as a member. [s399(2A)(LLP), s399(2B)(LLP)].

Other statutory exemptions from preparing group accounts are discussed in Chapter 8 at 3.1.1.

A UK company or LLP exempt from the statutory requirement to prepare group accounts is permitted still to do so. [s399(4), s399(4)(LLP)]. Such group accounts could be prepared as statutory group accounts, or as non-statutory group accounts for the members.

3.2.1 Voluntary preparation of consolidated financial statements

If a small entity that is a parent voluntarily chooses to prepare consolidated financial statements, it:

- (a) Must apply the consolidation procedures set out in Section 9 (see Chapter 8 at 3.5).
- (b) Is encouraged to provide the disclosures set out in paragraph 23 of Section 9 (see Chapter 8 at 3.9.1).

- (c) Must comply so far as practicable with the requirements of Section 1A as if it were a single entity (Schedule 6 of the Small Companies Regulations, paragraph 1(1)), subject to any restrictions or exemptions set out in legislation. [*6 Sch 1(1)(SC), 4 Sch 1(1)(LLP SC)*].

And

- (d) Must provide any disclosures required by Schedule 6 of the Small Companies Regulations (see 3.2.2 below). [*FRS 102.1A.22*].

3.2.2 Interaction with statutory requirements (where consolidated financial statements are prepared)

Group accounts are drawn up as at the same date as the accounts of the parent company or parent LLP. [*6 Sch 2(1A)(SC), 4 Sch 2(1A)(LLP SC)*]. The adapted formats or statutory formats can be applied in group accounts. See 4 below for further discussion of the formats.

Group accounts of small companies must comply with Schedule 6 to the Small Companies Regulations (and group accounts of small LLPs, with Schedule 4 to the Small LLP Regulations). The group accounts must comply so far as practicable with the provisions of Schedule 1 to the Small Companies Regulations/Small LLP Regulations as if the undertakings included in the consolidation were a single company (or LLP). This is similar to the requirement (c) in 3.2.1 above. These provisions include the balance sheet and profit and loss account formats (albeit with certain modifications for group accounts) and set out recognition, measurement and disclosure requirements for company and LLP individual accounts. The disclosure requirements for company and LLP individual accounts included in Schedule 1 to the Small Companies Regulations/Small LLP Regulations are largely reflected in Section 1A, see 5.1 below, and would need to be given for the consolidated group in group accounts (in addition to the disclosures for the individual company presented in the individual accounts).

Parent companies/LLPs preparing group accounts in accordance with the CA 2006 (for LLPs, the CA 2006 as applied to LLPs) can take advantage of the section 408 exemption not to publish the individual profit and loss account (providing the conditions for use of the exemption are met). See Chapter 1 at 5.3.2.

Schedule 6 to the Small Companies Regulations (and Schedule 4 to the Small LLP Regulations) also include further requirements over consolidation procedures, the acquisition method, the conditions for merger accounting and related disclosures. Part 2 of these schedules require disclosure of information on related undertakings to be given in the notes to the financial statements. There is an exemption from providing information on certain undertakings where the restrictive conditions of section 409(4) of the CA 2006 apply and use of the exemption is stated. [*Regulations (SC) 10, LLP SC Regulations 7*]. The disclosures include information on subsidiary undertakings, associated undertakings - which would generally include a jointly controlled entity and an associate, other undertakings in which the parent company/LLP or group has a significant holding, parent company or group's membership of qualifying undertakings, parent undertakings drawing up accounts for a larger group, and identification of the ultimate parent. These disclosures are not required in individual accounts of a small company/LLP. See 6.1.1 below.

The recognition and measurement requirements for group accounts in the Small Companies Regulations (and Small LLP Regulations) are the same as those set out in the Regulations (and LLP Regulations). These are discussed in Chapter 8 and Chapter 22.

As well as the items mentioned at 3.2.1 above, additional disclosures need to be given when group accounts are prepared. These are principally included in Part 15 of CA 2006 (for LLPs, the CA 2006 as applied to LLPs). The corresponding disclosures in individual accounts are addressed in 5.1 and 5.2 below. However, the scope and positioning of the disclosures in the group accounts can differ, for example:

- Certain disclosures are required below the individual company/LLP balance sheet only (e.g., approval of the annual accounts [*s414, s414 (LLP)*], the statement where an audit exemption is taken, [*s475, s475 (LLP)*], or the statement of the individual company/LLP's profit or loss where the section 408 exemption from presenting the individual accounts is taken). [*s408, s408 (LLP)*].
- In some cases, disclosure is required in the notes to both the individual and group accounts. Information is, therefore, given for both the individual company/LLP and the consolidated group (e.g., general information about the company/LLP, [*s396(A1), s396(A10 (LLP)), s404(A1), s404(A1)(LLP)*], the average number of employees, [*s411, s411 (LLP)*], and off-balance sheet arrangements, [*s410A, s410A (LLP)*]).
- In other cases, disclosure is required in the notes to the group accounts only. Information is, therefore, given only for the group (e.g., advances and credits granted to and guarantees of any kind entered into on behalf of the parent company's directors, by that company or by any of its subsidiary undertakings). [*s413*].

As few small entities will need to prepare group accounts, the requirements are not discussed in detail in this chapter.

3.3 Presentation requirements

Section 1A sets out the content of a complete set of financial statements (see 3.3.3 below).

A small entity's financial statements must also include a statement of compliance in the notes to the financial statements, although the form of this will differ from the statement of compliance given by an entity not applying Section 1A (see 5.1.2 below). In addition, a small entity that is also a public benefit entity must give an explicit and unreserved statement, that it is a public benefit entity. [FRS 102.1A.7, FRS 102.1AC.2A, FRS 102.PBE1AC.2B, FRS 102.3.3, FRS 102.PBE3.3A]. A small entity choosing to apply Section 1A also makes a statement that the financial statements are prepared in accordance with the provisions applicable to companies subject to the small companies regime (or the equivalent statement for small LLPs or other small entities) on the statement of financial position in a prominent position above the signature (see 3.3.2 below). [FRS 102.1A.6A, s414(3)(b), s414(3)(b)(LLP)].

A small entity applying Section 1A must still comply with Section 3, except for certain specified paragraphs (see 3.3.1 below). [FRS 102.1A.7, FRS 102.3.1A]. This means such an entity must still comply with Section 3's requirements on:

- The financial statements giving a 'true and fair view' (including the provisions for a 'true and fair override') (see 3.3.4 and 3.3.4.A below). [FRS 102.3.2, FRS 102.3.4, FRS 102.3.5, FRS 102.3.6]
 - Assessment of the entity's ability to continue as a going concern (see 3.3.5 below). [FRS 102.3.8, FRS 102.3.8A, FRS 102.3.9]
 - Frequency of reporting (see Chapter 6 at 2.2). [FRS 102.3.10]
 - Consistency of presentation, excluding the requirements on reclassification (see 3.3.6 below). [FRS 102.3.11]
 - Comparative information (see 3.3.6 below). [FRS 102.1A.10, FRS 102.3.14, FRS 102.3.14A, FRS 102.3.20]
 - Materiality and aggregation (see 3.3.7 below). [FRS 102.3.15, FRS 102.3.16, FRS 102.3.16A, FRS 102.3.16B]
 - Requirements to present each financial statement in a complete set of financial statements with equal prominence, and ability to use other titles for the financial statements as long as they are not misleading. [FRS 102.1A.11, FRS 102.3.21, FRS 102.3.22]
 - Identification of the financial statements, except for paragraph 3.24(b) of FRS 102 (see 3.3.8 below). [FRS 102.3.23, FRS 102.3.24(a)]
- And
- Interim financial reports, if prepared (see Chapter 39). [FRS 102.3.25].

3.3.1 Exemptions from certain presentation and disclosure requirements in FRS 102 for a small entity applying Section 1A

A UK small entity applying Section 1A is not required to comply with the following paragraphs of Section 3 (see also discussion below):

- The disclosure requirements of paragraph 3.12 (disclosures where the presentation or classification of items in the financial statements has changed, unless impracticable to do so – but paragraph 1AC.8 of FRS 102 requires certain disclosures, see 3.3.6 and 5.1.5 below). [FRS 102.1AC.8]
 - The disclosure requirements of paragraph 3.13 (disclosure of the reasons why it is impracticable to reclassify comparatives where the presentation or classification of items in the financial statements has changed).
 - Paragraph 3.17 (content of a complete set of financial statements – see 3.3.3 below for Section 1A's requirements for a complete set of financial statements).
 - Paragraph 3.18 (option to present a statement of income and retained earnings, where certain conditions are met).
 - Paragraph 3.19 (option to present only an income statement where there are no items of other comprehensive income, or to label the bottom line of the statement of comprehensive income as 'profit or loss').
- And
- The disclosure requirements of paragraph 3.24(b) (description of the nature of the entity's operations and its principal activities, unless disclosed in the business review (or similar statement) accompanying the financial statements). [FRS 102.1A.7, FRS 102.3.1A].

In addition, a small entity applying Section 1A is not required to comply with Sections 4, 5, 6 or 7 (which cover the primary statements – the statement of financial position, the income statement and the statement of comprehensive income, the statement of changes in equity (or statement of income and retained earnings) and the cash flow statement). A small entity is exempt from preparation of a cash flow statement (and the related disclosures in Section 7), whether or not Section 1A is applied, unless this is required by a SORP or law or other relevant regulation. [FRS 102.1A.7A, FRS 102.3.1B, FRS 102.7.1B].

A small entity is also not required to comply with the disclosure requirements of Sections 8 to 35 of FRS 102 although some of the disclosures required by these sections are incorporated by reference into Appendix C of Section 1A. However, a small entity must ensure that sufficient information is presented in the notes to the financial statements with Section 1A noting that the disclosures in those later sections of FRS 102 are usually considered relevant to financial statements giving a true and fair view. Accordingly, Section 1A explains that a small entity might need to provide any of those disclosures that are relevant to material transactions, other events or conditions in order to meet the requirement for its financial statements to give a true and fair view. [FRS 102.1A.16, FRS 102.1A.17].

3.3.2 Statements of compliance

Small entities choosing to apply Section 1A must make a statement of compliance that the financial statements are prepared in accordance with the provisions applicable to companies subject to the small companies regime (or to LLPs subject to the small LLPs regime), as required by legislation. Other entities may instead refer to the small entities regime. This statement is included on the individual statement of financial position, in a prominent position above the signature. [FRS 102.1A.6A, s414(3)(b), s414(3)(b)(LLP)].

Illustration 3-2 below provides examples of such statements.

Illustration 3-2: Statements where the small entities regime is applied (made on the individual statement of financial position, above the approval signature)

These financial statements have been prepared in accordance with the provisions applicable to companies subject to the small companies regime.

Or

These financial statements have been prepared in accordance with the provisions applicable to LLPs subject to the small LLPs regime.

Or

These financial statements have been prepared in accordance with the small entities regime set out in Section 1A Small Entities of FRS 102.

A small entity must also make an explicit and unreserved statement of compliance that the financial statements are prepared in accordance with FRS 102, clearly stating that Section 1A has been applied (where this is the case). This is to be given in the notes to the financial statements, rather than on the statement of financial position (see 5.1.2 below). [FRS 102.1A.7, FRS 102.1A.2A, FRS 102.3.3]. This is a separate requirement to the statement required by legislation that is discussed above.

Similarly, a small entity that is a public benefit entity that applies the 'PBE' prefixed paragraphs must make an explicit and unreserved statement that it is a public benefit entity in the notes to the financial statements. [FRS 102.1A.7, FRS 102.PBE1A.2B, FRS 102.PBE3.3A].

3.3.3 Content of complete set of financial statements

A complete set of financial statements of a small entity must include all the following (with comparatives – see 3.3.6 below): [FRS 102.1A.7, FRS 102.1A.8, FRS 102.3.20]

- A statement of financial position as at the reporting date, prepared in accordance with the requirements for a balance sheet set out in Part 1 General Rules and Formats of Schedule 1 to the Small Companies Regulations (or Part 1 General Rules and Formats of Schedule 1 to the Small LLP Regulations). [FRS 102.1A.12]
 - An income statement for the reporting period prepared in accordance with the requirements for a profit and loss account set out in Part 1 General Rules and Formats of Schedule 1 to the Small Companies Regulations (or Part 1 General Rules and Formats of Schedule 1 to the Small LLP Regulations). [FRS 102.1A.14]
- And
- Notes in accordance with paragraphs 1A.16 to 1A.17A (see 5 below). [FRS 102.1A.16, FRS 102.1A.16A, FRS 102.1A.17, FRS 102.1A.17A].

The formats for the statement of financial position and income statement are discussed at 4 below. Small entities that do not report under the CA 2006 need to follow those same formats except to the extent that those requirements are not permitted by any statutory framework under which such entities report.

[FRS 102.1A.4].

Small entities (regardless of whether applying Section 1A or not) need not prepare a cash flow statement, unless required to do so by an applicable SORP or law or other relevant regulation. [FRS 102.1A.7A, FRS 102.3.1B, FRS 102.7.1B].

A small entity is allowed to use other titles for the financial statements provided they are not misleading. [FRS 102.1A.7, FRS 102.1A.11, FRS 102.3.22]. Consequently, the terms 'balance sheet' or 'profit and loss account' remain acceptable for use. In a complete set of financial statements, an entity is required to present each financial statement with equal prominence. [FRS 102.1A.7, FRS 102.3.21].

There is nothing to prevent a small company from complying with requirements in FRS 102 for which an exemption exists, for example preparing a cash flow statement. Consequently, the presentation sections of FRS 102, beyond the mandatory paragraphs, may be relevant to small entities that present additional primary statements or disclosures.

Section 1A observes that a small entity that recognises gains or losses in other comprehensive income might need to present a statement of total comprehensive income, and a small entity with changes in equity (other than profit or loss) might need to present a statement of changes in equity or a statement of income and retained earnings. These additional statements could be needed in order for the financial statements to give a true and fair view. [FRS 102.1A.5, FRS 102.1A.9].

Notes to the financial statements contain information in addition to those presented in the primary financial statements and provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. [FRS 102 Appendix I].

Consistent with the Small Companies Regulations (and Small LLP Regulations), the notes must be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and in the income statement. [FRS 102.1AC.2, 1 Sch 42(2)(SC), 1 Sch 42(2)(LLP SC)].

See 5 below for further discussion of the requirements for the notes to the financial statements, including the disclosures required in Appendix C of FRS 102.

3.3.4 True and fair view

The financial statements of a small entity are required to give a true and fair view of the assets, liabilities, financial position and profit or loss of the small entity for the reporting period. [FRS 102.1A.5]. The 'true and fair view' requirement in paragraph 1A.5 of FRS 102 refers to profit or loss (rather than financial performance, as in paragraph 3.2 of FRS 102) and excludes reference to cash flows because small entities are not generally required to present a statement of comprehensive income or a cash flow statement (see 3.3.3 above).

This is consistent with the UK company law requirements. The directors of a company (or members of an LLP) must not approve financial statements unless they are satisfied that the financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the company (or LLP) (and in respect of any group accounts, the undertakings included in the consolidation as a whole, so far as concerns the members of the company (or LLP)). [s393, s393 (LLP)]. If compliance with the regulations, and any other provision made by or under the CA 2006 as to matters to be included in a company's (or LLP's) individual and/or group accounts or in notes to those financial statements, would not be sufficient to give a true and fair view, the necessary additional information must be given in the financial statements or in a note to the financial statements. [s396(4), s404(4), s396(4)(LLP), s404(4)(LLP)].

Section 3 of FRS 102 provides further guidance on the requirement that financial statements must give a true and fair view which also applies to small entities applying Section 1A (see Chapter 6 at 8.2). While Section 1A specifies fewer disclosures than full FRS 102, it contains a similar requirement to present additional disclosures where necessary to meet the requirement for the financial statements to give a true and fair view. [FRS 102.1A.16]. See also the discussion on information to be disclosed in the notes to the financial statements at 5 below and further discussion on the true and fair view requirement (including its relationship with accounting standards) in Chapter 1 at 6.2 and Chapter 6 at 8.2.

The general principles governing the preparation of financial statements - the going concern presumption, consistency (in applying accounting policies and measurement bases), use of prudence, use of the accruals basis, separate determination of individual assets and liabilities (no offsetting), and the requirement that the opening balance sheet for a financial year corresponds to the closing balance sheet for the previous financial year - are set out in the Small Companies Regulations (and Small LLP Regulations). [1 Sch 11 (SC), 1 Sch 12 (SC), 1 Sch 13 (SC), 1 Sch 14 (SC), 1 Sch 15(C), 1 Sch 15A (SC)].

In addition, at the balance sheet date, any provision made must represent the best estimate of the expenses likely to be incurred or, in the case of a liability, of the amount required to meet that liability, and provisions must not be used to adjust the values of assets. This requirement has been included within the general principles in the Small LLP Regulations but within Schedule 7 of the Small Companies Regulations. [7 Sch 2A(SC), 7 Sch 2B(SC)].

These general principles are the same as those set out in the Regulations (and LLP Regulations), as discussed in Chapter 6 at 8.1.1.

Similarly, the Small Companies Regulations (and Small LLP Regulations) set out the historical cost accounting rules, alternative accounting rules and fair value accounting rules. [1 Sch 16-41 (SC), 1 Sch 16-41 (LLP SC)]. These are the same recognition and measurement requirements as set out in the Regulations (and LLP Regulations) and are addressed, where relevant, in other chapters of this publication.

The Small Companies Regulations (and Small LLP Regulations) generally set out simpler disclosures than the Regulations (and LLP Regulations). However, a small company (or small LLP) is treated as complying with the relevant requirement of Schedule 1 to the Small Companies Regulations (or Schedule 1 to the Small LLP Regulations) if it complies with the corresponding provision in Schedule 1 to the Regulations (or Schedule 1 to the LLP Regulations). [Regulations (SC) 3(3), LLP SC Regulations 3(3)].

3.3.4.A True and fair override

In special circumstances when management concludes that compliance with any requirement of FRS 102 or applicable legislation (only when it allows for a true and fair override) is inconsistent with the requirement to give a true and fair view, the entity must depart from that requirement to the extent necessary to give a true and fair view, making the disclosures set out in paragraphs 3.5 and 3.6 of FRS 102. [FRS 102.1A.7, FRS 102.3.4, FRS 102.3.5, FRS 102.3.6]. See 5.1.6 below. These disclosures are consistent with the requirements of the CA 2006 for companies (for LLPs, the CA 2006 as applied to LLPs) to give the particulars of, reasons for, and effect of any such departure in a note to the financial statements. [s396(5), s404(5), s396(5)(LLP), s404(5)(LLP)]. There is further discussion of the true and fair override in FRS 102 and UK company law in Chapter 6 at 8.2.2.

Appendix III to FRS 102 highlights certain instances where the requirements of FRS 102 result in a departure from the requirements of the Regulations in order to give a 'true and fair view'. These examples, which are not exhaustive, are relevant to UK companies preparing Companies Act accounts (and similarly, LLPs preparing non-IAS accounts).

3.3.5 Going concern

FRS 102 requires management, when preparing financial statements, to make an assessment of an entity's ability to continue as a going concern. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue. [FRS 102.1A.7, FRS 102.3.8, FRS 102 Appendix I].

When a UK small entity's financial statements are prepared on a going concern basis, it must disclose that fact, along with confirmation that management has considered information about the future relating to a period which is at least, but is not limited to, twelve months from the date of authorisation of the financial statements for issue. If the entity has made significant judgements (see Chapter 6 at 8.3) in its assessment of its ability to continue as a going concern, these judgements are also disclosed. [FRS 102.1AC.2C, FRS 102.3.8A, FRS 102.8.6].

When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties are required to be disclosed in the financial statements. [FRS 102.1A.7, FRS 102.1AC.2C, FRS 102.3.9].

FRS 102 states that an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so. Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is no longer appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that a fundamental change in the basis of accounting is required, rather than an adjustment to the amounts recognised within the original basis of accounting. [FRS 102.32.7A, FRS 102.32.7B]. When financial statements are not prepared on a going concern basis, that fact must be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going

concern. [FRS 102.1A.7, FRS 102.1AC.2C, FRS 102.3.9]. Preparation of the financial statements on a non-going concern basis would also be a departure from one of the general principles (see 3.3.3 and 3.3.4 above). Particulars of the departure, the reasons for it and its effects are required to be disclosed (see 5.1.6 below). [FRS 102.1AC.10, 1 Sch 10(2)(SC), 1 Sch 10(2)(LLP SC)]. In practice, this is likely to require similar disclosures to those set out above.

FRS 102 provides no further guidance on the impact on the financial statements if it is determined that the going concern basis is not appropriate. Accordingly, entities will need to consider their individual circumstances to arrive at an appropriate basis. See also Chapter 6 at 8.3 for further discussion on FRS 102's going concern requirements.

FRS Factsheet 13, *The Going Concern Basis of Accounting for Small and Micro-entities* was issued by the FRC, in September 2025, to aid preparers of small company accounts in the UK in performing going concern assessments and in preparing financial statement disclosures about their conclusions and how those conclusions were reached. Factsheet 13 provides examples, in a table, of internal and external factors to consider in performing a going concern assessment.

3.3.6 Comparative information (including consistency of presentation)

Except when FRS 102 permits or requires otherwise, a small entity presents comparative information in respect of the preceding period for all amounts presented in the current period's financial statements. An entity is required to include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. [FRS 102.3.14, FRS 102.1A.7, FRS 102.1A.10]. This means that the requirement to present comparative information applies both to mandatory and voluntary information presented for the current period. See Chapter 6 at 2.4.

FRS 102's requirements are consistent with the General Rules to the formats in Schedule 1 to the Small Companies Regulations/Small LLP Regulations which contain requirements on corresponding amounts to the balance sheet and profit and loss account (see 4.1.4 below). The Small Companies Regulations and Small LLP Regulations, like FRS 102, only require one comparative period to be presented. [1 Sch 5(SC), 1 Sch 7(SC), 1 Sch 5(LLP SC), 1 Sch 7(LLP SC)]. Other statutory or regulatory frameworks may require further periods to be presented.

The general requirements for presenting comparatives for notes disclosures are covered in accounting standards rather than in the CA 2006, the Small Companies Regulations or the Small LLP Regulations. In certain cases, FRS 102 provides specific exemptions from presenting comparatives for notes disclosures (which are indicated in the disclosures listed at 5 below).

The requirements on consistency of presenting and classification of items in the financial statements where Section 1A is applied are, in effect, the same as under full FRS 102 (see Chapter 6 at 2.4.1). [FRS 102.3.11, FRS 102.1A.7]. While Section 1A scopes out the disclosures in paragraphs 3.12 and 3.13 of FRS 102, a UK small entity is required to give disclosures concerning the non-comparability of and any adjustment made to corresponding amounts (i.e., comparatives). See 5.1.5 below.

3.3.7 Materiality and aggregation

The principle of materiality and the level of aggregation is particularly relevant to small entities in determining whether additional information is required to be presented in the notes to the financial statements in order for the financial statements to give a true and fair view (see the discussion on notes disclosures at 3.3.3 above). [FRS 102.1A.16, FRS 102.1A.17]. The principles on materiality and aggregation set out in Section 3 of FRS 102 also apply to a small entity applying Section 1A and are discussed in Chapter 4 at 3.3.1.B and Chapter 6 at 8.4. [FRS 102.1A.7, FRS 102.3.15, FRS 102.3.16, FRS 102.3.16A, FRS 102.3.16B].

A small company (or small LLP) reporting under FRS 102 must comply with the balance sheet and profit and loss account formats set out in the Small Companies Regulations (or Small LLP Regulations) respectively (see 4 below). The General Rules to the formats have rules over whether prescribed line items can be combined. The application of the General Rules to statutory and adapted formats is explained further in 4.1 below.

FRS 102 states that an entity need not provide a specific disclosure required by the standard (including those set out in Appendix C of Section 1A) if the information resulting from that disclosure is not material, except when required by the CA 2006 regardless of materiality. [FRS 102.1A.17A, FRS 102.1AC.1, FRS 102.3.16B].

3.3.8 Identification of the financial statements

It is commonly the case that financial statements will form only part of a larger annual report, regulatory filing or other document, but FRS 102 only applies to the financial statements (including the notes).

The annual report and accounts for a small UK company, for example, comprise the directors' report and the annual accounts. [s394, s415].

Accordingly, FRS 102 requires that an entity clearly identifies the financial statements and the notes and distinguishes them from other information in the same document. In addition, the entity must display the following information prominently, and repeat it, when necessary, for an understanding of the information presented:

- The name of the reporting entity and any change in its name since the end of the preceding reporting period.
- Whether the financial statements cover the individual entity or a group of entities.
- The date of the end of the reporting period and the period covered by the financial statements.
- The presentation currency, as defined in Section 30 *Foreign Currency Translation* (discussed in Chapter 32 at 3.1 and 3.6).

And

- The level of rounding, if any, used in presenting amounts in the financial statements. [FRS 102.1A.7, FRS 102.3.23].

These requirements are discussed further in Chapter 6 at 2.5.

4 Statement of financial position and income statement (individual financial statements)

As noted at 3.3.3 above, a small entity applying Section 1A must present a statement of financial position and its profit or loss for the period in an income statement, in accordance with the requirements for a balance sheet and profit and loss account set out in Part 1 General Rules and Formats of Schedule 1 to the Small Companies Regulations (or Part 1 General Rules and Formats of Schedule 1 to the Small LLP Regulations). [FRS 102.1A.12, FRS 102.1A.14]. The statement of financial position is referred to as 'the balance sheet' in company and LLP law and the income statement is referred to as 'the profit and loss account' in company and LLP law.

Section 1A of FRS 102 and the legislation provide the following alternatives for the statement of financial position and the income statement: [FRS 102.1AA.1, FRS 102.1AB.1]

- Apply the prescribed balance sheet and profit and loss account statutory formats as set out in legislation, subject to any permitted flexibility (see 4.1.1 and 4.3 below).

Or

- Adapt one of the balance sheet and profit and loss account formats (see 4.1.3 and 4.4 below). [FRS 102.1AA.3, FRS 102.1AA.5, FRS 102.1AA.5, FRS 102.1AA.6, FRS 102.1AB.3, FRS 102.1AB.4].

The requirements do not preclude an entity from applying a different choice of format (statutory or adapted) to the profit and loss account and statement of financial position. [FRS 102.1AA.1, FRS 102.1AB.1, 1 Sch 1B (SC), 1 Sch 1B (LLP SC)].

Small entities that use the statutory formats also have an option to prepare an abridged balance sheet and profit and loss account, where appropriate to the entity's circumstances and providing consent has been obtained. [FRS 102.1AA.2, FRS 102.1AB.2]. See 4.1.2 below.

Small entities that do not report under the CA 2006 must also comply with these requirements, except to the extent that these requirements are not permitted by any statutory framework under which they report. [FRS 102.1A.4]. Therefore, such entities could have a more restricted choice (or need to make certain modifications to the formats adopted).

While 4.3 to 4.4 below refer to the formats applicable to LLPs, detailed guidance on LLPs is outside the scope of this chapter. LLPs are also subject to additional requirements in the extant LLP SORP.

A small entity is required to apply the guidance in Appendix A and Appendix B to Section 1A in meeting the above requirements. [FRS 102.1A.13, FRS 102.1A.15].

The General Rules to the formats that apply to statutory formats are discussed at 4.1.1 below, those that apply to adapted formats at 4.1.3 below and those that apply to all the formats at 4.1.4 below. Changes in the format used are addressed at 4.1.5 below.

FRS 102 explains that an income statement (which is referred to as the 'profit and loss account' in the CA 2006) presents all items of income and expense recognised in a reporting period, excluding the items of other comprehensive income. [FRS 102 Appendix I]. FRS 102 contains further guidance on presentation of line items in the statement of financial position and income statement that is relevant whatever format is used. See 4.2 below.

See 3.3.2 above for the statements required on the statement of financial position above the approval signature where the small entities regime is applied.

4.1 General Rules to the formats

The following discussion relates to the General Rules to the formats which apply to balance sheet and profit and loss account formats included in Part 1 of Schedule 1 to the Small Companies Regulations (and Part 1 of Schedule 1 to the Small LLP Regulations).

4.1.1 Statutory formats

Section B of Part 1 of Schedule 1 to the Small Companies Regulations (Section B of Part 1 of Schedule 1 to the Small LLP Regulations, for a small LLP) provides a choice of two balance sheet formats and two profit and loss account formats. [1 Sch 1(1)(SC), 1 Sch 1(1)(LLP SC)]. These are referred to as the 'statutory formats' in this Chapter.

While there are two statutory formats – Format 1 and Format 2 – available for the balance sheet, only Format 1 is commonly used and illustrated in this Chapter. Both Format 1 and Format 2 profit and loss accounts are commonly used. There are some differences in detail in the line items required in the LLP statutory formats compared to the company statutory formats.

See Figure 4-1 at 4.3.1 below for the Format 1 balance sheet for a small company and Figures 4-2 and 4-3 at 4.3.1.B below for the Format 1 balance sheet (and additional SORP requirements) for a small LLP. A small company (or small LLP) must show the line items listed in the format chosen, which are to be read together with any of the notes following the formats in Section B which apply to those items. *[1 Sch 1(2)(SC), 1 Sch 1(2)(LLP SC)]*. Each of the headings and sub-headings denoted with a capital letter or Roman numeral must be presented on the face of the balance sheet in the order shown. In certain cases, the notes to the formats allow alternative positions. *[1 Sch 1(3)(SC), 1 Sch 1(3)(LLP SC)]*. There is some flexibility to adapt the arrangement, headings and sub-headings or to combine items denoted with an Arabic number in certain circumstances (see the discussion at 4.1.4 below). In practice, the balance sheet line items denoted with an Arabic number are often presented in the notes to the financial statements.

See Figure 4-4 at 4.3.2.A below and Figure 4-6 at 4.3.2.B below for the Format 1 and 2 profit and loss accounts applicable for the individual accounts of a UK small company (and Figure 4-5 at 4.3.2.A below and Figure 4-7 at 4.3.2.B below for the corresponding formats for a UK small LLP). Since all the headings are denoted with an Arabic number, there is some flexibility to adapt the arrangement, headings and sub-headings or to combine items in certain circumstances (see the discussion at 4.1.4 below).

The letters or numbers assigned to the line items in the statutory formats do not need to be given (and are not given in practice). *[1 Sch 1(3)(SC), 1 Sch 1(3)(LLP SC)]*.

The individual line items in the statutory balance sheet and profit and loss account formats (and their related notes), which are similar to those in the Regulations and LLP Regulations, are discussed in Chapter 6 at 4.3 and 5.6.

4.1.2 Abridged formats

Abridged formats can be used where appropriate to the circumstances of the company's (or the LLP's) business. Abridged formats derive from the statutory formats only (i.e., cannot be used with adapted formats) but show fewer headings in the balance sheet and combine certain line items in the profit and loss account. Abridged formats are not available for use in group accounts. *[6 Sch 1(1A)(SC), 4 Sch 1(1A)(LLP SC)]*.

To use abridged formats, small companies must comply with the additional legal requirement that all members of the company have given consent to the drawing up of abridged financial statements (which may only be given in respect of the preceding financial year). In accordance with paragraph 1A(4) of Schedule 1 to the Small Companies Regulations this option is not available to small entities that are charities. When a small entity that is not a company chooses to prepare abridged financial statements, it should ensure that: *[FRS 102.A3.11E, 1 Sch 1A(SC), 1 Sch 1(1A)(LLP SC)]*

- Similar consent is obtained from the members of its governing body, taking into account its legal form.
And
- Abridged financial statements would not be prohibited by relevant laws or regulation.

A small entity choosing to draw up an abridged balance sheet must also meet the requirement for the financial statements to give a true and fair view. A small entity must therefore also consider the requirements of paragraph 1A.16 of FRS 102 and provide any additional disclosure that is necessary in the notes to the financial statements, for example in relation to disaggregating the information in the balance sheet. *[FRS 102.1AA.2]*.

FRS 102 does not provide guidance on what circumstances it may be appropriate to use abridged formats. The format of abridged accounts is not in the scope of this publication.

4.1.3 Adapted formats

Paragraph 1B of Part 1 of Schedule 1 to the Small Companies Regulations (or the Small LLP Regulations) sets out the requirements for adapted formats (see 4.4 below). This paragraph allows adaptation of the statutory formats as long as the information given is at least equivalent to that which would have been required by the use of such format had it not been thus adapted, the presentation is in accordance with generally accepted accounting principles or practice (consequently as specified in Section 1A) and, in respect of the balance sheet, distinguishes between current and non-current items in a different way.

[1 Sch 1B(SC), 1 Sch 1B(LLP SC)].

4.1.4 General Rules applying to statutory and adapted formats

The following provisions in the General Rules to the formats (which are set out in paragraphs 2 to 9A of Section A of Part 1 of Schedule 1 to the Small Companies Regulations/Small LLP Regulations) apply to the statutory formats, [1 Sch 1 (SC), 1 Sch 1 (LLP SC)], and so far as is practicable, to the adapted formats.

[1 Sch 1C (SC), 1 Sch 1C (LLP SC)].

The Small Companies Regulations and Small LLP Regulations do not provide further guidance on how 'so far as is practicable' is to be interpreted.

How we see it

In our view, the phrase 'so far as practicable' is needed because the General Rules to the formats have been written from the perspective of the statutory formats and refer to items given an Arabic number which may not have a direct counterpart in the adapted formats. In other cases, such as in relation to corresponding amounts (meaning comparatives), there are no difficulties in applying the requirements. We do not consider that 'so far as is practicable' allows small companies or small LLPs flexibility to regard the General Rules to the formats as optional.

The Small Companies Regulations and Small LLP Regulations require that every profit and loss account must show 'profit or loss before taxation' as a line item on the face of the profit and loss account.

[1 Sch 6 (SC), 1 Sch 6 (LLP SC)]. This line item is not required for a qualifying partnership preparing statutory accounts.²³

The General Rules to the formats allow any item to be shown in a company's (or an LLP's) balance sheet or profit and loss account in greater detail than required by the particular format used. The balance sheet or profit and loss account is permitted to include an item representing or covering the amount of any asset or liability, income or expenditure not otherwise covered by any of the items listed in the format used (with certain exclusions not relevant to FRS 102 reporters). [1 Sch 3 (SC), 1 Sch 3 (LLP SC)].

Where the special nature of the company's (or the LLP's) business requires it, the company's directors (or the members of the LLP) must adapt the arrangement, headings and sub-headings otherwise required in respect of items given an Arabic number in the balance sheet or profit and loss account format used. The directors (or the members of the LLP) may combine items to which Arabic numbers are given in the formats if their individual amounts are not material to assessing the state of affairs or profit or loss of the company (or the LLP) for the financial year in question; or the combination facilitates that assessment. In the latter case, the individual amounts of any items combined must be disclosed in a note to the accounts. [1 Sch 4 (SC), 1 Sch 4 (LLP SC)].

Where adapted formats are used, any amendments made would need to comply 'so far as is practicable' with the General Rules to the formats (as discussed above). [1 Sch 1B (SC), 1 Sch 1B (LLP SC), 1 Sch 4 (SC), 1 Sch 4 (LLP SC)]. Section 1A further explains that an entity is permitted to amend the descriptions used in the line items required in the statement of financial position (or the sub-classifications of those line items required by paragraph 1AA.4), the ordering of items or aggregation of similar items in the statement of financial position, according to the nature of the small entity and its transactions in order to provide information that is relevant to an understanding of the small entity's financial position. Such amendments are allowed, providing that the information given is at least equivalent to that required by the balance sheet format had it not been adapted. [FRS 102.1AA.5]. Similarly, a small entity is permitted to include additional line items in the income statement, amend the descriptions used, and the ordering of items, when this is necessary to explain the elements of financial performance, providing the information given is at least equivalent to that required by the profit and loss account format had it not been adapted. [FRS 102.1AB.4]. FRS 102's requirements on materiality and aggregation are discussed at 3.3.7 above and in Chapter 6 at 8.4.

The heading or sub-heading required for a particular item in the balance sheet or profit and loss account format must be presented where there is an amount for that item in either the current or immediately preceding financial year; otherwise, the heading or sub-heading must be omitted. [1 Sch 5 (SC), 1 Sch 5 (LLP SC)]. In other words, nil line items must not be presented.

A corresponding amount (i.e., comparative) for the immediately preceding financial year must be shown for every item shown in the balance sheet or profit and loss account. Where that corresponding amount is not comparable with the amount shown in the current financial year, the corresponding amount may be adjusted. Particulars of the non-comparability and of any adjustment must be disclosed in a note to the financial statements (see 5.1.5 below). [1 Sch 7 (SC), 1 Sch 7 (LLP SC), FRS 102.1AC.8]. This statutory requirement

²³ Partnerships (Accounts) Regulations 2008 (SI 2008/569), para. 4 and Schedule, para. 2(1)(a).

allows FRS 102's requirements on restatement of comparatives to be followed (as discussed at 3.3.6 above).

Amounts in respect of items representing assets or income are not permitted to be set off against amounts in respect of items representing liabilities or expenditure (as the case may be), or *vice versa*. [1 Sch 8 (SC), 1 Sch 8 (LLP SC)]. FRS 102's requirements on offset are discussed in Chapter 6 at 8.1.1.C.

The company's directors (or the members of an LLP) must, in determining how amounts are presented within items in the profit and loss account and balance sheet, have regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice. [1 Sch 9 (SC), 1 Sch 9 (LLP SC)]. This requirement facilitates the presentation of certain shares as liabilities in accordance with FRS 102. See further discussion on the statutory requirements and FRS 102's requirements on 'substance over form' in Chapter 6 at 8.1.1.A.

Where an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the financial statements. [1 Sch 9A (SC), 1 Sch 9A (LLP SC)]. See 5.1.7.A below.

Examples of situations where this may be relevant include:

- Items which are partly reported in debtors: amounts falling due within one year and debtors: amounts falling due after more than one year, where reported separately on the balance sheet (in the statutory formats).
 - Items which are partly reported in creditors: amounts falling due within one year and creditors: amounts falling due after more than one year (in the statutory formats).
- And
- Items which are partly reported as current and non-current assets or liabilities (in the adapted formats).

This disclosure requirement does not appear to extend to reporting the relationship between assets and liabilities that derive from a single transaction (e.g., an asset acquired on a lease has an impact both on fixed assets and lease creditors) nor to identifying the associated deferred tax consequences of an asset or liability.

How we see it

Where a single asset or liability is required to be reported as more than one line item in the statement of financial position, e.g., split accounting for a convertible loan between equity and liability elements, or a loan at off-market rates made by a parent to its subsidiary is split between investment and loan asset, it would seem appropriate, in our view, to disclose the relationship between these line items.

4.1.5 Changes in formats

The General Rules to the formats (see 4.1 above) require that the company's directors (or the members of the LLP) use the same statutory balance sheet and profit and loss account format in preparing Companies Act accounts (non-IAS accounts for an LLP) for subsequent financial years, unless in their opinion there are special reasons for a change. Particulars of any such change must be given in a note to the financial statements in which the new format is first used, and the reasons for the change must be explained.

[1 Sch 2 (SC), 1 Sch 2 (LLP SC)].

While this paragraph refers to the statutory formats (see 4.3 below), the General Rules apply so far as is practicable to adapted formats (see 4.4 below).

How we see it

In our view, the same requirements apply to changes in the statutory format used and changes between adapted and statutory formats. Indeed, FRS 102 requires the same disclosure for a change in presentation of a small entity's statement of financial position or income statement, referencing this statutory requirement (see 5.1.5 below).

A change in the format applied is regarded as a change in accounting policy for the purposes of FRS 102 and, therefore, is applied retrospectively. [FRS 102.10.11(d)]. Accounting policies are defined as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements". [FRS 102 Appendix I, FRS 102.10.2]. See Chapter 9 at 3.3 for the requirements on changes in accounting policy.

4.2 Presentation requirements in full FRS 102 relevant to small entities

Full FRS 102 includes additional requirements on presentation that are relevant whatever format is used. For instance:

- There is guidance on operating profit, where this is presented (see Chapter 6 at 5.7.3). *[FRS 102.5.9B]*.
- Incoming dividends and similar income receivable are recognised at an amount that includes any withholding tax but excludes other taxes, such as attributable tax credits. Any withholding tax suffered is shown as part of the tax charge (see Chapter 31 at 3.2 and 9.1.2). *[FRS 102.29.19]*.
- Section 28 Employee Benefits does not specify how the cost of a defined benefit plan should be presented in the income statement. *[FRS 102.28.23]*. Therefore, entities may present the cost as a single item or disaggregate the cost into components presented separately (see Chapter 30 at 3.5.10).
- Section 20 Leases requires a lessor to present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset (see Chapter 23 at 7.7). *[FRS 102.20.113]*.
- An entity issuing a convertible or compound instrument is required to allocate the proceeds between the liability and equity components. *[FRS 102.22.13]*. See Chapter 6 at 5.10.3.

Other chapters of this publication contain guidance on presentation of certain items under statutory or adapted formats. This guidance is also relevant for a small entity to apply as the formats under the Small Companies Regulations and Small LLP Regulations are similar to those under the Regulations and LLP Regulations.

FRS 102 specifies when items are to be reported in other comprehensive income rather than profit or loss. The Small Companies Regulations and Small LLP Regulations also restrict when unrealised profits can be reported in the profit and loss account. Consequently, certain unrealised profits may be required to be reported in other comprehensive income. See Chapter 6 at 5.2 for further information.

A small company (or small LLP) applying Section 1A is not required to present a separate line item (and columnar analysis) for discontinued operations on the face of the separate income statement (or profit or loss section of a single statement of comprehensive income, if any) since a small entity is not required to apply Section 5 of FRS 102. *[FRS 102.1A.7A, FRS 102.5.5B(f), FRS 102.5.7A, FRS 102.5.7E, FRS 102.5.7F]*.

4.3 Statutory formats

UK companies (and LLPs) applying statutory formats have a choice of two balance sheet and two profit and loss account formats, with the line items required set out in Section B of Part 1 of Schedule 1 to the Small Companies Regulations (and Section B of Part 1 of Schedule 1 to the Small LLP Regulations). *[1 Sch 1(1)(SC), 1 Sch 1(1)(LLP SC), FRS 102.1A.12, FRS 102.1A.14]*.

Statutory formats, as modified by Schedule 6 to the Small Companies Regulations (or Schedule 4 to the Small LLP Regulations), can also be used in group accounts (see 3.2 above). *[6 Sch 1 (SC), 4 Sch 1 (LLP SC)]*. These are not dealt with in this Chapter.

The General Rules to the formats (see 4.1 above) apply to the statutory formats.

4.3.1 Balance sheet formats

Schedule 1 to the Small Companies Regulations (and Schedule 1 to the Small LLP Regulations) provide a choice of two statutory formats for the balance sheet. Format 1 is a vertical format and is adopted by virtually all UK companies and LLPs. Format 2 presents assets separately from liabilities (including capital and reserves) and is rarely used. This chapter only discusses the format 1 balance sheet.

Figure 4-1 below sets out the Format 1 individual balance sheet for a small UK company. This needs to be read together with the notes to the formats discussed at 4.3.1.A below. *[1 Sch 1(2)(SC), 1 Sch 1(2)(LLP SC)]*.

Figure 4-1: Format 1 individual balance sheet – small UK company

A	Called up share capital not paid*
B	Fixed assets
I	Intangible assets
1	Goodwill
2	Other intangible assets
II	Tangible assets
1	Land and buildings
2	Plant and machinery etc.
III	Investments
1	Shares in group undertakings and participating interests
2	Loans to group undertakings and undertakings in which the company has a participating interest
3	Other investments other than loans
4	Other investments
C	Current assets
I	Stocks
1	Stocks
2	Payments on account
II	Debtors
1	Trade debtors
2	Amounts owed by group undertakings and undertakings in which the company has a participating interest
3	Other debtors*
III	Investments
1	Shares in group undertakings
2	Other investments
IV	Cash at bank and in hand
D	Prepayments and accrued income*
E	Creditors: amounts falling due within one year
1	Bank loans and overdrafts
2	Trade creditors
3	Amounts owed to group undertakings and undertakings in which the company has a participating interest
4	Other creditors* **
F	Net current assets (liabilities)
G	Total assets less current liabilities
H	Creditors: amounts falling due after more than one year
1	Bank loans and overdrafts
2	Trade creditors

	3	Amounts owed to group undertakings and undertakings in which the company has a participating interest
	4	Other creditors* **
I		Provisions for liabilities
J		Accruals and deferred income*
K		Capital and reserves
	I	Called up share capital***
	II	Share premium account
	III	Revaluation reserve
	IV	Other reserves~
	V	Profit and loss account
* The notes to format 1 provide alternative positions for prepayments and accrued income, and accruals and deferred income. Prepayments and accrued income may be shown within sub-heading C.II.3 and accruals and deferred income may be shown within E.4, H.4 or both (as the case may require). In determining the amount of net current assets (liabilities), any prepayments and accrued income must be taken into account (wherever shown). Called up share capital not paid may also be shown within C.II.3.		
** There must be shown separately (a) the amount of any convertible loans and (b) the amount for creditors in respect of taxation and social security.		
*** The company must show separately the amount of allotted share capital and the amount of called up share capital which has been paid up.		
~ There is no breakdown of 'Other reserves' in the formats in the Small Companies Regulations (unlike the Regulations).		

Each of the headings and sub-headings denoted with a capital letter or Roman numeral (which have been bolded for emphasis in Figure 4-1 above), must be presented on the face of the Format 1 balance sheet in a company's individual accounts, in the order and under the headings and sub-headings shown. The Format 1 balance sheet includes sub-headings denoted with an Arabic number. The General Rules to the formats (see 4.1 above) explain further the presentation of line items with an Arabic number.

The balance sheet statutory formats set out in the Small Companies Regulations (and Small LLP Regulations) distinguish between 'Fixed assets' and 'Current assets'. 'Fixed assets' are assets of a company (or an LLP) which are intended for use on a continuing basis in the company's (or the LLP's) activities, and 'Current assets' are assets not intended for such use. FRS 102 broadens the definitions to refer to 'an entity'. [8 Sch 3 (SC), 5 Sch 3 (LLP SC), FRS 102 Appendix I]. See Chapter 6 at 4.2.2.

In addition, the balance sheet statutory formats distinguish between 'Creditors: amounts falling due within one year' and 'Creditors: amounts falling due after more than one year'. In distinguishing amounts between the two categories of creditor, the deciding factor is the earliest date of payment. Section 4 of FRS 102 provides further guidance which, while not directly scoped into Section 1A, is relevant as the same distinction would be made for the statutory formats under the Regulations. A creditor is classified as due within one year when the entity does not have an unconditional right, at the end of the reporting period, to defer settlement of the creditor for at least 12 months after the reporting date. [FRS 102.4.7]. This is intended to be consistent with the statutory requirements in the Small Companies Regulations (and Small LLP Regulations) that: "A loan is treated as falling due for repayment, and an instalment of a loan is treated as falling due for payment, on the earliest date on which the lender could require repayment or (as the case may be) payment, if he exercised all options and rights available to him". [8 Sch 6 (SC), 5 Sch 6 (LLP SC), FRS 102.4.7]. A loan is not classified as 'Creditor: amounts falling due within one year' merely because the company expects to repay within twelve months of the reporting date. See further discussion at Chapter 6 at 4.2.3.

The notes to the balance sheet formats require that amounts falling due after more than one year must be shown separately for each item included under 'Debtors' (items C.II.1-3). Section 4 of FRS 102 requires that where the amount of debtors due after more than one year is so material in the context of the total net current assets that in the absence of disclosure of the debtors due after more than one year on the face of the statement of financial position readers may misinterpret the financial statements, the amount is disclosed on the face of the statement of financial position within current assets. In most cases, it will be satisfactory to disclose the amount due after more than one year in the notes to the financial statements. [FRS 102.4.4A].

How we see it

While FRS 102's presentation requirements for debtors due after more than one year do not apply directly to small entities using Section 1A, we would generally expect this practice to continue to be followed by a small entity applying Section 1A and using the statutory formats.

The headings for the format 1 balance sheet in the Small Companies Regulations (and Small LLP Regulations) are slightly simpler than the headings for the format 1 balance sheet in Schedule 1 to the Regulations (and LLP Regulations) and fewer disclosures are required in the notes to the financial statements. However, the guidance on the statutory balance sheet format headings in Schedules to the Regulations (and LLP Regulations) in Chapter 6 at 4.3 remains relevant.

Where an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the financial statements. [1 Sch 9A (SC), 1 Sch 9A (LLP SC)]. See discussion of this requirement at 4.1.4 above.

FRS 102 has accounting requirements for various items that do not have separate line items in Format 1. Such items include investment property, right-of-use assets, heritage assets, financial assets, biological assets, cash and cash equivalents and deferred tax. FRS 102's requirement (in Section 4) to present additional line items on the face of the statement of financial position where relevant to an understanding of the entity's financial position does not apply to small entities applying Section 1A. [FRS 102.1A.7A, FRS 102.4.3]. However, the General Rules to the formats provide flexibility to present line items in additional detail (see 4.1 above). So, for example, a property company might distinguish its investment property from other tangible fixed assets.

4.3.1.A Notes to the formats

Certain alternative positions for line items are indicated in Figure 4-1 above. In addition, the notes on the balance sheet formats clarify that:

- Amounts falling due after more than one year must be shown separately for each item included under 'Debtors' (items C.II.1-3).
- Within 'Other creditors' (items E4, H4 and J), there must be shown separately:
 - (a) The amount of any convertible loans.
 - And
 - (b) The amount for creditors in respect of taxation and social security.
- In determining the amount shown as 'Net current assets (liabilities)' (item F), any prepayments and accrued income must be taken into account, wherever shown.
- And
- The amount of allotted share capital and amount of called up share capital which has been paid up must be shown separately (item K.1).

Notes to the balance sheet formats that are not relevant to FRS 102 reporters or where FRS 102 has stricter requirements are not referred to above.

4.3.1.B Modifications of the Format 1 balance sheet for small LLPs

The Format 1 balance sheet in the Small LLP Regulations differs in certain respects, as shown in Figure 4-2 below. The Format 1 balance sheet needs to be read together with the notes to the formats included in the Small LLP Regulations which are the same as detailed at 4.3.1.A above for companies except for the omission of items relating to shares (which are not relevant for an LLP) and an additional requirement to analyse 'Loans and other debts due to members' to show separately: the aggregate amount of money advanced to the LLP by the members by way of loan; the aggregate amount of money owed to members by the LLP in respect of profits; and any other amounts.²⁴

The discussion at 4.3.1 on the format 1 balance sheet for a small company is also relevant for LLPs.

²⁴ Note 7 to the LLP balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1912.

Figure 4-2: Format 1 individual balance sheet – small LLP

A Fixed assets	
I Intangible assets	
1	Goodwill
2	Other intangible assets
II Tangible assets	
1	Land and buildings
2	Plant and machinery etc.
III Investments	
1	Shares in group undertakings and participating interests
2	Loans to group undertakings and undertakings in which the LLP has a participating interest
3	Other investments other than loans
4	Other investments
B Current assets	
I Stocks	
1	Stocks
2	Payments on account
II Debtors	
1	Trade debtors
2	Amounts owed by group undertakings and undertakings in which the LLP has a participating interest
3	Other debtors*
III Investments	
1	Shares in group undertakings
2	Other investments
IV Cash at bank and in hand	
C Prepayments and accrued income*	
D Creditors: amounts falling due within one year	
1	Bank loans and overdrafts
2	Trade creditors
3	Amounts owed to group undertakings and undertakings in which the LLP has a participating interest
4	Other creditors* **
E Net current assets (liabilities)	
F Total assets less current liabilities	
G Creditors: amounts falling due after more than one year	
1	Bank loans and overdrafts
2	Trade creditors

	3	Amounts owed to group undertakings and undertakings in which the LLP has a participating interest
	4	Other creditors* **
H		Provisions for liabilities
I		Accruals and deferred income*
		Net assets attributable to members
		Represented by: #
J		Loans and other debts due to members***
K		Members' other interests
	I	Members' capital
	II	Revaluation reserve
	III	Other reserves~
	*	The notes to format 1 provide alternative positions for prepayments and accrued income, and accruals and deferred income. Prepayments and accrued income may be shown within sub-heading B.II.3 and accruals and deferred income may be shown within D.4, G.4 or both (as the case may require). In determining the amount of net current assets (liabilities), any prepayments and accrued income must be taken into account (wherever shown).
	**	There must be shown separately (a) the amount of any convertible loans and (b) the amount for creditors in respect of taxation and social security.
	***	The LLP must show separately (a) the aggregate amount of money advanced to the LLP by the members by way of loan; (b) the aggregate amount of money owed to members by the LLP in respect of profits; and (c) any other amounts.
	~	There is no breakdown of 'Other reserves' in the formats in the Small LLP Regulations (unlike the LLP Regulations).
	#	The LLP SORP requires a total for 'Net assets attributable to members', and 'Total members' interests' (as a memorandum item) to be disclosed on the face of the balance sheet (see the discussion below this figure and Figure 4-3 below).

The LLP SORP provides further guidance on members' interests and the application of the statutory formats for LLPs.

The LLP SORP requires the face of the balance sheet to show a total for 'Net assets attributable to members' (i.e., a balance sheet total before 'Loans and other debts due to members' (item J) and 'Members' other interests' (item K)). In addition, 'Total members' interests' (i.e., the total of 'Loans and other debts due to members' (item J) and 'Members' other interests' (item K) less any amounts due from members included in debtors) must be presented as a memorandum item on the face of the balance sheet. The SORP also provides illustrations of LLP balance sheets for different situations (depending on whether the partnership interests are classified as equity or a liability or part equity/part liability). [LLP SORP.1, LLP SORP.58, Appendix 1, Appendix 2]. A possible presentation of this memorandum item is illustrated in Figure 4-3 below.

LLPs with no equity, e.g., because of the classification of the partnership interests in the LLP, will not have items to report for 'Members' other interests' in the balance sheet.

Figure 4-3 Presentation of small LLP balance sheet (following LLP SORP)

	£'000
Net assets attributable to members	xxx
Represented by:	£'000
Loans and other debts due to members within one year	
Members' capital classified as liability	x
Other amounts	x
	x (1)
Members' other interests	
Members' capital classified as equity	x
Members' other interests - other reserves classified as equity	x
	x (2)
	xxx
Total members' interests	
Amounts due from members	(x)
Loans and other debts due to members (1)	x
Members' other interests (2)	x
	xx

Adapted from the example in Exhibit B of Appendix 1 of the LLP SORP for an LLP (with some equity). See discussion above this figure.

4.3.2 Profit and loss account

Schedule 1 to the Small Companies Regulations (and Schedule 1 to the Small LLP Regulations) provides a choice of two statutory formats for the profit and loss account. [FRS 102.1A.14].

Format 1 analyses expenses by function and is illustrated at Figure 4-4 (for a small UK company) and Figure 4-5 (for a small LLP) at 4.3.2.A below.

Format 2 analyses expenses by nature and is illustrated at Figure 4-6 (for a small UK company) and Figure 4-7 (for a small LLP) at 4.3.2.B below.

The General Rules to the formats (see 4.1 above) apply. As all the line items are denoted with Arabic numbers, these allow a degree of flexibility in the profit and loss account formats.

The individual line items in the profit and loss account formats in the Small Companies Regulations (and Small LLP Regulations) are the same as in the Regulations (and LLP Regulations) and are discussed in Chapter 6 at 5.6 (disclosures in other sections of FRS 102, as referred to in that discussion, are generally not mandated for small entities applying Section 1A). [FRS 102.1A.17].

4.3.2.A Format 1 profit and loss account

Figure 4-4 below sets out the profit and loss account, analysing expenses by function (Format 1) for a small UK company. This needs to be read together with the notes to the formats in Section B of Schedule 1 to the Small Companies Regulations (see 4.3.2.C below).

Figure 4-4: Format 1 individual profit and loss account - small UK company

1	Turnover
2	Cost of sales
3	Gross profit or loss
4	Distribution costs
5	Administrative expenses
6	Other operating income
7	Income from shares in group undertakings
8	Income from participating interests†
9	Income from other fixed asset investments
10	Other interest receivable and similar income
11	Amounts written off investments
12	Interest payable and similar expenses
	Profit or loss before taxation*
13	Tax on profit or loss
14	Profit or loss after taxation
19	Other taxes not shown under the above items**
20	Profit or loss for the financial year†
* While not in format 1, every profit and loss account must show the amount of a company's profit or loss before taxation. [1 Sch 6 (SC)].	
** Rarely seen in practice.	

Figure 4-5 below sets out the profit and loss account, analysing expenses by function (Format 1) for a small LLP. This needs to be read together with the notes to the formats in Section B of Schedule 1 to the Small LLP Regulations (see 4.3.2.C below).

The LLP SORP provides further guidance on application of the statutory formats for LLPs. The SORP requires that the 'Profit or loss for the financial year before members' remuneration and profit shares' (the final line item in the statutory formats), 'Members' remuneration charged as an expense' (including related employment costs) and the 'Profit or loss for the financial year available for discretionary division among members' are separately presented on the face of the profit and loss account (or statement of comprehensive income). The LLP SORP provides extensive guidance on the treatment of members' remuneration. The LLP SORP provides guidance and illustrations of LLP profit and loss accounts for different situations, including where the partnership interest is classified as equity, liability or part equity/part liability. [LLP SORP. 51-54, LLP SORP.Appendix 1, LLP SORP.Appendix 2].

How we see it

In our view, small LLPs need to present 'Members' remuneration charged as an expense' and 'Profit or loss for the financial year available for discretionary division among members' on the face of the profit and loss account (or statement of comprehensive income, if any). This is because that presentation allows the income statement to show all items of income and expense, as required by the Glossary definition of an income statement in FRS 102.

Figure 4-5: Format 1 individual profit and loss account – small LLP

1	Turnover
2	Cost of sales
3	Gross profit or loss
4	Distribution costs
5	Administrative expenses
6	Other operating income
7	Income from shares in group undertakings
8	Income from participating interests
9	Income from other fixed asset investments
10	Other interest receivable and similar income
11	Amounts written off investments
12	Interest payable and similar expenses
	Profit or loss before taxation*
13	Tax on profit or loss
14	Profit or loss after taxation
19	Other taxes not shown under the above items**
20	Profit or loss for the financial year before members' remuneration and profit shares
SORP	Members' remuneration charged as an expense ~
SORP	Profit or loss for the financial year available for discretionary division among members ~
* While not in format 1, every profit and loss account must show the amount of an LLP's profit or loss before taxation. [1 Sch 6 (LLP SC)].	
** Rarely seen in practice.	
~ Supplementary presentation requirements in the LLP SORP. See discussion above this figure.	

4.3.2.B Format 2 profit and loss account

Figure 4-6 below sets out the profit and loss account, analysing expenses by nature (Format 2) for a small UK company. This needs to be read together with the notes to the formats in Section B of Schedule 1 to the Small Companies Regulations (see 4.3.2.C below).

Figure 4-6 Format 2 individual profit and loss account - small UK company

1	Turnover
2	Change in stocks of finished goods and in work in progress
3	Own work capitalised
4	Other operating income
5	(a) Raw materials and consumables
	(b) Other external charges
6	Staff costs
	(a) wages and salaries
	(b) social security costs
	(c) other pension costs
7	(a) Depreciation and other amounts written off tangible and intangible fixed assets
	(b) Amounts written off current assets, to the extent that they exceed write-offs which are normal in the undertaking concerned
8	Other operating expenses
9	Income from shares in group undertakings
10	Income from participating interests
11	Income from other fixed asset investments
12	Other interest receivable and similar income
13	Amounts written off investments
14	Interest payable and similar expenses
	Profit or loss before taxation*
15	Tax on profit or loss
16	Profit or loss after taxation
21	Other taxes not shown under the above items**
22	Profit or loss for the financial year
* While not in format 2, every profit and loss account must show the amount of a company's profit or loss before taxation. [1 Sch 6 (SC)].	
** Rarely seen in practice.	

Figure 4-7 below sets out the profit and loss account, analysing expenses by nature (format 2) for a small LLP. This needs to be read together with the notes to the formats in Section B of Schedule 1 to the Small LLP Regulations (see 4.3.2.C below).

The additional requirements of the LLP SORP discussed above Figure 4-5 at 4.3.2.A above are also relevant to the format 2 profit and loss account for an LLP.

Figure 4-7 Format 2 individual profit and loss account - small LLP

1	Turnover
2	Change in stocks of finished goods and in work in progress
3	Own work capitalised
4	Other operating income
5	(a) Raw materials and consumables
	(b) Other external charges
6	Staff costs
	(a) wages and salaries
	(b) social security costs
	(c) other pension costs
7	(a) Depreciation and other amounts written off tangible and intangible fixed assets
	(b) Amounts written off current assets, to the extent that they exceed write-offs which are normal in the undertaking concerned
8	Other operating expenses
9	Income from shares in group undertakings
10	Income from participating interests
11	Income from other fixed asset investments
12	Other interest receivable and similar income
13	Amounts written off investments
14	Interest payable and similar expenses
	Profit or loss before taxation*
15	Tax on profit or loss
16	Profit or loss after taxation
21	Other taxes not shown under the above items**
22	Profit or loss for the financial year before members' remuneration and profit shares
SORP	Members' remuneration charged as an expense~
SORP	Profit or loss for the financial year available for discretionary division among members~
* While not in format 2, every profit and loss account must show the amount of an LLP's profit or loss before taxation. [1 Sch 6 (LLP SC)].	
** Rarely seen in practice.	
~ Supplementary presentation requirements in the LLP SORP. See discussion above Figure 4-5 at 4.3.2.A above.	

4.3.2.C Notes to the formats

The line items in the formats need to be read together with the notes to the formats. [1 Sch 1(2)(SC), 1 Sch 1(2)(LLP SC)]. These require that:

- 'Cost of sales', 'Distribution costs' and 'Administrative expenses' (Format 1, items 2, 4 and 5) are stated after taking into account any necessary provisions for depreciation or diminution in value of assets.
- In 'Income from other fixed asset investments' and 'Other interest receivable and similar income' (Format 1, items 9 and 10; Format 2, items 11 and 12), income and interest derived from group undertakings must be shown separately from income and interest derived from other sources. In addition, for LLPs, interest receivable from members must not be included under this item.

And

- In 'Interest payable and similar expenses' (Format 1, item 12; Format 2, item 14), the amount payable to group undertakings must be shown separately. In addition, for LLPs, interest payable to members must not be included under this item.

4.4 Adapted formats

Paragraph 1B of Schedule 1 to the Small Companies Regulations (and paragraph 1B of Schedule 1 to the Small LLP Regulations) set out the adaptations to the statutory formats permitted for the balance sheet and profit and loss account. These provide limited guidance on the content of the adapted formats, leaving the detail to UK accounting standards. [FRS 102.1AA.3, FRS 102.1AA.4, FRS 102.1AA.5, FRS 102.1AA.6, FRS 102.1AB.3, FRS 102.1AB.4]. See 7 below for amendments to the adapted formats which are effective for accounting periods beginning on or after 1 January 2027, with early application permitted.

A company's directors (or the members of an LLP) may adapt one of the balance sheet formats in Section B of Part 1 of Schedule 1 to the Small Companies Regulations (or Section B of Part 1 of Schedule 1 to the Small LLP Regulations), so to distinguish between current and non-current items in a different way, provided that:

- (a) The information given is at least equivalent to that which would have been required by the use of such format had it not been thus adapted.

And

- (b) The presentation of those items is in accordance with generally accepted accounting principles or practice. [1 Sch 1B(1)(SC), 1 Sch 1B(1)(LLP SC)].

Similarly, a company's directors (or the members of an LLP) may adapt one of the profit and loss account formats in Section B of Part 1 of Schedule 1 to the Small Companies Regulations (or Section B of Part 1 of Schedule 1 to the Small LLP Regulations), provided that:

- (a) The information given is at least equivalent to that which would have been required by the use of such format had it not been thus adapted.

And

- (b) The presentation is in accordance with generally accepted accounting principles or practice. [1 Sch 1B(2)(SC), 1 Sch 1B(2)(LLP SC)].

Adapted formats are also available in group accounts, where prepared (see 3.2 above). [6 Sch 1 (SC), 3 Sch 1 (LLP SC)].

So far as is practicable, the provisions of paragraphs 2 to 9A of the General Rules to the formats (see 4.1.4 above) – which address the requirements in the Small Companies Regulations/Small LLP Regulations on presentation of line items – apply to the balance sheet or profit and loss account of a company (or an LLP), notwithstanding use of the adapted formats. [1 Sch 1C (SC), 1 Sch 1C (LLP SC)].

Small entities applying adapted formats for the balance sheet and profit and loss account follow the requirements for adapted formats in Section 1A of FRS 102 which allow a presentation of the balance sheet and profit and loss account which is much closer to IAS 1 *Presentation of Financial Statements*.

[FRS 102.1AA.3-1AA.6, FRS 102.1AB.3, FRS 102.1AB.4]. Section 1A specifies that, at a minimum, certain line items are presented on the face of the statement of financial position and income statement, with further sub-classifications of items in the statement of financial position in the notes to the financial statements (see 4.4.1 below). In general, few difficulties should arise over classification of line items where adapted formats are applied since the required line items are aligned with the categories of assets and liabilities discussed in FRS 102. Some areas to watch on classification are, however, discussed at Chapter 6 at 4.1 and 5.5.

How we see it

In our view, small entities applying Section 1A could also choose to follow the adapted formats set out in Sections 4 and 5 of FRS 102 as these simply require more detailed analysis. See Chapter 6 at 4.1 and 5.5.

4.4.1 Adapted balance sheet

An entity choosing to adapt one of the balance sheet formats shall, as a minimum, include in its statement of financial position the line items presented in Figure 4-14 below, distinguishing between those items that are current and those that are non-current (see 4.4.1.A and 4.4.1.B below). [FRS 102.1AA.3]. To comply with this requirement, an entity must present as separate classifications: current assets and non-current assets, and current liabilities and non-current liabilities. [FRS 102.1AA.6].

Where adapted formats are used, there is no requirement to disclose debtors: amounts falling due after more than one year or to classify creditors: amounts falling due within or after more than one year. This is clarified by Section 4 of FRS 102 in respect of adapted formats under full FRS 102. [FRS 102.4.4A, FRS 102.4.7]. While Section 1A is silent on this matter, this will also be the case where adapted formats are used in accordance with Section 1A.

For adapted balance sheet formats for accounting periods beginning on or after 1 January 2027, see 7 below.

Figure 4-14: Balance sheet – line items included in adapted formats

(a)	Property, plant and equipment
(b)	Investment property carried at fair value through profit or loss
(c)	Intangible assets
(d)	Financial assets (excluding amounts shown under (e), (f), (j) and (k))
(e)	Investments in associates
(f)	Investments in jointly controlled entities
(g)	Biological assets carried at cost less accumulated depreciation and impairment
(h)	Biological assets carried at fair value through profit or loss
(i)	Inventories
(j)	Trade and other receivables
(k)	Cash and cash equivalents
(l)	Trade and other payables
(m)	Provisions
(n)	Financial liabilities (excluding amounts shown under (l) and (m))
(o)	Liabilities and assets for current tax*
(p)	Deferred tax liabilities and deferred tax assets (classified as non-current)*
(q)	Non-controlling interest, presented within equity separately from the equity attributable to the owners of the parent #
(r)	Equity attributable to the owners of the parent~
~	For LLPs, additional line items are required on the face of the balance sheet – see the discussion below this figure and at 4.3.1.B above.
#	The line item (q) for non-controlling interest is relevant only where consolidated financial statements are prepared (see 3.2 above). Consolidated financial statements are not addressed in detail in this chapter.
*	While line items (o) and (p) appear to combine liabilities and assets for current tax and deferred tax respectively, the assets will need to be shown separately from the liabilities. Deferred tax is always classified as non-current.

The LLP SORP requires that, in order for the adapted formats to show the equivalent information to the statutory formats, 'Loans and other debts due to members' (item J in the statutory formats) and 'Members' other interests' (item K in the statutory formats) are separately disclosed on the face of the statement of financial position. [LLP SORP.26C].

The LLP SORP also requires that the face of the adapted balance sheet shows the 'Net assets attributable to members of the LLP' (i.e., a balance sheet total before 'Loans and other debts due to members' (item J) and 'Members' other interests' (item K)). In addition, 'Total members' interests' (being the total of 'Loans and other debts due to members' (item J) and 'Members' other interests' (item K) less any amounts due from members in debtors) is disclosed as a memorandum item on the face of the balance sheet.

[LLP SORP.26B, LLP SORP.58]. These are the same additional disclosures required by the LLP SORP where statutory formats are used (see 4.3.1.B above).

The prescribed line items for the balance sheet, where adapted formats are used under Section 1A, are the same as those required when full FRS 102 is applied. [FRS 102.1AA.3, FRS 102.4.2A]. Chapter 6 at 4.1 addresses application issues on the line items in adapted formats. In addition, Illustration 4-2 in Chapter 6 at 4.1.15 presents an illustrative statement of financial position (using adapted formats) relevant to both Section 1A and Section 4 of FRS 102.

So far as is practicable, the provisions of paragraphs 2 to 9A of the General Rules to the formats (see 4.1 above) apply to the adapted formats. [1 Sch 1C (SC), 1 Sch 1C (LLP SC)]. Where an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the financial statements. [1 Sch 9A (SC), 1 Sch 9A (LLP SC)].

In addition, the following sub-classifications of the line items presented must be disclosed either in the statement of financial position or in the notes:

- Property, plant and equipment in classifications appropriate to the entity
- Goodwill and other intangible assets
- Investments, showing separately shares and loans
- Trade and other receivables showing separately amounts due from related parties, and amounts due from other parties
- Trade and other payables, showing separately amounts payable to trade suppliers, and amounts payable to related parties
- And
- Classes of equity, such as called up share capital, share premium, retained earnings, revaluation reserve, fair value reserve and other reserves. [FRS 102.1AA.4].

The sub-classifications of line items required in the notes to the financial statements are less extensive than those required under Section 4 of FRS 102.

A small entity is permitted to amend the descriptions of the line items in the statement of financial position set out in Figure 4-14 above, [FRS 102.1AA.3], the descriptions of the sub-classifications of those line items referred to above, [FRS 102.1AA.4], and the ordering of items or aggregation of similar line items, according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position. This is allowed, providing the information given is at least equivalent to that required by the balance sheet format had it not been adapted. [FRS 102.1AA.5]. Generally, FRS 102's provisions on adapting the descriptions, order and aggregation of line items are consistent with the General Rules to the formats.

4.4.1.A Current and non-current assets

The definitions of current and non-current assets discussed below apply only where an entity chooses to use adapted formats in accordance with paragraph 1B(1) of Schedule 1 to the Small Companies Regulations (or paragraph 1B(1) of Schedule 1 to the Small LLP Regulations).

FRS 102 defines 'current assets' as: "Assets of an entity which ... are not non-current assets".

[FRS 102 Appendix I].

FRS 102 defines non-current assets as assets of the entity which:

- (a) It does not expect to realise, or intend to sell or consume, in its normal operating cycle (see Chapter 6 at 4.1.1.A).
- (b) It does not hold primarily for the purpose of trading (see Chapter 6 at 4.1.1.B).
- (c) It does not expect to realise within 12 months after the reporting period.

Or

- (d) Are cash or cash equivalents restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period. [FRS 102 Appendix I].

The adapted formats also require that deferred tax assets are always classified as non-current.

[FRS 102.1AA.3].

'Cash or cash equivalents' are also defined in the FRS 102 Glossary, [FRS 102 Appendix I], and would be interpreted in a manner consistent with Section 7 of FRS 102 (see Chapter 7 at 3.2).

IAS 1/IFRS 18 *Presentation and Disclosure in Financial Statements* require an entity to classify an asset as current if the asset meets any of the conditions in (a) to (d) of paragraph 66 of IAS 1 or paragraph 99 of IFRS 18 respectively (and all other assets are non-current). [IAS 1.66, IFRS 18.99]. The conditions in (a) to (d) above in FRS 102's definition of 'non-current assets' are broadly the converse of the conditions (a) to (d) in

IAS 1/IFRS 18's definition of a current asset. By choosing to define non-current assets (leaving current assets as the residual), rather than current assets as in IAS 1/IFRS 18, there are potential ambiguities in the wording of the definition, which we consider are unintended.

How we see it

In our view, the FRC intended that the classification of assets as non-current and current is consistent with the requirements of paragraph 66 of IAS 1 (and paragraph 99 of IFRS 18).

FRS 102 provides no additional guidance beyond the definition above. However, since the intention is to provide a format more aligned with IAS 1, management may consider, as permitted by the hierarchy in Section 10 Accounting Policies, Estimates and Errors, the requirements of IFRS for further guidance.

[FRS 102.10.4, FRS 102.10.5, FRS 102.10.6].

See Chapter 6 at 4.1.1 for further discussion of the classification of current and non-current assets. The guidance presented there refers to IAS 1/IFRS 18's requirements, where appropriate.

The current portion of non-current financial assets would be classified as current, consistent with IFRS.

[IAS 1.68, IFRS 18.B95].

4.4.1.B Current and non-current liabilities

The definitions of current liabilities and non-current liabilities discussed below apply only where an entity chooses to use adapted formats in accordance with paragraph 1B(1) of Schedule 1 to the Small Companies Regulations (or paragraph 1B(1) of Schedule 1 to the Small LLP Regulations).

FRS 102 defines current liabilities as liabilities of the entity which:

- (a) It expects to settle in its normal operating cycle (see Chapter 6 at 4.1.2.A).
- (b) It holds primarily for the purpose of trading (see Chapter 6 at 4.1.2.B).
- (c) Are due to be settled within 12 months after the reporting period (see Chapter 6 at 4.1.2.C).

Or

- (d) It does not have an unconditional right to defer settlement for at least 12 months after the reporting period. (See Chapter 6 at 4.1.2.D). [FRS 102 Appendix I].

Meeting any one of (a) to (d) leads to the liability being required to be classified as current.

The FRS 102 Glossary defines non-current liabilities as liabilities of the entity which are not current liabilities (i.e., the residual). [FRS 102 Appendix I]. This approach is consistent with IAS 1 and IFRS 18. [IAS 1.69, IFRS 18.101, IFRS 18.102]. The adapted formats also require that deferred tax liabilities are always classified as non-current. [FRS 102.1AA.3].

The definition of current liabilities in extant FRS 102 does not wholly align with extant IAS 1 and IFRS 18. See Chapter 6 at 4.1.2.D for further discussion of the extant IFRS requirements and guidance on part (d) of the definition.

4.4.2 Adapted profit and loss account

Adapted formats may be used provided that the information given is at least equivalent to that which would have been required by the use of the statutory format had it not been thus adapted and the presentation is in accordance with generally accepted accounting principles or practice. [1 Sch 1B(2)(SC), 1 Sch 1B(2)(LLP SC)]. The detail, however, is left to accounting standards, namely Section 1A of FRS 102.

A small entity choosing to adapt one of the profit and loss account formats must, as a minimum, include in its income statement line items that present amounts (a) to (f) for the period (as set out in Figure 4-15 below). [FRS 102.1AB.3].

For adapted profit and loss formats for accounting periods beginning on or after 1 January 2027 see 7 below.

Figure 4-15 Profit and loss account – line items included in adapted formats

(a)	Revenue
(b)	Finance costs
(c)	Share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method [#]
(d)	Profit or loss before taxation
(e)	Tax expense (excluding tax allocated to other comprehensive income or equity)
(f)	Profit or loss [~]
~	The LLP SORP requires further line items for LLPs. See discussion below this figure.
#	Only required in consolidated financial statements, as the equity method is not applied in individual financial statements under FRS 102. Consolidated financial statements are not addressed in detail in this chapter.

The LLP SORP provides guidance on adapted formats which we would expect to apply to all LLPs (including small LLPs) as the adaptations are intended to provide equivalent information to the statutory formats.

Adapted formats for an LLP are required to show a line item for 'Profit or loss for the financial year before members' remuneration and profit shares'. 'Members' remuneration charged as an expense' (which would include related employment costs) must then be deducted as an additional expense, [LLP SORP.26C, LLP SORP.53, LLP SORP.Appendix 1], presumably coming to the final line item of 'Profit or loss for the financial year available for discretionary division among members' (which would correspond to item (f) in Figure 4-15 above). This would be the same presentation on the face of the profit and loss account (or statement of comprehensive income) as discussed for statutory formats in Figure 4-5 at 4.3.2.A above and Figure 4-7 at 4.3.2.B above.

The provisions of paragraphs 2 to 9A of Section A of the General Rules to the formats (see 4.1 above) apply, so far as practicable, to the profit and loss account, notwithstanding the use of adapted formats.

[1 Sch 1C (SC), 1 Sch 1C (LLP SC)].

A small entity is permitted to include additional line items in the income statement and amends the descriptions used in the line items set out in (a) to (f) in Figure 4-15 above and the ordering of items, when this is necessary to explain the elements of financial performance, providing the information given is at least equivalent to that required by the profit and loss account format had it not been adapted.

[FRS 102.1AB.4].

An analysis of expenses in the notes to the financial statements or on the face of the income statement is not explicitly required by Section 1A of FRS 102 (since Section 5 of FRS 102 does not apply), [FRS 102.1A.7A, FRS 102.5.5B, FRS 102.5.7A]. However, adapted formats still need to give equivalent information to the statutory formats, [1 Sch 1B(2) (SC), 1 Sch 1B(2) (LLP SC)], and meet the true and fair requirement.

[FRS 102.1A.16]. Therefore, a small entity might consider that additional analysis is necessary to explaining elements of financial performance. [FRS 102.1AB.4].

Illustration 5-1 in Chapter 6 at 5.5.2 shows a statement of comprehensive income for an entity using adapted formats in full FRS 102 which provides an analysis of expenses. A small entity presenting only an income statement would omit the lines after 'profit for the year' in Illustration 5-1.

5 Information to be presented in the notes to the financial statements

Notes to the financial statements contain information in addition to those presented in the primary financial statements and provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. *[FRS 102 Appendix I]*.

Consistent with the Small Companies Regulations (and Small LLP Regulations), the notes must be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and in the income statement. *[FRS 102.1AC.2, 1 Sch 42(2)(SC), 1 Sch 42(2)(LLP SC)]*.

A small entity must present sufficient information in the notes to the financial statements to meet the requirement for the financial statements to give a true and fair view of the assets, liabilities, financial position and profit or loss of the small entity for the reporting period. *[FRS 102.1A.6, FRS 102.1A.7, FRS 102.1A.16, FRS 102.3.2]*.

A small entity in the UK must provide, at a minimum, when relevant to its transactions, other events and conditions, the disclosures in Appendix C of FRS 102. *[FRS 102.1A.16A, FRS 102.1AC.1]*. These disclosures (which are set out in 5.1 below) are based mainly on the statutory requirements for UK companies subject to the small companies regime. The Small Companies Regulations (and Small LLP Regulations) set out supplementary information, analyses and reconciliations of line items to be given in the notes to the financial statements which apply whether statutory formats or the adapted formats are used. One complexity is that the information required generally refers to items found in the statutory formats (which differ to the line items identified where the adapted formats are used). For example, the adapted formats do not refer to fixed assets, creditors: amounts falling due within one year, creditors: amounts falling due after more than one year or investments. While the classification of non-current assets and current assets used in adapted formats differs to the fixed assets and current assets classification required in statutory formats, the statutory definition of 'fixed assets' (see Chapter 6 at 4.2.2) is relevant for the purposes of disclosures in respect of fixed assets in the Small Companies Regulations (and Small LLP Regulations). Section 1A of FRS 102 includes nearly all the statutory disclosures but restates these disclosures in a way that can be applied even if statutory formats are not used.

The list of disclosures in Appendix C of Section 1A is not quite exhaustive to meet the statutory disclosure requirements. There are some additional disclosures in legislation that derive from the notes to the statutory formats, where there are some differences for companies and LLPs (see 4.3 above) or are included in the CA 2006 (or the CA 2006 as applied to LLPs) itself – see 5.2 below.

Entities subject to a SORP may find that the SORP recommends additional disclosures. See Chapter 1 at 3.6 and Chapter 3 at 2.3 on application of SORPs.

A small entity need not provide a specific disclosure (including those set out in Appendix C of Section 1A) if the information resulting from that disclosure is not material, except when required by the CA 2006 regardless of materiality. *[FRS 102.1A.17A, FRS 102.1AC.1, FRS 102.3.16B]*.

See also the discussion of notes to the financial statements at 3.3.3 above, true and fair view at 3.3.4 above (which might necessitate a small entity providing additional disclosures) and materiality and aggregation at 3.3.7 above.

5.1 Disclosure requirements for small entities in the UK (included in Appendix C of Section 1A)

Appendix C of Section 1A sets out the disclosure requirements for small entities in the UK. The appendix, which is an integral part of Section 1A, sets out both requirements of Section 1A of FRS 102 and those of UK company law applicable to small entities. Some disclosure requirements cross-refer to other sections of FRS 102.

The disclosure requirements based on UK company law are shown in italic font in the appendix. The FRC states that the drafting is as close as possible to that set out in company law.

Appendix C observes that a small entity must make the disclosures stated as a minimum. A small entity need not provide a specific disclosure set out in the appendix if the information resulting from that disclosure is not material, except when required by company law regardless of materiality. *[FRS 102.1AC.1]*. The disclosure requirements are stated as they would apply in individual financial statements. Disclosures in consolidated financial statements are not dealt with in detail in this chapter, but 3.2 above provides some guidance.

Paragraphs in FRS 102 that have been cross referenced in Appendix C are also highlighted in the left-hand margin of other sections of the standard with a * (where there is a similar disclosure requirement in full FRS 102 to the statutory disclosures on which Appendix C of FRS 102 was originally based) or a ^ (where Appendix C has incorporated certain disclosures by cross reference to the full standard that the FRC considers are required in order for the financial statements to give a true and fair view). [FRS 102.1A.16B].

5.1.1 Structure of notes

The notes must be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and in the income statement. [1 Sch 42(2)(SC), 1 Sch 42(2)(LLP SC)].

Paragraphs 8.3 and 8.4 of FRS 102 address similar requirements (see Chapter 6 at 7.1). [FRS 102.1AC.2, FRS 102.8.3, FRS 102.8.4].

5.1.2 Compliance with FRS 102

A small entity applying Section 1A whose financial statements comply with FRS 102 must make an explicit and unreserved statement of compliance in the notes to the financial statements that the financial statements are prepared in accordance with FRS 102, clearly stating that Section 1A has been applied. A similar requirement is in paragraph 3.3 of FRS 102. [FRS 102.1AC.2A, FRS 102.1A.7, FRS 102.3.3].

Similarly, a small entity that is a public benefit entity that applies the 'PBE' prefixed paragraphs must make an explicit and unreserved statement that it is a public benefit entity. A similar requirement is in paragraph PBE 3.3A of FRS 102. [FRS 102.PBE1AC.2B, FRS 102.1A.7, FRS 102.PBE3.3A].

See 3.3.2 above for discussion and examples of compliance statements.

5.1.3 Going concern

A small entity applying Section 1A must make the following disclosures in respect of going concern: [FRS 102.1AC.2C].

- Disclosure that the financial statements are prepared on a going concern basis (where this is the case), as well as confirmation that management has considered information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue. [FRS 102.1A.7, FRS 102.3.8A].
- Disclosure of any significant judgements made in assessing the entity's ability to continue as a going concern. [FRS 102.1A.7, FRS 102.8.6].
- Disclosure of material uncertainties (if any), of which management is aware, in making its going concern assessment, related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. [FRS 102.1A.7, FRS 102.3.9].
- Disclosure that the financial statements are not prepared on a going concern basis, if applicable, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern. [FRS 102.1A.7, FRS 102.3.9].

See 3.3.5 above and Chapter 6 at 8.3 for further discussion of the going concern basis of accounting. As discussed in 3.3.5 above, the FRC has issued FRS Factsheet 13, to aid preparers of small company accounts in the UK in performing going concern assessments and in preparing financial statement disclosures.

5.1.4 Accounting policies

The accounting policies adopted by the small entity in determining the amounts to be included in respect of items shown in the statement of financial position and in determining the profit or loss of the small entity must be stated (including such policies with respect to the depreciation and impairment of assets).

[1 Sch 44 (SC), 1 Sch 44 (LLP SC)].

Paragraphs 8.5 and 8.5A of FRS 102 address similar requirements for disclosing accounting policy information. Appendix C of Section 1A notes that including information about the judgements made in applying the small entity's accounting policies, as set out in paragraph 8.6 of FRS 102, may be useful to users of the small entity's financial statements (see Chapter 6 at 7.2 and 7.3). [FRS 102.1AC.3, FRS 102.8.5, FRS 102.8.5A, FRS 102.8.6].

If any amount is included in a small entity's statement of financial position in respect of development costs, the note on accounting policies must include the following information:

(a) The period over which the amount of those costs originally capitalised is being or is to be written off.

And

(b) The reasons for capitalising the development costs in question. [1 Sch 21(2)(SC), 1 Sch 21(2)(LLP SC)].

Paragraph 18.27(a) of FRS 102 addresses similar requirements to (a) above (see Chapter 21 at 3.4.2).

[FRS 102.1AC.4, FRS 102.18.27(a)].

Where development costs are shown or included as an asset in the small entity's financial statements and the amount is not treated as a realised loss because there are special circumstances justifying this, a note to the financial statements must state the reasons for showing development costs as an asset and that it is not a realised loss. [s844, FRS 102.1AC.5].

TECH 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006*, issued by the ICAEW and ICAS, clarifies that this exception for special circumstances allowing a capitalised development cost not to be treated as a realised loss would apply where the costs are carried forward in accordance with applicable accounting standards. [TECH 02/17BL.2.38]. In other words, development costs capitalised under FRS 102 are not treated as realised losses for distribution purposes.

Unrealised revaluation profits on capitalised development costs are not treated as realised losses. [s844(2)].

Where in exceptional cases, the useful life of intangible assets cannot be reliably estimated, there must be disclosed in a note to the financial statements the period over which those intangible assets are being written off and the reasons for choosing that period. [1 Sch 22(4)(SC), 1 Sch 22(4)(LLP SC)]. Intangible assets include goodwill. Paragraphs 18.27(a) of FRS 102 (see Chapter 21 at 3.4.2) and 19.25(g) of FRS 102 (see Chapter 22 at 4.1) address similar disclosure requirements. [FRS 102.1AC.6, FRS 102.18.27(a), FRS 102.19.25(g)].

5.1.5 Changes in presentation and accounting policies and corrections of prior period errors

Where there is a change in the presentation of a small entity's statement of financial position or income statement, particulars of any such change must be given in a note to the financial statements in which the new presentation is first used, and the reasons for the change must be explained. [1 Sch 2(2)(SC), 1 Sch 2(2)(LLP SC)]. Paragraphs 3.12 and 3.13 of FRS 102 address similar requirements (see 3.3.6 above). [FRS 102.1AC.7, FRS 102.3.12, FRS 102.3.13].

Where the corresponding amount for the immediately preceding reporting period is not comparable with the amount to be shown for the item in question in respect of the reporting period, and the corresponding amount is adjusted, the particulars of the non-comparability and of any adjustment must be disclosed in a note to the financial statements. [1 Sch 7(2)(SC), 1 Sch 7(2)(LLP SC)].

Changes in corresponding amounts occur, usually, where there has either been a change in accounting policy or the correction of a material prior period error. Paragraphs 10.13, 10.14 and 10.23 of FRS 102 address similar requirements (see 3.3.6 and 4.1 above, and Chapter 9 at 3.6.1 and 3.6.3). [FRS 102.1AC.8, FRS 102.10.13, FRS 102.10.14, FRS 102.10.23].

The statutory disclosures require particulars of non-comparability of comparatives regardless of whether or not any adjustment is made (see 4.1.4 above). [1 Sch 7(2)(SC), 1 Sch 7(2)(LLP SC)]. In most cases, a change in accounting policy, a correction of a prior period error or a reclassification would be retrospectively effected. Where amounts are not restated, e.g., due to transitional provisions in accounting policies or where it is impracticable to determine the effects of a change in accounting policies/material errors on earlier periods, [FRS 102.10.11, FRS 102.10.12, FRS 102.10.22], entities will need to disclose the non-comparability.

Where any amount relating to a preceding reporting period is included in any item in the income statement, the effect must be stated. [1 Sch 61(1)(SC), 1 Sch 59(1)(LLP SC), FRS 102.1AC.9].

5.1.6 True and fair override

If it appears to the small entity that there are special reasons for departing from any of the principles set out in company law in preparing the small entity's financial statements in respect of any reporting period, it may do so, in which case particulars of the departure, the reasons for it, and its effects must be given in the notes to the financial statements. [1 Sch 10(2)(SC), 1 Sch 10(2)(LLP SC)].

Section 1A notes that this is only expected to occur in special circumstances. Paragraphs 3.4 and 3.5 of FRS 102 (which also apply to a small entity applying Section 1A) address similar requirements.

[FRS 102.1AC.10, FRS 102.1A.7, FRS 102.3.4, FRS 102.3.5].

Paragraphs 3.5 and 3.6 of FRS 102 both apply to a small entity also and contain extra disclosure requirements as follows:

- When an entity departs from a requirement of FRS 102 (in special circumstances, in order to give a true and fair view) or from a requirement of applicable legislation, it must disclose:
 - (a) That management has concluded that the financial statements give a true and fair view of the entity's financial position, financial performance and, when required to be presented, cash flows.
 - (b) That it has complied with FRS 102 or applicable legislation, except that it has departed from a particular requirement of the standard or applicable legislation to the extent necessary to give a true and fair view.

And

 - (c) The nature and effect of the departure, including the treatment that FRS 102 or applicable legislation would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in Section 2 and the treatment adopted.
- When an entity has departed from a requirement of FRS 102 or applicable legislation in a prior period and that departure affects the amounts recognised in the financial statements for the current period, it must make the disclosures set out in (c) above. [FRS 102.3.5, FRS 102.3.6].

How we see it

FRS 102 does not explain what is required by 'the effect of the departure', but in our view, this means financial effect.

See 3.3.4 above for further discussion of the 'true and fair view' and 3.3.4.A above for further discussion of the 'true and fair override'.

5.1.7 An asset or liability relating to more than one item in the statement of financial position

Where an asset or liability relates to more than one item in the statement of financial position, the relationship of such asset or liability to the relevant items must be disclosed either under those items or in the notes to the financial statements. [1 Sch 9A (SC), 1 Sch 9A (LLP SC), FRS 102.1AC.11].

See 4.1.4 above for further discussion concerning situations where this disclosure requirement may apply.

5.1.8 Deferred tax

A small entity must provide the disclosures relating to deferred tax set out in paragraph 29.27(e) of FRS 102. [FRS 102.1AC.11A, FRS 102.29.27(e)].

5.1.9 Fixed assets

In respect of each item which is shown under the general item 'fixed assets' in the small entity's statement of financial position, the following information must be given:

- (a) The aggregate amounts (on the basis of cost or revaluation) in respect of that item as at the date of the beginning of the reporting period and as at the reporting date respectively.
- (b) The effect on any amount shown in the statement of financial position in respect of that item of:
 - (i) Any revision of the amount in respect of any assets included under that item made during the reporting period as a result of revaluation.
 - (ii) Acquisitions during the reporting period of any assets.
 - (iii) Disposals during the reporting period of any assets.

And

 - (iv) Any transfers of assets of the small entity to and from that item during the reporting period.

[1 Sch 48(1)(SC), 1 Sch 48(2)(SC), 1 Sch 47(1)-(2)(LLP SC), FRS 102.1AC.12].

In respect of each item within paragraph 1AC.12 of FRS 102 above, there must also be stated:

- (a) The cumulative amount of provisions for depreciation and impairment of assets included under that item as at the date of the beginning of the reporting period and as at the reporting date respectively.
- (b) The amount of any such provisions made in respect of the reporting period.

- (c) The amount of any adjustments made in respect of any such provisions during the reporting period in consequence of the disposal of any such assets.

And

- (d) The amount of any other adjustments made in respect of any such provisions during the reporting period. [1 Sch 48(3)(SC), 1 Sch 47(3)(LLP SC), FRS 102.1AC.13].

These two paragraphs above apply to all fixed assets, including investment property, plant and equipment, intangible assets (including goodwill), right-of-use assets, fixed asset investments, biological assets and heritage assets recognised in the statement of financial position.

Each item refers to a class of fixed assets shown separately either in the statement of financial position or in the notes to the financial statements. The reconciliations need not be presented for prior periods.

FRS 102 addresses similar requirements for investment property (paragraph 16.10(e) of FRS 102), property, plant and equipment (paragraphs 17.31(d) and (e) of FRS 102), intangible assets other than goodwill (paragraphs 18.27(c) and (e) of FRS 102), goodwill (paragraph 19.26 of FRS 102), right-of-use assets (paragraphs 20.81(a) and (b) of FRS 102), biological assets (paragraphs 34.7(c) and 34.10(e) of FRS 102) and heritage assets recognised in the statement of financial position (paragraphs 34.55(e) and (f) of FRS 102). [FRS 102.1AC.13, FRS 102.16.10, FRS 102.17.31, FRS 102.18.27, FRS 102.19.26, FRS 102.20.81, FRS 102.34.7, FRS 102.34.10, FRS 102.34.55]. These are discussed in Chapter 19 at 4.3, Chapter 20 at 3.9.1, Chapter 21 at 3.4.2, Chapter 22 at 4.2, Chapter 23 at 6.8, Chapter 36 at 2.9.1 and 2.9.2, and Chapter 36 at 5.4.4 respectively.

'Fixed assets' means assets of an entity which are intended for use on a continuing basis in the entity's activities, and 'Current assets' means assets not intended for such use. [8 Sch 3 (SC), 5 Sch 3 (LLP SC), FRS 102 Appendix I]. See 4.3.1 above and Chapter 6 at 4.2.2. The above disclosures are still required even if adapted formats with a non-current and current analysis of assets and liabilities are applied (see 4.4 above).

5.1.9.A Fixed assets (measured at revalued amounts using the alternative accounting rules)

Section 1A of FRS 102 requires disclosures for fixed assets revalued using the alternative accounting rules. These apply where:

- Investments in subsidiaries, associates and joint ventures are measured at fair value with changes in fair value recognised in other comprehensive income.
- Property, plant and equipment are revalued using the revaluation model set out in paragraphs 17.15B to 17.15F of FRS 102.
- Intangible assets other than goodwill are revalued using the revaluation model set out in paragraphs 18.18B to 18.18H of FRS 102.

And

- Right-of-use assets are revalued using the revaluation model set out in paragraph 20.61 of FRS 102. [FRS 102.1AC.14].

These disclosure requirements do not apply to investment property and biological assets measured at fair value through profit or loss. [FRS 102.1AC.14, FRS 102.1AC.15, FRS 102.1AC.16, FRS 102.1AC.17, FRS 102.1AC.18]. This is because such accounting for investment property and biological assets is in accordance with the fair value accounting rules rather than being a revaluation under the alternative accounting rules.

The disclosures in respect of fixed assets measured at revalued amounts using the alternative accounting rules are as follows:

- Where fixed assets are measured at revalued amounts, the items affected and the basis of valuation adopted in determining the amounts of the assets in question in the case of each such item must be disclosed in the note on accounting policies. [1 Sch 34(2)(SC), 1 Sch 34(2)(LLP SC), FRS 102.1AC.14].

Paragraphs 9.27(b), 17.31(a), 18.29A(c) and 20.85 of FRS 102 address similar disclosure requirements (see Chapter 8 at 4.6.1, Chapter 20 at 3.9.1, Chapter 21 at 3.4.4 and Chapter 23 at 6.8). [FRS 102.9.27, FRS 102.17.31, FRS 102.18.29A, FRS 102.20.85].

- Where any fixed assets of the small entity (other than listed investments) are included under any item shown in the small entity's statement of financial position at a revalued amount, the following information must be given:
 - (a) The years (so far as they are known to the directors) in which the assets were severally valued and the several values.
 - (b) In the case of assets that have been valued during the reporting period, the names of the persons who valued them or particulars of their qualifications for doing so (and whichever is stated), the bases of valuation used by them. *[1 Sch 49 (SC), 1 Sch 48 (LLP SC)]*.

Paragraphs 17.32A(a) and (c), 18.29A(a) and (c), and 34.55(e)(ii) of FRS 102 address similar requirements (see Chapter 20 at 3.9.1, Chapter 21 at 3.4.4 and Chapter 36 at 5.4.4). Section 1A of FRS 102 states that these paragraphs do not require the names or qualifications of the persons who valued the fixed assets to be disclosed. *[FRS 102.1AC.15, FRS 102.17.32A, FRS 102.18.29A, FRS 102.34.55]*.

A 'listed investment' means an investment as respects which there has been granted a listing on (a) a recognised investment exchange other than an overseas investment exchange (both as defined in Part 18 of the Financial Services and Markets Act 2000) or (b) a stock exchange of repute outside the UK. *[8 Sch 5 (SC), 5 Sch 5 (LLP SC)]*. A list of recognised investment exchanges (and recognised overseas investment exchanges) is available on the Financial Conduct Authority website.²⁵ AIM is not a recognised investment exchange.

In the case of each item in the statement of financial position measured at a revalued amount, the comparable amounts determined according to the historical cost accounting rules must be shown in a note to the financial statements. *[1 Sch 34(3) (SC), 1 Sch 34(3) (LLP SC)]*.

The comparable amount refers to the aggregate amount of cost and the aggregate of accumulated depreciation and accumulated impairment losses that would have been required according to the historical cost accounting rules. *[1 Sch 34(4) (SC), 1 Sch 34(4) (LLP SC)]*.

Paragraphs 17.32A(d), 18.29A(d) and 20.85 of FRS 102 address similar requirements (see Chapter 20 at 3.9.1, Chapter 21 at 3.4.4 and Chapter 23 at 6.8). *[FRS 102.1AC.16, FRS 102.17.32A, FRS 102.18.29A, FRS 102.20.85]*.

Where fixed assets are measured at revalued amounts, the following information must be given in tabular form:

- (a) Movements in the revaluation reserve in the reporting period, with an explanation of the tax treatment of items therein.

And

- (b) The carrying amount in the statement of financial position that would have been recognised had the fixed assets not been revalued. *[1 Sch 54(2) (SC), 1 Sch 53(2) (LLP SC)]*.

Paragraphs 6.3A (see Chapter 6 at 6.1), 17.32A(d), 18.29A(d), and 29.27(a) of FRS 102 (see Chapter 20 at 3.9.1, Chapter 21 at 3.4.4 and Chapter 31 at 12.3) address similar requirements. *[FRS 102.1AC.17, FRS 102.6.3A, FRS 102.17.32A, FRS 102.18.29A, FRS 102.29.27]*.

The treatment for taxation purposes of amounts credited or debited to the revaluation reserve must be disclosed in a note to the financial statements. *[1 Sch 35(6) (SC), 1 Sch 35(3) (LLP SC)]*.

Paragraph 29.27(a) of FRS 102 (see Chapter 31 at 12.3) addresses similar requirements. *[FRS 102.1AC.18, FRS 102.29.27]*.

5.1.10 Capitalisation of borrowing costs

Where a small entity adopts a policy of capitalising borrowing costs, the inclusion of interest in determining the cost of the asset and the amount of the interest so included is disclosed in a note to the financial statements. *[1 Sch 27(3) (SC), 1 Sch 27(3) (LLP SC)]*.

Paragraph 25.3A(a) of FRS 102 addresses a similar requirement to the second part of this (see Chapter 27 at 4.1). *[FRS 102.1AC.19, FRS 102.25.3A]*.

5.1.11 Impairment of assets

Provisions for impairment of fixed assets (including fixed asset investments) must be disclosed separately in a note to the financial statements if not shown separately in the income statement. *[1 Sch 19(3) (SC), 1 Sch 19(3) (LLP SC)]*.

²⁵ [Recognised Investment Exchanges](#), FCA website (accessed 28 August 2025).

Paragraph 27.32(a) of FRS 102 (see Chapter 29 at 9) addresses similar requirements. [FRS 102.1AC.20, FRS 102.27.32].

Any provisions for impairment of fixed assets that are reversed because the reasons for which they were made have ceased to apply must be disclosed (either separately or in aggregate) in a note to the financial statements if not shown separately in the income statement. [1 Sch 20(2)(SC), 1 Sch 20(2)(LLP SC)].

Paragraph 27.32(b) of FRS 102 (see Chapter 29 at 9) addresses similar requirements. [FRS 102.1AC.21, FRS 102.27.32].

5.1.12 Fair value measurement

Where financial instruments or other assets have been measured in accordance with the fair value accounting rules there must be stated:

- (a) The significant assumptions underlying the valuation models and techniques used to determine the fair values.
- (b) For each category of financial instrument or other asset, the fair value of assets in that category and the change in value:
 - (i) Included directly in the income statement.
 - Or
 - (ii) Credited to or (as the case may be) debited from the fair value reserve, in respect of those assets. [1 Sch 51(2)(a)(SC), 1 Sch 51(2)(b)(SC), 1 Sch 50(2)(a)(LLP SC), 1 Sch 50(b)(LLP SC)].

Section 1A of FRS 102 explains that this disclosure does not apply where financial instruments or other assets are measured at fair value only on initial recognition. Instead, this disclosure applies where financial instruments, certain inventories, investment property, and biological assets are subsequently measured at fair value through profit or loss, which is permitted or required by paragraphs 9.26(c), 11.14(b), 11.14(d)(iii), 11.14(d)(iv), 12.8, 13.4A, 14.4(d), 15.9(d), 16.7 and 34.4 of FRS 102.

Paragraphs 11.41, 11.43, 11.48(a)(i), 11.48(a)(ii), 12.28, 12.29(c) and 12.29(e) of FRS 102 address similar disclosure requirements for financial instruments. See Chapter 15 at 4.1.

Paragraphs 16.10(a) and 16.10(e)(ii) of FRS 102 address similar disclosure requirements for investment property. See Chapter 19 at 4.3.

Paragraphs 34.7(b) and 34.7(c)(i) of FRS 102 address similar disclosure requirements for biological assets. See Chapter 36 at 2.9.1. [FRS 102.1AC.22].

How we see it

The requirements in paragraph 51(2)(b) of Schedule 1 to the Small Companies Regulations, and paragraph 50(2)(b) of Schedule 1 to the Small LLP Regulations and Section 1A (and (b)(ii) in paragraph 1AC.22 above) refer to 'changes in value ... in respect of those assets'.

This appears to be a drafting error, when compared to both Directive 2013/34/EU (the Accounting Directive) and the previous statutory disclosure requirement for financial instruments. In our view, the disclosure is intended to be 'in respect of those financial instruments or other assets'.

Where financial instruments or other assets have been measured in accordance with the fair value accounting rules there must be stated for each class of derivatives, the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows. [1 Sch 51(2)(c)(SC), 1 Sch 50(2)(c)(LLP SC), FRS 102.1AC.23].

Where any amount is transferred to or from the fair value reserve during the reporting period, there must be stated in tabular form:

- (a) The amount of the reserve as at the beginning of the reporting period and as at the reporting date respectively.
- And
- (b) The amount transferred to or from the reserve during that year. [1 Sch 51(3)(SC), 1 Sch 50(3)(LLP SC)].

Paragraphs 6.3A (see Chapter 6 at 6.1), 12.29(c) and 12.29(d) (see Chapter 15 at 4.1) address similar requirements. [FRS 102.1AC.24, FRS 102.6.3A, FRS 102.12.29]. See Chapter 6 at 4.3.12.H for use of the fair value reserve, where certain financial instruments are held at fair value.

5.1.12.A Financial instruments measured at fair value

Financial instruments which under UK-adopted international accounting standards may be included in accounts at fair value, may be so included, provided that the disclosures required by such accounting standards are made. [1 Sch 36(4)(SC), 1 Sch 36(4)(LLP SC)].

Section 1A of FRS 102 explains that this only applies in certain circumstances, for example, it does not apply to derivatives. It applies where investments in subsidiaries, associates and joint ventures are measured at fair value through profit or loss. When it applies, the disclosures required by Section 11 that relate to financial assets and financial liabilities measured at fair value, including paragraph 11.48A of FRS 102, must be given. [FRS 102.1AC.26, FRS 102.11.48A].

The explanatory guidance above is consistent that this disclosure applies only to financial instruments that are held at fair value subject to the requirements of paragraph 36(4) to Schedule 1 to the Small Companies Regulations (or paragraph 36(4) to Schedule 1 to the Small LLP Regulations). Therefore, the disclosures would not apply to all financial instruments held at fair value but would apply to those financial instruments held at fair value that are listed in paragraphs 36(2) and (3) of those Schedules but are permitted to be held at fair value in accordance with UK-adopted international accounting standards.

How we see it

In our view, the above disclosure applies to all small entities applying Section 1A with such financial instruments, whether or not subject to the statutory disclosure requirements of paragraph 36(4) (except to the extent that these requirements are not permitted by any statutory framework under which such entities report).

5.1.13 Indebtedness, guarantees and financial commitments

For the aggregate of all items shown under 'Creditors' in the small entity's statement of financial position there must be stated the aggregate of the following amounts:

- (a) The amount of any debts included under 'Creditors' which are payable or repayable otherwise than by instalments and fall due for payment or repayment after the end of the period of five years beginning with the day next following the reporting date.

And

- (b) In the case of any debts so included which are payable or repayable by instalments, the amount of any instalments which fall due for payment after the end of that period. [FRS 102.1AC.27, 1 Sch 55(1)(SC), 1 Sch 54(1)(LLP SC)].

In respect of each item shown under 'Creditors' in the small entity's statement of financial position there must be stated the aggregate amount of any debts included under that item in respect of which any security has been given by the small entity with an indication of the nature and form of any such security. [1 Sch 55(2)(SC), 1 Sch 54(2)(LLP SC)].

Paragraphs 11.46, 13.22(e), 16.10(c), 17.32(a) and 18.28(c) address similar requirements.

[FRS 102.1AC.28, FRS 102.11.46, FRS 102.13.22, FRS 102.16.10, FRS 102.17.32, FRS 102.18.28]. See Chapter 15 at 4.1, Chapter 16 at 3.5.2, Chapter 19 at 4.3 and Chapter 20 at 3.9.1.

The above disclosures are still required even if adapted formats with a non-current and current analysis of assets and liabilities are applied (see 4.4 above).

The total amount of any financial commitments, guarantees and contingencies that are not included in the balance sheet must be stated. [1 Sch 57(1)(SC), 1 Sch 55(1)(LLP SC)].

The total amount of any commitments concerning pensions must be separately disclosed. [1 Sch 57(3)(SC), 1 Sch 55(3)(LLP SC)].

The total amount of any commitments which are undertaken on behalf of or for the benefit of:

- (a) Any parent, fellow subsidiary or any subsidiary of the small entity (see definitions in Chapter 3 at 3.1.2)
- Or
- (b) Any undertaking in which the small entity has a participating interest (see definitions in Chapter 6 at 4.3.4.D)

must be separately stated and those within (a) must also be stated separately from those within (b).

[1 Sch 57(4)(SC), 1 Sch 55(4)(LLP SC)].

Section 1A of FRS 102 explains that such commitments can arise in a variety of situations including in relation to group entities, investments, property, plant and equipment, leases and pension obligations. [FRS 102.1AC.29].

An indication of the nature and form of any valuable security given by the small entity in respect of commitments, guarantees and contingencies within paragraph 1AC.29 of FRS 102 (the above bullet) must be given. [1 Sch 57(2)(SC), 1 Sch 55(2)(LLP SC)].

Paragraphs 11.46, 13.22(e), 16.10(c), 17.32(a) and 18.28(c) address similar requirements.

[FRS 102.1AC.30, FRS 102.11.46, FRS 102.13.22, FRS 102.16.10, FRS 102.17.32, FRS 102.18.28]. See Chapter 15 at 4.1.2.D, Chapter 16 at 3.5.2, Chapter 19 at 4.3 and Chapter 20 at 3.9.1.

If in any reporting period a small entity is or has been party to arrangements that are not reflected in its statement of financial position and at the reporting date the risks or benefits arising from those arrangements are material, the nature and business purpose of the arrangements must be given in the notes to the financial statements to the extent necessary for enabling the financial position of the small entity to be assessed. [s410A, s410A (LLP)].

Examples of off-balance sheet arrangements given in Section 1A of FRS 102 include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase arrangements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate entities, pledged assets, leases for which the lessee has taken a recognition exemption, outsourcing and the like. In many cases, the disclosures about financial commitments and contingencies required by paragraphs 1AC.29 and 1AC.30 of FRS 102 (the two preceding bulleted disclosures) will also address such arrangements. [FRS 102.1AC.31].

See Chapter 6 at 7.8 for discussion of off-balance sheet arrangements.

5.1.14 Leases

A small entity that is a lessee must provide a general description of its significant leasing arrangements. A similar disclosure requirement is set out in paragraph 20.76 of FRS 102. [FRS 102.1AC.31A, FRS 102.20.76]. See Chapter 23 at 6.8.

If necessary to enable users to understand its significant leasing arrangements, a lessee shall provide additional qualitative and quantitative information. A similar disclosure requirement is set out in paragraph 20.77 of FRS 102. [FRS 102.1AC.31C, FRS 102.20.77]. See Chapter 23 at 6.8.

5.1.15 Provisions and contingencies

A small entity shall provide the disclosures relating to provisions and contingencies set out in paragraphs 21.14 to 21.17A of FRS 102. [FRS 102.1AC.31C, FRS 102.21.14, FRS 102.21.15, FRS 102.21.16, FRS 102.21.17, FRS 102.21.17A]. See Chapter 24 at 4.

5.1.16 Share-based payments

A small entity must provide the disclosures relating to share-based payment transactions set out in paragraphs 26.18(a), 26.18(b)(i), 26.18(b)(vi), 26.18(b)(vii) and 26.23 of FRS 102. [FRS 102.1AC.31D, FRS 102.26.18, FRS 102.26.23]. See Chapter 28 at 14.1 and 14.3.

5.1.17 Notes supporting the income statement

5.1.17.A Exceptional items

The amount and nature of any individual items of income or expenses of exceptional size or incidence must be stated. [1 Sch 61(2)(SC), 1 Sch 59(2)(LLP SC)].

Paragraph 5.9A of FRS 102 addresses a similar requirement in relation to material items. [FRS 102.1AC.32, FRS 102.5.9A]. See Chapter 6 at 5.7.5.

5.1.17.B Leases

A small entity must provide the disclosures relating to short-term leases, leases of low value assets and variable lease payments set out in paragraphs 20.80(b) to 20.80(d) of FRS 102. [FRS 102.1AC.32A, FRS 102.20.80]. See Chapter 23 at 6.8.

5.1.17.C Revenue from contracts with customers

A small entity must provide the disclosures relating to its performance obligations in contracts with customers set out in paragraphs 23.135(a) to 23.135(c) of FRS 102. [FRS 102.1AC.32B, FRS 102.23.135]. See Chapter 25 at 11.4.1.D.

5.1.17.D Tax

A small entity must provide the disclosures relating to current tax and deferred tax set out in paragraphs 29.26 and 29.27(b) of FRS 102. [FRS 102.1AC.32C, FRS 102.29.26, FRS 102.29.27]. See Chapter 31 at 3.7.3.D.

5.1.18 Information about employee numbers

The notes to a small entity's financial statements must disclose the average number of persons employed by the small entity in the reporting period. [s411(1), s411(1)(LLP), FRS 102.1AC.33].

The average number is ascertained by determining the number of persons employed under contracts of service by the company for each month in the financial year (whether throughout the month or not – so including both part- and full-time employees), adding together all the monthly numbers and dividing by the numbers of months in the financial year. [s411(3), s411(4), s411(3)(LLP), s411(4)(LLP)]. See Chapter 6 at 7.7.

5.1.19 Related party disclosures

5.1.19.A Parent of small entity preparing consolidated financial statements

Where the small entity is a subsidiary, the following information must be given in respect of the parent of the smallest group for which consolidated financial statements are drawn up of which the small entity is a member:

- (a) The name of the parent which draws up the consolidated financial statements.
- (b) The address of the parent's registered office (whether in or outside the UK).

Or

- (c) If it is unincorporated, the address of its principal place of business. [1 Sch 65 (SC), 1 Sch 63 (LLP SC)].

Paragraph 33.5 of FRS 102 addresses a similar requirement to paragraph (a). [FRS 102.1AC.34, FRS 102.33.5]. See Chapter 35 at 4.1.

How we see it

In the Small LLP Regulations, as detailed above, (c) reads if it is incorporated, the address of its principal place of business. This differs to the Small Companies Regulations and appears to be a drafting error. We believe that the disclosure at (c) above is also intended for LLPs.

5.1.19.B Related party transactions

A small entity must provide the disclosures required by paragraphs 33.9 and 33.14 of FRS 102 subject to the provisions of paragraphs 33.1A and 33.11 of FRS 102 (see Chapter 35 at 4.3.3.). [FRS 102.1AC.35, FRS 102.33.1A, FRS 102.33.9, FRS 102.33.11, FRS 102.33.14]. 'Related parties' are defined as in paragraph 33.2 (see Chapter 35 at 3.1). [FRS 102.33.2].

Therefore, a small entity that has related party transactions must disclose the nature of the related party relationship as well as information about the transactions, outstanding balances and commitments necessary for an understanding of the potential effect of the relationship on the financial statements.

At a minimum, disclosures must include:

- (a) The amount of the transactions.
- (b) The amount of outstanding balances and commitments, and:
 - (i) Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement.

And

 - (ii) Details of any guarantees given or received.
- (c) Provisions for uncollectible receivables related to the amount of outstanding balances.

And

- (d) The expense recognised during the period in respect of bad or doubtful debts due from related parties.

Such transactions could include purchases, sales, or transfers of goods or services, leases, guarantees and settlements by the entity on behalf of the related party or *vice versa*. [FRS 102.1AC.35, FRS 102.33.9].

An entity may disclose items of a similar nature in the aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity. [FRS 102.1AC.35, FRS 102.33.14].

FRS 102 provides two exemptions from the above disclosure of related party transactions in paragraphs 33.1A and 33.11 of the standard.

- Disclosures need not be given of transactions entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member. [FRS 102.1AC.35, FRS 102.33.1A]. See Chapter 35 at 1.1.2 for discussion on the application of this exemption. The formats themselves require certain information containing transactions and balances with group undertakings and participating interests.

And

- An entity is exempt from the above disclosure requirements in relation to related party transactions, outstanding balances and commitments with:

(a) A government that has control, joint control or significant influence over the reporting entity.

And

(b) Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity. [FRS 102.1AC.35, FRS 102.33.11].

See Chapter 35 at 4.3.3 for discussion on the meaning of this exemption.

The FRC has confirmed that small entities disclosing all transactions with related parties in accordance with paragraph 1AC.35 will be compliant with the equivalent requirements of the Small Companies Regulations. [FRS 102.A3.11F, FRS 102.BC.B1A.10]. Hence, the Small Companies Regulations disclosures are not listed in this publication. Nevertheless, questions have arisen as to whether paragraph 1AC.35 and/or the statutory disclosures require information on directors' remuneration or key management personnel compensation. This issue is addressed at 5.1.19.C below.

5.1.19.C Directors' remuneration and key management personnel disclosures

Section 1A requires small entities to give the related party transaction disclosures referred to at 5.1.19.B above. Section 1A does not scope in paragraph 33.7 which requires total key management personnel compensation to be given. However, because the text of paragraph 33.9 of FRS 102 also states that "Those disclosure requirements are in addition to the requirements in paragraph 33.7 to disclose key management personnel compensation", there was uncertainty as to whether a small entity applying Section 1A of FRS 102 needed to disclose total key management personnel compensation.

The position in relation to disclosure of key management compensation and directors' remuneration has been clarified by the FRC in a note on the FRC website²⁶ as follows:

- Paragraphs FRS 102.33.7 and FRS 102.33.9 are intended to be complementary, not duplicative. Accordingly, there is no explicit requirement in FRS 102 for a UK small entity to disclose directors' remuneration.
- However, the small entity may still need to disclose this information to comply with the following provisions:
 - Directors' remuneration not concluded under normal market conditions would require disclosure by law (paragraph 66 of Schedule 1 to the Small Companies Regulations) (see 5.1.19.C above). [1 Sch 66 (SC)].
 - Section 393 of the CA 2006 requires the financial statements of a company to give a true and fair view. [s393, s393 (LLP)]. In order to comply, a small entity may need to provide disclosures in addition to those explicitly required by FRS 102. This could in principle apply to directors' remuneration; judgement may be required.
 - Transactions with directors that fall outside the definition of key management personnel compensation, and therefore outside the scope of paragraph FRS 102.33.7, require disclosure under paragraph FRS 102.33.9 (see 5.1.19.B above). [FRS 102.1AC.35, FRS 102.33.7, FRS 102.33.9].

5.1.19.D Advances, credits and guarantees

Details of advances and credits granted by the small entity to its directors and guarantees of any kind entered into by the small entity on behalf of its directors must be shown in the notes to the financial statements.

The details required of an advance or credit are:

- (a) Its amount
- (b) An indication of the interest rate
- (c) its main conditions
- (d) Any amounts repaid
- (e) Any amounts written off

And

- (f) Any amounts waived.

There must also be stated in the notes to the financial statements the totals of amounts stated under (a), (d), (e) and (f).

The details required of a guarantee are:

- (a) Its main terms
- (b) The amount of the maximum liability that may be incurred by the small entity

And

- (c) Any amount paid and any liability incurred by the small entity for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee).

There must also be stated in the notes to the financial statements the totals of amounts stated under (b) and (c). [s413].

Paragraph 33.9 of FRS 102 addresses similar requirements for all related parties. [FRS 102.33.9, FRS 102.1AC.35]. See 5.1.19.B above and Chapter 35 at 4.3.2.

A small entity that is not a company shall provide this disclosure in relation to members of its governing body. [FRS 102.1AC.36].

See Chapter 6 at 7.9 for discussion of the scope and content of this disclosure (which also addresses the disclosures required where the entity prepares group accounts).

5.1.20 Other requirements

5.1.20.A General requirements

The financial statements must state:

- (a) The part of the UK in which the small entity is registered.
- (b) The small entity's registered number.
- (c) Whether the small entity is a public or a private company and whether the small entity is limited by shares or by guarantee.
- (d) The address of the small entity's registered office.

And

- (e) Where appropriate, the fact that the entity is being wound up. [s396, s396 (LLP)].

Paragraph 3.24(a) of FRS 102 (which applies to a small entity applying Section 1A of FRS 102) has similar disclosure requirements, i.e., the legal form of the entity, its country of incorporation, and the address of its registered office (or principal place of business, if different). [FRS 102.1AC.37, FRS 102.1A.7, FRS 102.3.24(a)].

Paragraph 1AC.37(c) above is not required for a small LLP.

This disclosure is discussed further in Chapter 6 at 7.5.

See also 3.3.8 above which addresses the general requirements of FRS 102 on identification of the financial statements.

Where items to which Arabic numbers are given in the formats have been combined, unless they are not material, the individual amounts of any items which have been combined must be disclosed in a note to the financial statements. [1 Sch 4(3)(SC), 1 Sch 4(3)(LLP SC), FRS 102.1AC.38].

See the discussion on the General Rules to the formats at 4.1 above.

The nature and financial effect of material events arising after the reporting date which are not reflected in the income statement or statement of financial position must be stated. [1 Sch 64 (SC), 1 Sch 62 (LLP SC)].

Paragraphs 32.10 and 32.11 of FRS 102 address similar requirements. See Chapter 34 at 3.3 and 3.1.3. [FRS 102.1AC.39, FRS 102.32.10, FRS 102.32.11].

5.1.20.B Requirements for dividends and on transition

A small entity must disclose dividends declared and paid or payable during the period. Paragraph 6.5(b) of FRS 102 addresses similar requirements. See Chapter 6 at 6.2. [FRS 102.1AC.40, FRS 102.6.5].

On first-time adoption of FRS 102, a small entity must provide an explanation of how the transition has affected its financial position and financial performance as set out in paragraph 35.13 of FRS 102.

[FRS 102.1AC.41, FRS 102.35.13].

This would include:

- A description of the nature of each change in accounting policy.
- Reconciliations of the entity's equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with FRS 102 for both of the following dates:
 - (i) The date of transition to FRS 102.
 - And
 - (ii) The end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.
 - And
- A reconciliation of the entity's profit or loss determined in accordance with its previous financial reporting framework for the latest period in its most recent annual financial statements to its profit or loss determined in accordance with FRS 102 for the same period.

See Chapter 37 at 6.3 for further discussion of the reconciliations presented by a first-time adopter of FRS 102.

5.2 Statutory disclosures not mentioned in Section 1A

Financial statements of a small entity will also need to comply with any statutory requirements arising from the CA 2006 and applicable regulations, or other legal framework that applies to the small entity.

Section 1A does not contain a complete list of all statutory requirements for a small company (or LLP) applying the small companies regime (or small LLPs regime). Some additional disclosures in individual accounts are noted below.

5.2.1 Auditor limitation of liability agreements

A small company which has entered into a liability limitation agreement (that purports to limit the liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust, occurring in the course of the audit of the accounts, of which the auditor may be guilty in relation to the company [s534]) must disclose its principal terms, the date of the resolution approving the agreement or the agreement's principal terms or, in the case of a private company, the date of the resolution waiving the need for such approval. This disclosure is required in a note to the annual accounts for the financial year to which the agreement relates, unless the agreement was entered into too late for it to be reasonably practicable for the disclosure to be made in those accounts (in which case, the disclosure is made in a note to the company's next accounts). [s538].²⁷ This disclosure does not apply to a small LLP.

A company subject to the small companies regime and an LLP subject to the small LLPs regime is not required to disclose remuneration received or receivable by the company's auditor. [s494, s494 (LLP)].²⁸

²⁷ The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) (as amended), regulation 8.

²⁸ The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489) (as amended), regulation 4.

5.2.2 Audit exemption statement

If a small company takes advantage of an exemption from audit of its annual accounts, its balance sheet will need to contain a statement by the directors to the effect that:

- (a) The company is exempt from audit under section 477 (small companies), section 479A (subsidiary companies), section 480 (dormant companies) or under section 482 (non-profit-making companies subject to public sector audit) of the CA 2006, stating the relevant exemption.
- (b) The members have not required the company to obtain an audit of its accounts for the year in question in accordance with section 476 of the CA 2006.

And

- (c) The directors acknowledge their responsibilities for complying with the requirements of the CA 2006 with respect to accounting records and the preparation of accounts.

The statement must appear above the signature of the director required by section 414 of the CA 2006 (see 5.2.5 below). [s475, s414]. From 1 April 2027 (an absolute date), condition (a) will require the balance sheet to include a statement by the company's directors identifying the exemption in question and confirming that the company qualifies for the exemption.²⁹

LLPs have a similar but not identical audit exemption statement.

If a small LLP takes advantage of an exemption from audit of its annual accounts, its balance sheet will need to contain a statement by the members of the LLP to the effect that:

- (a) The LLP is exempt from audit under section 477 (small LLPs), section 479A (subsidiary LLPs) or section 480 (dormant LLPs) of the CA 2006 (as applied to LLPs by The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008), stating the relevant exemption.

And

- (b) The members acknowledge their responsibilities for complying with the requirements of the CA 2006 (as applied to LLPs by The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008) with respect to accounting records and the preparation of accounts.

The statement must appear above the signature of the designated member of the LLP required by section 414 of the CA 2006, as applied to LLPs (see 5.2.5 below). [s475 (LLP), s414 (LLP)].

Companies House guidance available on the Companies House website includes suitable wording of the audit exemption statements.³⁰

5.2.3 Group accounts not prepared by a parent company

A company subject to the small companies regime (or an LLP subject to the small LLPs regime) is usually exempt from preparing group accounts (unless the additional restrictions discussed in section 399(2A)-(2B) of the CA 2006 apply – see 3.2 above). There is no requirement to disclose use of the exemption available in section 399(2A)-(2B) from preparing group accounts. [s399(2A), s399(2B), s399(2A)(LLP), s399(2B)(LLP)].

However, if the exemption from preparing group accounts in sections 400 or 401 of the CA 2006 is taken, the parent company (or parent LLP) must disclose in the notes to its individual accounts that it is exempt from the obligation to prepare and deliver group accounts. [s400(2)(c), s401(2)(d), s400(2)(c)(LLP), s401(2)(d)(LLP)].

5.2.4 Fixed asset investments valued at deemed cost

Where fixed asset investments (falling under item B.III in the statutory balance sheet format for companies and item A.III for LLPs – see 4.1 above) are included at a value determined on any basis which appears to the directors (for an LLP, the members) to be appropriate in the circumstances of the company/LLP, particulars of the method of valuation adopted and of the reasons for adopting it must be disclosed in a note to the accounts. This disclosure only applies where the valuation is in accordance with the alternative accounting rules but is not required where investments are included at a market value determined as at the date of their last valuation. [1 Sch 32(3)(SC), 1 Sch 32(3)(LLP SC)].

²⁹ [Changes to accounts - Changes to UK company law](#) on Companies House website (accessed 28 August 2025).

³⁰ [Companies House accounts guidance - GOV.UK](#), section 11.1 and [Filing LLP accounts at Companies House - GOV.UK](#), section 10.1 (accessed on 28 August 2025).

This disclosure is required where, for example, investments in subsidiaries, associates or jointly controlled entities are carried using a deemed cost in individual or separate financial statements on transition to FRS 102. [FRS 102.35.10(f)]. See Chapter 37 at 3.4.2. The disclosure does not apply when fixed asset investments are measured at fair value.

6 Small companies and LLPs – UK statutory exemptions

There are two sets of exemptions available for small companies (and small LLPs):

- The small companies regime (and small LLPs regime)
This applies to the preparation of the financial statements (see 6.1 to 6.1.2 below) and the content of the directors' report (see 6.1.3 below).
And
- The small companies exemption
This provides an exemption from preparation of a strategic report and an exemption from certain disclosures in and filing of the directors' report (see 6.2.1 and 7.3 below). [*s414A(2), s414B, s415A, s444A*].

Companies House have confirmed that the option for a small company not to file a directors' report and/or profit and loss account will no longer be available from 1 April 2027 (an absolute date).³¹ It is not clear at the time of writing whether filing requirements will change for small LLPs.

There is no equivalent of the small companies exemption for small LLPs. This is because an LLP is not required to prepare a strategic report (unless it is a traded LLP or banking LLP, categories which are excluded from the small LLPs regime – see 2.3.2 above, [*s414A(1)(LLP), s384(1)(LLP)*]) or a directors' report. In addition, a small LLP would not meet the size criteria to prepare an energy and carbon report. [*s415A (LLP), s416A (LLP)*]. The SORP includes specific disclosures scoped in for small LLPs that might be included in a 'members' report' but are permitted anywhere in the annual report. If a members' report was prepared, this would not be a statutory report.

The small companies regime, small LLPs regime and small companies exemption are available in both:

- Companies Act accounts (non-IAS accounts for an LLP) – i.e., those prepared in accordance with FRS 101 and FRS 102.
And
- IAS accounts, i.e., those prepared in accordance with UK-adopted international accounting standards.

The discussion below sets out the requirements in the CA 2006 and Small Companies Regulations and the equivalents for the small LLPs regime. Unlike the rest of the chapter, both Companies Act accounts and IAS accounts are discussed. It does not cover companies or LLPs applying the micro-entity provisions (which are discussed in Chapter 1 at 5.4).

A company subject to the small companies regime (or an LLP subject to the small LLPs regime) must meet certain small size criteria and not be excluded from the small companies regime (or small LLPs regime), i.e., it must not be one of the types of ineligible company (or LLP) nor a member of an ineligible group. See 2.2 and 2.3 above.

A company entitled to the small companies exemption (see 6.2 below) must meet the same small size criteria as for the small companies regime and must not be an ineligible company (although it may be a member of an ineligible group). The criteria to be subject to the small companies regime are, therefore, more onerous than for the small companies exemption; companies subject to the small companies regime will also qualify for the small companies exemption.

These exemptions operate independently from each other – a company entitled to both the small companies regime and the small companies exemption may choose to apply both, neither, the small companies regime only or the small companies exemption only.

The exemptions in the CA 2006 (and the CA 2006 as applied to LLPs) from preparing group accounts available for small companies and LLPs (which have certain additional restrictions) are discussed at 3.2 and 5.2.3 above.

Certain statements are required where the financial statements are prepared in accordance with the small companies regime (or the small LLPs regime) or small company exemptions are taken in preparing the directors' report or for an audit exemption. See 6.1.3 and 6.2.3 below and 5.2.2 above.

31 *Economic Crime and Corporate Transparency Act 2023*, section 54, 58(3). [Economic Crime and Corporate Transparency Act 2023](#) (which amends section 444 of CA 2006) and [Changes to accounts - Changes to UK company law](#) on Companies House website (accessed 28 August 2025).

6.1 Use of the small companies regime and the small LLPs regime

Companies subject to the small companies regime (see 2.2 above), whether preparing Companies Act accounts or IAS accounts, must provide the disclosures required by the CA 2006, the Small Companies Regulations and other applicable regulations, but are exempt from certain disclosures in Part 15 of the CA 2006 that are required by companies not subject to the small companies regime.

Similarly, LLPs subject to the small LLPs regime (see 2.3 above), whether preparing non-IAS accounts or IAS accounts, must provide the disclosures required by the CA 2006 (as applied to LLPs), the Small LLP Regulations and other applicable regulations, but are exempt from certain disclosures in Part 15 of the CA 2006 (as applied to LLPs) that are required by LLPs not subject to the small LLPs regime.

Different schedules of the Small Companies Regulations and Small LLP Regulations apply to Companies Act accounts (non-IAS accounts for an LLP) and IAS accounts. See 6.1.1 below.

The disclosures of the relevant accounting standard followed must also be given.

The statutory disclosures required in the individual financial statements of a company applying Section 1A are set out at 5.1 and 5.2 above. These incorporate the disclosures of Part 15 of the CA 2006 and Schedule 1 to the Small Companies Regulations (the Small LLP Regulations have similar disclosures). The disclosures for LLPs are generally the same as those for companies, although there are a few differences noted in 5.1 above and LLPs preparing FRS 102 financial statements are also subject to the LLP SORP (see 5 above).

Disclosures in the CA 2006 generally apply both to IAS accounts and Companies Act accounts.

In addition, a company preparing IAS individual and/or group accounts must state that the individual accounts (and any group accounts) are prepared in accordance with UK-adopted international accounting standards. [s397(2), s406(2), s474, s397(2)(LLP), s406(2)(LLP), s474 (LLP)].

How we see it

Our view is that companies subject to the small companies regime (and LLPs subject to the small LLPs regime) can still apply FRS 101 or full FRS 102. However, this does not preclude the small company or small LLP taking advantage of other exemptions applicable to companies subject to the small companies regime (or LLPs subject to the small LLPs regime), although any disclosures required by FRS 101 or full FRS 102, as applicable, will need to be given.

6.1.1 Small Companies Regulations and Small LLP Regulations

The Small Companies Regulations (and Small LLP Regulations) contain significantly fewer disclosures than the Regulations (and LLP Regulations).

Figure 6-1 below sets out the schedules that apply to small companies and small LLPs (certain schedules were removed in 2015 and 2016 which is why the lists are not consecutive).

Figure 6-1 Schedules that apply in the Small Companies Regulations and Small LLP Regulations (as amended)

Small Companies Regulations	Small LLP Regulations
Schedule 1 (Companies Act individual accounts)	Schedule 1 (Non-IAS individual accounts)
Schedule 5 (Matters to be dealt with in directors' report)*	
Schedule 6 (Group accounts)	Schedule 4 (Group Accounts)
- Part 1	- Part 1
- Part 2*	- Part 2*
Schedule 7 (Interpretation of term 'provision')	
Schedule 8 (General interpretation)*	Schedule 5 (General interpretation)*
	Note this includes the definition of a provision.
* Applies to both Companies Act accounts and IAS accounts	* Applies to both non-IAS accounts and IAS accounts

A company subject to the small companies regime preparing Companies Act accounts must comply with all applicable requirements of the Small Companies Regulations. Similarly, an LLP subject to the small LLPs regime preparing non-IAS accounts must comply with all applicable requirements of the Small LLP Regulations.

A company subject to the small companies regime preparing IAS accounts does not apply Schedule 1 nor, where group accounts are prepared, Part 1 of Schedule 6 to the Small Companies Regulations. These schedules set out the formats for the profit and loss account and balance sheet, recognition and measurement principles, and disclosure requirements in Companies Act accounts. Similarly, an LLP subject to the small LLPs regime preparing IAS accounts does not apply Schedule 1 nor Part 1 of Schedule 4 to the Small LLP Regulations.

However, both Companies Act group accounts (non-IAS group accounts for an LLP) and IAS group accounts must give the information on related undertakings set out in Part 2 of Schedule 6 to the Small Companies Regulations (Part 2 of Schedule 4 to the Small LLP Regulations) in the notes to the financial statements. There is an exemption from providing information on certain undertakings where the restrictive conditions of section 409(4) of the CA 2006 apply and use of the exemption is stated. [*Regulations (SC) 10, LLP SC Regulations 7*]. See 3.2.2 above.

Companies subject to the small companies regime (and LLPs subject to the small LLPs regime) that choose to apply Section 1A follow the statutory or adapted formats in Schedule 1 to the Small Companies Regulations (or Schedule 1 to the Small LLP Regulations) (see 4 above).

Where a small entity chooses to apply FRS 101 or full FRS 102 (where Section 1A is not applied), these accounting standards require use of the statutory or adapted formats included in the Regulations (or LLP Regulations). [*FRS 101.AG1, FRS 102.4.2, FRS 102.4.2A, FRS 102.5.5, FRS 102.5.5B, FRS 102.5.7, FRS 102.5.7A*].

A small entity preparing IAS accounts prepares a complete set of financial statements as described in UK-adopted international accounting standards.

6.1.2 Disclosure exemptions for small companies regime and small LLPs regime in IAS accounts and Companies Act accounts

The disclosures included in Part 15 of the CA 2006 apply both to Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts. UK companies subject to the small companies regime (and LLPs subject to the small LLPs regime) benefit from the following disclosure exemptions from the requirements of Part 15 of the CA 2006 (or the CA 2006 as applied to LLPs):

- The financial impact of off-balance sheet arrangements on the company/LLP (and where group accounts are prepared, on the consolidated group) is not required. However, the nature and business purpose of the arrangements, to the extent necessary for enabling the financial position of the company/LLP (and where group accounts are prepared, of the consolidated group) to be assessed, must be disclosed. [*s410A, s410A (LLP)*]. See 5.1.13 above and Chapter 6 at 7.8).
- Information analysing employee numbers by category and staff costs is not required, although the total (monthly) average number of persons employed by the company/LLP (and where group accounts are prepared, the consolidated group) must be disclosed (see 5.1.18 above and Chapter 6 at 7.7). [*s411, s411 (LLP)*]
And
- No disclosure is required of remuneration received or receivable by the company's (or LLP's) auditor. [*s494, s494 (LLP)*]. See 5.2.1 above.

In addition, the disclosures in Schedule 1 to the Small Companies Regulations and Schedule 1 to the Small LLP Regulations are significantly fewer than those required for large and medium-sized companies applying the Regulations. These disclosures are largely set out in Appendix C of Section 1A (see 5.1 above) and only apply to Companies Act accounts (for a company) and non-IAS accounts (for an LLP).

A company (or LLP) gives disclosures for related undertakings (set out in Part 2 of Schedule 6 to the Small Companies Regulations and Part 2 of Schedule 4 to the Small LLP Regulations) only in group accounts, where prepared (see 3.2.2 above). This disclosure exemption applies to both Companies Act accounts (non-IAS accounts for an LLP) and IAS accounts.

6.1.3 Statements required in the financial statements where the small companies regime or small LLPs regime are used

If a company's financial statements are prepared in accordance with the small companies regime, the company's balance sheet must contain, in a prominent position above the signature of the director (and printed name of the director signing), a statement to the effect that the financial statements have been prepared in accordance with the provisions applicable to companies subject to the small companies regime. A similar statement on the balance sheet is required above the signature (and printed name) of the designated member of the LLP, where the LLP's financial statements are prepared in accordance with the small LLPs regime. This statement does not apply where the company or LLP applies the micro-entity provisions (see Chapter 1 at 5.4). [s414(3)(b), s414(3)(b)(LLP)].

This requirement has been included in Section 1A (and adapted for other small entities). See 3.3.2 above (which includes examples of the above statement) and 5.1.2 above (which covers the related statement of compliance with FRS 102, made in the notes to the financial statements).

6.2 Criteria for use of the small companies exemption

A company is entitled to the small companies exemption in relation to the directors' report (see 6.2.1 below) and the strategic report (see 6.2.2 below) for a financial year if it is entitled to prepare financial statements for the year in accordance with the small companies regime (see 2.2 above) or would be so entitled but for being or having been a member of an ineligible group. [s414B, s415A].

The company must, therefore, meet the same small size criteria as for the small companies regime (and if the company is a parent company, it must head a small group). The company must also not have been an ineligible company itself at any time during the financial year to which the accounts relate (but may still use the small companies exemption if it was a member of an ineligible group at any time during that financial year). See 2.2.3 above for the list of ineligible companies. The small companies exemption, consequently, extends to more companies than those entitled to use the small companies regime.

The small companies exemption is available both to companies preparing Companies Act accounts and companies preparing IAS accounts (i.e., prepared using UK-adopted international accounting standards).

There is no equivalent of the small companies exemption for small LLPs. This is because an LLP is not required to prepare a strategic report (unless it is a traded LLP or banking LLP, categories which are excluded from the small LLPs regime – see 2.3.2 above, [s414A(1)(LLP), s384(1)(LLP)]) or a directors' report.

6.2.1 Disclosure exemptions for the small companies exemption – directors' report

Companies entitled to the small companies exemption are exempt from including the amount recommended by the directors to be paid by way of dividend (required by section 416(3) of the CA 2006). [s415A(2), s416(3)].

If a company is entitled to the small companies exemption, the directors' report must still include:

- The names of persons who were, at any time during the financial year, directors of the company. [s416(1)(a)]
- Specified disclosures of qualifying third party indemnity provisions and qualifying pension scheme indemnity provisions. [s236]

And

- The statement as to disclosure of relevant information to auditors (unless the company has taken advantage of an audit exemption). [s418].

A company subject to the small companies regime may comply with Schedule 5 to the Small Companies Regulations which has fewer disclosures for the directors' report.

Schedule 5 requires disclosure of:

- Certain particulars of UK political donations and UK political expenditure (where the aggregate donations and expenditure made or incurred by the company and its subsidiaries exceed £2,000) and the amount of contributions to a non-UK political party. Wholly-owned subsidiaries of a UK parent company are not required to make this disclosure.
- And
- The company's policy relating to the employment of disabled persons (where the average weekly number of employees exceeds 250). (This disclosure is removed from both the Small Companies Regulations and Regulations for financial years beginning on or after 6 April 2025).³² [5 Sch 2, 5 Sch 3, 5 Sch 5].

³² [The Companies \(Accounts and Reports\) \(Amendment and Transitional Provision\) Regulations 2024](#), paras. 4 and 5.

Where any of the above exemptions are taken, the required statement in the directors' report that the company has taken advantage of the small companies exemption in preparing the directors' report must be made. See Illustration 6-1 at 6.2.3 below.

Where the company is entitled to the small companies exemption, but not subject to the small companies regime, the company must comply with the requirements for the directors' report in Schedule 7 to the Regulations. [Regulations 10].

6.2.2 Small companies exemption from preparing strategic report

A company entitled to the small companies exemption is not required to prepare a strategic report. [s414A(2)]. A company subject to the small companies regime is explicitly not required to prepare a non-financial and sustainability report containing climate-related financial disclosures even if it chose to prepare a strategic report. [s414CA(3)(a)].

While there is no statutory requirement to do so, where a company entitled to the small companies exemption takes advantage of the exemption not to prepare a strategic report, a statement is commonly included in the directors' report, above the signature of the director or secretary (and printed name of the signatory) to explain that it has done so.

6.2.3 Statements required in the directors' report where the small companies exemption is used

The directors' report must be approved by the board of directors and signed on behalf of the board by a director or secretary, [s419(1)], and the name of the signatory printed. [s444(6), s444A(3)]. Where a company has taken advantage of the small companies exemption in preparing the directors' report, a statement to this effect is required in the directors' report, in a prominent place above the signature of the director (or secretary) signing on behalf of the board. [s419(2)]. The statement made in the directors' report refers to the small companies exemption even if the company is also subject to the small companies regime. See Illustration 6-1 for an example of such a statement.

Illustration 6-1: Example small companies exemption statement in directors' report

The directors' report has been prepared in accordance with the provisions applicable to companies entitled to the small companies exemption.

7 Future developments

In February 2026 the FRC published *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* to reflect the replacement of IAS 1 with IFRS 18. These amendments are applicable for accounting periods beginning on or after 1 January 2027 (to align with the effective date of IFRS 18) with early application permitted.

The amendments:

- Change the requirements for classifying assets and liabilities as current or non-current when choosing to adapt one of the balance sheet formats. [FRS 102.1.72].
- And
- Change the presentation requirements when choosing to adapt one of the statement of financial position formats and/or one of the profit and loss formats. [FRS 102.1.73].

Early application is permitted separately for the amendments related to the classification of assets and liabilities as current or non-current provided that fact is disclosed. [FRS 102.1.72].

Early application is permitted for the changes to the presentation requirements of the statement of financial position and/or profit and loss formats provided the changes to the classification of assets and liabilities as current or non-current are also early applied. Early application must be disclosed. [FRS 102.1.73].

7.1 Changes to the adapted statement of financial position formats

The following changes are made: [FRS 102.1AA.3, FRS 102.1AA.3A, FRS 102.1AA.4]

- 'Intangible assets' is renamed 'intangible assets other than goodwill'
- 'Goodwill' must be shown as a separate line on the face of the statement below 'intangible assets other than goodwill'

- The following must be presented as separate classifications in the statement of financial position:
 - Current assets
 - Non-current assets
 - Current liabilities
 - And
 - Non-current liabilities

When determining the classification of liabilities as current or non-current, an entity must apply paragraphs 4A.8 to 4A.19 of FRS 102. See Chapter 6 at 4.1.2.D. [FRS 102.1AA.3A]. As a result of these amendments paragraph 1AA.6 is deleted.

7.2 Changes to the adapted profit and loss account formats

The profit and loss account formats must include, as a minimum the following amounts for the period:
[FRS 102.1AB.3, FRS 102.1AB.5]

Figure 7-1 Profit and loss account – line items included in adapted formats from 1 January 2027

(a)	Revenue
(b)	Operating expenses
(c)	Operating profit or loss
(d)	Share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method ^{#1}
(e)	Profit or loss before financing and taxation ^{#2}
(f)	Finance costs
(g)	Profit or loss before taxation
(h)	Tax expense excluding tax allocated to other comprehensive income or equity
(f)	Profit or loss
#1	Only required in consolidated financial statements, as the equity method is not applied in individual financial statements under FRS 102. Consolidated financial statements are not addressed in detail in this chapter.
#2	If an entity presents within operating profit, finance income and/or finance expenses that do not relate to providing financing to customers, it must not present this line item.

Material accounting policy information may include an entity's choice to adapt one of the balance sheet formats. [FRS 102.1AA.7, FRS 102.1AB.6].

In determining operating profit, a small entity applies the guidance in Section 5 of FRS 102. See Chapter 6 at 5.7.3. [FRS 102.5.9B].

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

Act	The Companies Act 2006
adopted IFRS	IFRS accounting standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. In the Republic of Ireland, this refers to EU-adopted IFRS.
cash	Cash on hand and demand deposits.
cash equivalents	Short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.
consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
current assets	Assets of an entity which: (a) for an entity choosing to apply paragraph 1A(1) of Schedule 1 to the Regulations, are not non-current assets; or (b) for all other entities, are not fixed assets.
current liabilities (for the purposes of an entity applying paragraph 1A(1) of Schedule 1 to the Regulations)	Liabilities of the entity which: (a) it expects to settle in its normal operating cycle; (b) it holds primarily for the purpose of trading; (c) are due to be settled within 12 months after the reporting period; or (d) it does not have an unconditional right to defer settlement for at least 12 months after the reporting period.
fixed assets	Assets of an entity which are intended for use on a continuing basis in the entity's activities.
group	A parent and all its subsidiaries.
income statement	Financial statement that presents all items of income and expense recognised in a reporting period, excluding the items of other comprehensive income (referred to as the profit and loss account in the Act).
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term.
interim financial report	A financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.
LLP Regulations	The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913)

material	Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.
non-controlling interest	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
non-current assets	Assets of the entity which: (a) it does not expect to realise, or intend to sell or consume, in its normal operating cycle; (b) it does not hold primarily for the purpose of trading; (c) it does not expect to realise within 12 months after the reporting period; or (d) are cash or cash equivalents restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.
non-current liabilities	Liabilities of the entity which are not current liabilities.
notes (to financial statements)	Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, income statement (if presented), combined statement of income and retained earnings (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements.
other comprehensive income	Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by this FRS or by law.
parent	An entity that has one or more subsidiaries.
profit or loss	The total of income less expenses, excluding the components of other comprehensive income.
qualifying entity (for the purposes of this FRS)	A member of a group where the parent of that group prepares publicly available consolidated financial statements which are intended to give a true and fair view (of the assets, liabilities, financial position and profit or loss) and that member is included in the consolidation*.
Regulations	*As set out in section 474(1) of the Act. The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410)
related party	A related party is a person or entity that is related to the entity that is preparing its financial statements (the reporting entity). (a) A person or a close member of that person's family is related to a reporting entity if that person: (i) has control or joint control over the reporting entity; (ii) has significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions apply: (i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). (ii) one entity is an associate or joint venture of the other entity (or of a member of a group of which the other entity is a member).

Extract from FRS 102

	(iii) both entities are joint ventures of the same third entity. (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity. (v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. (vi) the entity is controlled or jointly controlled by a person identified in (a). (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). (viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.
related party transaction	A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.
reporting date	The end of the latest period covered by financial statements or by an interim financial report.
reporting period	The period covered by financial statements or by an interim financial report.
revenue	Income arising in the course of an entity's ordinary activities.
Small Companies Regulations	The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)
small entity	A small entity is: (a) a company meeting the definition of a small company as set out in section 382 or 383 of the Act and not excluded from the small companies regime by section 384; (b) an LLP qualifying as small and not excluded from the small LLPs regime, as set out in LLP Regulations; or (c) any other entity that would have met the criteria in (a) had it been a company incorporated under company law.
Small LLP Regulations	The Small Limited Liability Partnership (Accounts) Regulations 2008 (SI 2008/1912)
statement of cash flows	Financial statement that provides information about the changes in cash and cash equivalents of an entity for a period, showing separately changes during the period from operating, investing and financing activities.
statement of changes in equity	Financial statement that presents an entity's profit or loss for a reporting period, other comprehensive income for the period, the effects of changes in accounting policies and corrections of material errors recognised in the period, and the amounts of investments by, and dividends and other distributions to, equity investors during the period.
statement of comprehensive income	Financial statement that presents all items of income and expense recognised in a period, including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income. If an entity chooses to present both an income statement and a statement of comprehensive income, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income.

Extract from FRS 102

statement of financial position	Financial statement that presents the relationship of an entity's assets, liabilities and equity as of a specific date (referred to as the balance sheet in the Act).
statement of income and retained earnings	Financial statement that presents the profit or loss and changes in retained earnings for a reporting period.
Statement of Recommended Practice (SORP)	An extant Statement of Recommended Practice developed in accordance with Policy on Developing Statements of Recommended Practice (SORPs). SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.
subsidiary	An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).
turnover	The amounts derived from the provision of goods and services after deduction of: (a) trade discounts; (b) value added tax; and (c) any other taxes based on the amounts so derived.

Certain abbreviations used in this chapter are included at 1.4 above.

Relevant definitions for the small companies regime and small LLPs regime are included at 2.2.3.A above

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Chapter 6

Presentation of financial statements

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Overview

There is no single section in FRS 102 dealing with the purpose, form, content and structure of financial statements; these topics are addressed principally in the following sections:

- Section 3 Financial Statement Presentation
- Section 4 Statement of Financial Position
- Section 5 Statement of Comprehensive Income and Income Statement
- Section 6 Statement of Changes in Equity and Statement of Income and Retained Earnings
- Section 7 Statement of Cash Flows
- Section 8 Notes to the Financial Statements
- Section 10 Accounting Policies, Estimates and Errors

Chapter 6 addresses sections 3-6 and 8 of FRS 102. Note that Sections 7 and 10 are addressed in Chapters 7 and 9 respectively.

What you need to know

- Sections 3-6 and 8 together set out the requirement for financial statements to give a true and fair view, the requirements for compliance with FRS 102 and what constitutes a complete set of financial statements. Each element of a complete set of financial statements is then elaborated on in its individual section.
- Statutory accounts prepared in accordance with FRS 102 by UK companies are Companies Act accounts and must also comply with statutory requirements of the Companies Act 2006 and applicable regulations. These requirements are discussed where relevant in this chapter.
- Section 3 specifies that a complete set of financial statements includes:
 - A statement of financial position as at the reporting date (to be presented either according to the requirements of the Companies Act 2006 and applicable regulations or following an 'adapted' format, similar to IAS 1 *Presentation of Financial Statements* (for reporting periods beginning on or after 1 January 2027, similar to IFRS 18 *Presentation and Disclosure in Financial Statements* - see section 1.3) with specified line items).
 - Either:
 - A single statement of comprehensive income (to be presented either according to the requirements of the Companies Act 2006 and applicable regulations or following an 'adapted' format, similar to IAS 1 (or IFRS 18), with specified line items).
 - Or
 - A separate income statement and a separate statement of comprehensive income.
 - A statement of changes in equity for the reporting period.
 - A statement of cash flows for the reporting period (see Chapter 7 on the requirements of Section 7).
 - Notes, comprising material accounting policy information and other explanatory information.
- Section 8 expands on what this information must include: the basis of preparation; accounting policies (including judgements made and key sources of estimation uncertainty); disclosures required by FRS 102 not presented elsewhere in the financial statements; and information relevant to understanding the financial statements not presented elsewhere in the financial statements.

1 Introduction

The following sections of FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland* - address the presentation, i.e., the form, content and structure, of financial statements:

- Section 3 - *Financial Statement Presentation*
 - Section 4 - *Statement of Financial Position*
 - Section 5 - *Statement of Comprehensive Income and Income Statement*
 - Section 6 - *Statement of Changes in Equity and Statement of Income and Retained Earnings*
 - Section 7 - *Statement of Cash Flows*
- And
- Section 8 - *Notes to the Financial Statements*

The above sections cover the content of a complete set of FRS 102 financial statements of an entity applying the full version of FRS 102, as issued in September 2024, including the primary statements and notes required, the concept of a true and fair view, and general principles underlying preparation of financial statements.

This chapter deals only with Sections 3 to 6 (see 3 to 6 below) and Section 8 (see 7 and 8 below). Section 7 is addressed in Chapter 7. FRS 102's requirements on presentation overlap with Section 1 - *Scope* (which covers the reduced disclosure framework - see Chapter 3), Section 2 - *Concepts and Pervasive Principles* (see Chapter 4) and Section 10 (see Chapter 9). As a consequence of the Periodic Review 2024, minor amendments have been made to these sections, which are incorporated in the discussion in that chapter.

Small entities applying the small entities regime in FRS 102 apply the simpler presentation and disclosure requirements in Section 1A - *Small Entities*. These are based on the statutory requirements for companies subject to the small companies regime. Any requirements relating specifically to small entities contained in Sections 3-6 and Section 8 are addressed in Chapter 5.

Statutory accounts prepared in accordance with FRS 102 by UK companies are Companies Act accounts and must also comply with statutory requirements included in:

- The Companies Act 2006 ('CA 2006')
- And
- *The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410), as amended ('the Regulations') or *The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* (SI 2008/409), as amended ('the Small Companies Regulations')

Companies Act accounts are required to give a true and fair view, and to comply with the applicable regulations governing the form and content of the balance sheet and profit and loss account and additional notes. [s396, s404].

Similarly, LLPs preparing statutory accounts and reports in accordance with FRS 102 prepare non-IAS accounts and must comply with the requirements of:

- *The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2008/1911), as amended
- And
- *The Small Limited Partnerships (Accounts) Regulations 2008* ('Small LLP Regulations') (SI 2008/1912) and *The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008* ('the LLP Regulations') (SI 2008/1913), as amended

Non-IAS accounts for LLPs are required to give a true and fair view and comply with the applicable regulations governing the form and content of the balance sheet and profit and loss account and additional notes. [s396 (LLP), s404 (LLP)].

Chapter 1 at 5 provides information on CA 2006 requirements for statutory accounts and reports for UK companies. The requirements for the accounts of LLPs are similar to those for UK companies. LLPs are not required to prepare statutory reports such as a strategic or directors' report.

FRS 102 mandates that UK companies and LLPs must comply with the requirements for a balance sheet and profit and loss account in the applicable schedules to the Regulations or the LLP Regulations.

[FRS 102.4.2, FRS 102.5.5]. Sections 4 and 5 extend this requirement to other entities, except to the extent that this conflicts with the statutory frameworks that apply to their financial statements. [FRS 102.4.1, FRS 102.5.1].

The Regulations, LLP Regulations and FRS 102 share basic principles underlying the preparation of financial statements such as going concern, prudence, accruals, materiality, aggregation and consistency, although the Regulations and LLP Regulations further restrict when profits may be reported in the profit and loss account (see 8 below). The Regulations and LLP Regulations also set out certain requirements for recognition and measurement of assets and liabilities, namely the historical cost accounting rules, the alternative accounting rules and the fair value accounting rules.

1.1 Applicability to UK companies, LLPs, and other entities

Except where otherwise stated, the rest of this chapter covers the presentation requirements for UK companies and for LLPs.

While this chapter (see 4 below) addresses which profit and loss account and balance sheet formats are applied by a UK banking company (see 3.1.2 below), a UK insurance company (see 3.1.3 below) or, in group accounts, by the holding company of a banking or insurance group, it does not address the content of such formats in detail. The format and content of a profit and loss account and balance sheet of a UK insurance company is discussed in Chapter 38.

LLPs, qualifying partnerships (unless exempt under regulation 7 of *The Partnerships (Accounts) Regulations* 2008) and certain other entities preparing annual accounts in accordance with Part 15 of CA 2006 (see 3.1.4 and 3.1.5 below) are subject to similar requirements to those for UK companies preparing Companies Act accounts, modified as necessary by the specific regulations that govern the content of their annual accounts. The formats for qualifying partnerships are based on those required for UK companies with the modifications discussed at 3.1.4. The formats applicable to LLPs are addressed throughout this chapter, but the main focus of the chapter is on UK companies. The *Statement of Recommended Practice - Accounting by Limited Liability Partnerships* (November 2025) ('LLP SORP') issued by the Consultative Committee of Accounting Bodies (CCAB) provides additional guidance on the requirements of both FRS 102 and the LLP Regulations. The LLP SORP is referred to, where relevant, but its requirements are not covered in detail in this publication.

The presentation requirements in Sections 4 and 5 apply to all entities that apply FRS 102, whether or not they report under CA 2006. Entities that do not report under CA 2006 shall comply with these requirements and with the Regulations (or, where applicable, the LLP Regulations), where referred to, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. [FRS 102.4.1, FRS 102.5.1].

1.2 Other entities

Other entities that apply FRS 102 may include entities required by their governing legislation, or other regulation or requirement to prepare financial statements that present a true and fair view of the financial position and performance of the reporting entity. Entities that are not UK companies need to satisfy themselves that FRS 102 does not conflict with any relevant legal obligations. [FRS 102.A3.41].

The FRC sets out summary information concerning the statutory frameworks for certain entities whose financial statements are required to present a true and fair view, including: building societies, charities established in any part of the UK (accruals accounts), co-operative and community benefit societies, friendly societies and occupational pension schemes. The FRC also comment on how application of FRS 102 relates to the required statutory framework. [FRS 102.A3.42].

1.3 February 2026 (FRS 102 (2026)) amendments that form part of the Periodic Review 2024

IAS 1 will be replaced by IFRS 18 for periods beginning on or after 1 January 2027. Wherever the presentation requirements of IAS 1 are referenced in this chapter, the equivalent reference to the comparable requirement in IFRS 18 is also provided. Some of the requirements of IAS 1 have been moved to IAS 8, which is renamed IAS 8 *Basis of Preparation of Financial Statements*. If the presentation requirements of IAS 1 referenced in this chapter have been moved to IAS 8, the relevant reference in IAS 8 is given.

On 18 February 2026, FRC published *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime* (FRS 102 (2026) amendments), following the introduction of IFRS 18. These amendments introduce two main sets of requirements which enable FRS 102 preparers applying the adapted formats to align with the requirements of IFRS 18, clarify the definition of current liabilities and align requirements for the classification of loan arrangements with covenants to those in IAS 1 and IFRS 18.

The February 2026 amendments relating to the adapted formats are effective for periods on or after 1 January 2027, with early adoption permitted (see 9 below).

2 Composition of financial statements

Financial statements are a structured representation of the financial position, financial performance and cash flows of an entity. *[FRS 102 Appendix I]*.

Section 3 explains the requirement that financial statements give a 'true and fair view', what compliance with the standard requires and what a complete set of financial statements contains. *[FRS 102.3.1]*.

UK companies preparing Companies Act accounts must also comply with CA 2006 and the Regulations or the Small Companies Regulations (and other applicable regulations), which set out further recognition, measurement and disclosure requirements. Similarly, LLPs preparing non-IAS accounts must also comply with SI 2008/1911 (which applies the accounts and audit provisions of CA 2006 to LLPs), the LLP Regulations or the Small LLP Regulations (and other applicable regulations), which set out further recognition, measurement and disclosure requirements.

The statutory requirements in the Regulations and LLP Regulations are addressed, where appropriate, in the relevant sections below.

The general principles in the Regulations, LLP Regulations and FRS 102 (which are similar) are discussed at 8 below. There are three accounting models in the Regulations and LLP Regulations for the recognition and measurement of assets and liabilities:

- Historical cost accounting rules
 - Alternative accounting rules (which provide an alternative measurement basis to the historical cost rules, usually at a valuation)
- And
- Fair value accounting rules (which may be applied to living animals and plants, financial instruments, investment properties, and certain categories of stocks)

FRS 102's requirements are generally consistent with, but often more restrictive than, those in the Regulations and LLP Regulations. Certain areas where FRS 102's requirements are in conflict with the Regulations (and consequently, also with the LLP Regulations) are highlighted in Appendix III to FRS 102. The Small Companies Regulations and Small LLP Regulations, where applied, have the same general principles and accounting models, albeit with fewer related disclosures. See Chapter 5 at 6.1.1 and at 6.1.2.

This chapter refers to certain concepts in the Regulations and LLP Regulations. Unless otherwise indicated, these references are interpreted as follows:

- 'General Rules to the formats' are the General Rules included in Section A of Part 1 of Schedule 1 to the Regulations and Section A of Part 1 of Schedule 1 to the LLP Regulations
 - 'Statutory formats' are the formats in Section B of Part 1 of Schedule 1 to the Regulations and Section B of Part 1 of Schedule 1 to the LLP Regulations
- And
- 'Adapted formats' are the formats permitted by paragraph 1A of Schedule 1 to the Regulations and paragraph 1A of Schedule 1 to the LLP Regulations (as an alternative to the 'statutory formats')

2.1 Objectives of sections in FRS 102 addressing presentation of financial statements

Sections 3 to 8 include the following objectives:

- To set out the requirement that the financial statements of an entity shall give a true and fair view, what compliance with FRS 102 requires and what is a complete set of financial statements. *[FRS 102.3.1]*.
- To set out the information that shall be presented in a statement of financial position (referred to as the 'balance sheet' under CA 2006) and how to present it. *[FRS 102.4.1]*.
- To require an entity to present total comprehensive income for a period, being its financial performance for the period - in one or two- statements - and to set out the information that shall be presented in those statements and how to present it. *[FRS 102.5.1]*.
- To set out requirements for presenting the changes in an entity's equity for a period either in a statement of changes in equity, or if specified conditions are met and an entity chooses, in a statement of income and retained earnings. *[FRS 102.6.1]*.

- To set out the information required in a statement of cash flows and how to present it. See Chapter 7 for further details. [FRS 102.7.1].
- And
- To set out the principles underlying information to be presented in the notes to the financial statements and how to present it. In addition, nearly every section of FRS 102 requires disclosures that are normally presented in the notes. [FRS 102.8.1].

2.2 Frequency of reporting and period covered

An entity must present a complete set of financial statements (including comparative information) at least annually.

When the end of an entity's reporting period changes and annual financial statements are presented for a period longer or shorter than one year, the entity shall disclose that fact, the reason for using a longer or shorter period, and the fact that comparative amounts presented in the financial statements, including the related notes, are not entirely comparable. [FRS 102.3.10].

Normally, financial statements are consistently prepared covering a one year period, which, for a UK company or LLP, will generally end with the last day of the accounting reference period, based on the accounting reference date notified to the Registrar.

Some entities, particularly in the retail sector, present financial statements for a 52-week period. This practice is permitted by CA 2006 - companies and LLPs may prepare financial statements to a financial year end, not more than 7 days before or after the end of the accounting reference period, as the directors or members of the LLP may determine. [s390(2)(b), s391, s390(2)(b)(LLP), s391 (LLP)].

How we see it

While FRS 102 does not explicitly address the issue, we consider that financial statements prepared in accordance with FRS 102 can be made up to a financial year end not more than 7 days from the end of the accounting reference period.

2.3 Components of a complete set of financial statements

A complete set of financial statements under FRS 102 (for an entity not applying Section 1A) includes all of the following, each of which must be presented with equal prominence: [FRS 102.3.17, FRS 102.3.21]

- A statement of financial position as at the reporting date (see 3 and 4 below)
 - A statement of comprehensive income for the reporting period (see 3 and 5 below) to be presented either as:
 - A single statement of comprehensive income, displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income
 - Or
 - A separate income statement and a separate statement of comprehensive income. In this case, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income
 - A statement of changes in equity for the reporting period (see 6 below)
 - A statement of cash flows (unless exempt) for the reporting period (see Chapter 7)
- And
- Notes, comprising material accounting policy information and other explanatory information (see 7 below)

In addition to information about the reporting period, FRS 102 also requires comparative information in respect of the preceding period for all amounts presented in the current period's financial statements, unless FRS 102 specifically permits or requires otherwise. Therefore, a complete set of financial statements includes, at a minimum, two of each of the required financial statements and related notes. [FRS 102.3.14, FRS 102.3.20]. Comparative information, including the statutory requirements of the Regulations and LLP Regulations, is discussed at 2.4 below.

Chapter 7 at 3.1 sets out exemptions from preparing a cash flow statement. Qualifying entities (see Chapter 3 at 3.1 and 3.3.1 using the reduced disclosure framework in individual financial statements) are also exempt. FRS 102 further exempts a small entity (as defined in Chapter 5 at 3.3.3) from preparing a cash flow statement. This cash flow exemption is available both to small entities applying Section 1A and to small entities applying the full version of FRS 102, unless they are required to prepare one by an applicable SORP or law or other relevant regulation. [FRS 102.3.1B].

Sections 4 and 5 require that the balance sheet and profit and loss account formats in Part 1 of the applicable schedule of the Regulations or LLP Regulations are followed in presenting the statement of financial position and the 'profit and loss' section of the statement of comprehensive income. These formats include both the statutory formats and the adapted formats available as an alternative to statutory formats under Schedule 1 to the Regulations and Schedule 1 to the LLP Regulations. [FRS 102.4.2, FRS 102.5.5, FRS 102.5.7]. See 3 below for further discussion of the formats.

Other titles for the financial statements can be used, as long as they are not misleading. [FRS 102.3.22]. For instance, an entity may wish to refer to a balance sheet (for the statement of financial position) or the profit and loss account (instead of an income statement, where total comprehensive income is presented in two statements).

If an entity has no items of other comprehensive income in any of the periods presented, it may present only an income statement or a statement of comprehensive income in which the 'bottom line' is labelled profit or loss. [FRS 102.3.19].

If the only changes to equity during the periods presented in the financial statements arise from profit or loss, payments of dividends, corrections of prior period errors and changes in accounting policy, the entity may present a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity. [FRS 102.3.18].

FRS 102 explains that notes contain information in addition to that presented in the primary statements and provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements. [FRS 102.8.1].

2.4 Comparative information

Except when FRS 102 permits or requires otherwise, an entity presents comparative information in respect of the preceding period for all amounts presented in the current period's financial statements, including both the primary statements and the notes. This means that the requirement to present comparative information applies both to mandatory and voluntary information presented for the current period. With regard to narrative and descriptive information, comparatives must be provided when this is relevant to an understanding of the current period's financial statements. [FRS 102.3.14].

In certain cases, FRS 102 provides specific exemptions from presenting comparatives. For example, there is no requirement to present comparatives for the reconciliations of movements in the number of shares outstanding, or of the movements in the carrying amounts of certain assets. The standard clarifies that an entity providing reconciliations of items of fixed assets in accordance with paragraph 51 of Schedule 1 to the Regulations, need not present these reconciliations for prior periods. [FRS 102.3.14A].

The Regulations and LLP Regulations require only one comparative period to be presented for the balance sheet and profit and loss account formats. [1 Sch 7, 1 Sch 7 (LLP)]. The Regulations and LLP Regulations do not specifically require comparative note disclosures but these are required by FRS 102, unless specifically exempted. Other statutory or regulatory frameworks may require further periods to be presented.

The General Rules to the formats (see 3.4 below) require that for each item presented in the balance sheet and profit and loss account, the corresponding amount for the immediately preceding financial year (i.e., the comparative) must also be shown. [1 Sch 7(1), 1 Sch 7(1) (LLP)].

The heading or sub-heading required for a particular item in the balance sheet or profit and loss account format must be presented where there is an amount for that item in either the current or immediately preceding financial year; otherwise, the heading or sub-heading must be omitted. [1 Sch 5 (SC), 1 Sch 5 (LLP SC)]. In other words, nil line items must not be presented.

2.4.1 Consistency of, and reclassification of comparative information

An entity must retain the presentation and classification of items in the financial statements from one period to the next unless: *[FRS 102.3.11]*

- It is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for selection and application of accounting policies in Section 10 (see Chapter 9).
Or
- FRS 102 (or another applicable FRS) requires a change in presentation.

When entities change the presentation or classification of items in the financial statements, the comparatives must be reclassified, unless this is impracticable, in which case the reason should be disclosed. When comparative amounts are reclassified, the following disclosures are required:

- The nature of the reclassification
 - The amount of each item (or class of items) reclassified
- And
- The reasons for the reclassification *[FRS 102.3.12, FRS 102.3.13]*

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. *[FRS 102 Appendix I]*.

This situation should be distinguished from a reclassification due to a change in use of an asset. An example is a reclassification out of investment property because it ceases to meet the definition of investment property in the current period. This is treated as a transfer arising in the current period and does not lead to a reclassification of comparatives. *[FRS 102.16.9]*.

In addition, the initial application of a policy to revalue property, plant and equipment (or intangible assets, where the strict criteria are met) is treated as a revaluation in accordance with Section 17 - *Property, Plant and Equipment* - and Section 18 - *Intangible Assets other than Goodwill* - respectively. *[FRS 102.10.10A]*. This means that it is reflected as an adjustment in the period of application of the revaluation policy rather than retrospectively.

Restatements of comparatives may also arise from:

- Changes in accounting policy (see Chapter 9 at 3.3)
 - Correction of prior period errors (see Chapter 9 at 3.5)
 - Presentation of discontinued operations (see 5.8 below)
- And
- Hindsight adjustments in respect of provisional fair values of identifiable assets, liabilities and contingent liabilities arising on business combinations (see Chapter 22 at 3.7.4)

FRS 102 (unlike IAS 1/IFRS 18) does not require presentation of a third balance sheet at the beginning of the preceding period when there is a retrospective restatement due to an accounting policy change, reclassification or correction of a material error. *[IAS 1.10(f), IAS 1.40A, IAS 1.40B, IAS 1.40C, IAS 1.40D, IFRS 18.37]*. See Chapter 9 at 2.3.

Where the comparative shown in the balance sheet and profit and loss account formats is not comparable with the amount shown in the current period, the General Rules to the formats (see 3.4 below) permit the comparative to be adjusted. Particulars of the non-comparability, and of any adjustment, must be disclosed in a note to the accounts. *[1 Sch 7(2), 1 Sch 7(2)(LLP)]*. This statutory requirement would permit FRS 102's requirements on restatement of comparatives to be followed. Where amounts are not restated, e.g., due to transitional provisions in accounting policies or where it is impracticable to determine the effects of a change in accounting policies on earlier periods, *[FRS 102.10.11, FRS 102.10.12]*, a note to the financial statements will need to disclose the non-comparability.

2.5 Identification of the financial statements

It is commonly the case that financial statements will form part of a larger annual report, regulatory filing or other document, but FRS 102 only applies to the financial statements (including the notes). An LLP is not required to prepare a members' report, but the LLP SORP requires certain information to be disclosed which may be included in a separate members' report. *[LLP SORP.30, LLP SORP.31]*. A traded LLP or a banking LLP is also required to prepare a strategic report. *[s414A(1), s414A(1)(LLP)]*.

Accordingly, FRS 102 requires that an entity clearly identifies the financial statements and the notes and distinguishes them from other information in the same document. In addition, the entity must display the following information prominently, and repeat it when necessary, for an understanding of the information presented: [FRS 102.3.23]

- The name of the reporting entity and any change in its name from the end of the preceding reporting period.
- Whether the financial statements cover the individual entity or a group of entities.
- The date of the end of the reporting period and the period covered by the financial statements.
- The presentation currency, as defined in Section 30 - *Foreign Currency Translation* (discussed in Chapter 32 at 3.1 and 3.6).

And

- The level of rounding, if any, used in presenting amounts in the financial statements.

In practice, these requirements can be met through the use of appropriate headings for pages, statements, notes and columns etc., for example: the inclusion of a basis of preparation note within the accounting policies; the use of appropriate titles for the primary financial statements, distinguishing group and company; and the use of appropriate headings in the columns in the primary financial statements (and notes to the financial statements). Entities will need to consider how best to present the required information where financial statements are made available electronically.

Financial statements are usually presented to an appropriate level of rounding, such as thousands or millions of currency units. An appropriate level of rounding can avoid obscuring useful information, but entities need to ensure that material information is not omitted (see 8.4 below). The level of rounding used must be clearly disclosed in the primary statements and notes to the financial statements. Entities are not precluded from using lower levels of rounding in certain notes to the financial statements. For example, where the financial statements are presented in millions of units of the presentation currency, it may be appropriate to include information on directors' remuneration at a lower level of rounding. In all cases, it is important that the units used are clearly stated.

FRS 102 also requires disclosures in the notes concerning matters relating to legal form and registration, see 7.5 below.

2.6 Statement of compliance

A set of financial statements prepared in accordance with FRS 102 must contain an explicit and unreserved statement of compliance with FRS 102 in the notes to the financial statements. Financial statements must not be described as complying with FRS 102 unless they comply with *all* the requirements of the standard.

[FRS 102.3.3, FRS 100.9].

FRS 102 additionally requires a public benefit entity (see Chapter 36 at 6 for the definition of a public benefit entity) that applies the 'PBE' prefixed paragraphs to make an explicit and unreserved statement that it is a public benefit entity. [FRS 102.PBE3.3A]. This is because the specific requirements reserved for public benefit entities (prefixed with 'PBE') must not be applied directly, or by analogy by entities that are not public benefit entities (other than, where specifically directed, entities within a public benefit entity group). [FRS 102.1.2]. See Chapter 3 at 2.5.2.

An example is presented Illustration 2-1 below.

Illustration 2-1: Statement of Compliance - illustrative wording

These financial statements were prepared in accordance with Financial Reporting Standard 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'. [The [company/entity] is a public benefit entity as defined in Financial Reporting Standard 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'].*

* delete as applicable.

In special circumstances when management concludes that compliance with any requirement of FRS 102 or applicable legislation (only where it allows for a true and fair override) is inconsistent with the requirement to give a true and fair view, the entity shall depart from that requirement to the extent necessary to give a true and fair view, giving the required disclosures set out in paragraph 5 of section 3 of the standard.

[FRS 102.3.4, FRS 102.3.5]. See 8.2 below for further discussion of the 'true and fair override' under FRS 102 (and where applicable, under CA 2006), together with the implications for the statement of compliance.

2.6.1 Statement that financial statements have been prepared in accordance with applicable accounting standards

The Regulations (and LLP Regulations) require a large UK company preparing Companies Act accounts (or a large LLP preparing non-IAS accounts) to state in the notes to the accounts whether the accounts have been prepared in accordance with applicable accounting standards, giving particulars of any material departure from those standards and the reasons for it (see Chapter 1 at 3.5). [1 Sch 45, 1 Sch 45 (LLP)].

This statement is also required in the group accounts of a medium-sized company or LLP (see Chapter 1 at 5.6.1) but not in its individual accounts. [Regulations 4(2A), 1 Sch 45, LLP Regulations 4(2A), 1 Sch 45 (LLP)].

Where a 'true and fair override' in accordance with paragraph 5 of section 3 of the standard (see 8.2 below) is applied in the financial statements, the above statement will need to include or refer to the disclosures of the override.

Financial statements prepared in accordance with FRS 102 are prepared in accordance with applicable accounting standards (which are defined in section 464 of CA 2006). [s464, s464 (LLP)].

2.7 Segmental reporting

FRS 102 requires certain entities to apply IFRS 8 *Operating Segments*. IFRS 8 applies to an entity whose debt or equity instruments are publicly traded, or that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, or an entity that chooses to provide information described as segment information.

FRS 102 states that if an entity discloses disaggregated information, but that information does not comply with IFRS 8's requirements, it is not permitted to describe that information as segment information.

[FRS 102.1.5].

The determination of whether a group falls into the scope of IFRS 8 relates solely to the parent entity, rather than to subsidiaries within the group. [IFRS 8.BC.23]. Therefore, IFRS 8 does not apply to a group headed by a parent that has no listed financial instruments, even if the group contains a subsidiary that has any of its equity or debt instruments traded in a public market. Of course, a subsidiary with publicly traded debt or equity instruments preparing FRS 102 financial statements would be required to provide segment information in accordance with IFRS 8 in its financial statements.

IFRS 8 describes a 'public market' as including a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets, [IFRS 8.2], but does not define what would make some markets 'public' and others not.

How we see it

In our view, a market is 'public' when buyers and sellers (market participants) can transact with one another (directly; through agents; or in a secondary market) at a price determined in that market. A public market does not exist when the buyers and sellers can transact only with the entity itself (or an agent acting on its behalf).

The requirement for an entity to list its securities on a stock exchange is not the sole factor in determining whether the entity is in scope of IFRS 8. Its securities must be traded in a public market meeting the criteria above.

See the EY publication, International GAAP®, for a discussion of the scope of IFRS 8 and its requirements for segmental reporting. See 7.6 below for further discussion of the segmental disclosures of turnover.

3 Company law formats

Sections 4 and 5 of FRS 102 cover the requirements for the statement of financial position and statement of comprehensive income (and income statement, where the statement of comprehensive income is presented as two statements) respectively.

Sections 4 and 5 apply to *all* FRS 102 reporters (apart from small entities applying Section 1A), whether or not they report under CA 2006. Entities that do not report under CA 2006 are required to comply with the requirements set out in Sections 4 and 5 and with the Regulations (or, where applicable, the LLP Regulations) where referred to in Sections 4 and 5, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. *[FRS 102.1A.7, FRS 102.4.1, FRS 102.4.1A, FRS 102.5.1, FRS 102.5.1A]*.

3.1 Which formats should be applied?

3.1.1 UK companies and LLPs applying FRS 102 (but not Section 1A)

3.2.1 and 3.2.2 below explain which formats are applied by UK companies and LLPs applying the full version of FRS 102.

The definitions of banking company, banking group, insurance company, and insurance group are relevant to determining which formats are required. See 3.1.2 and 3.1.3 below.

3.1.2 Definition of banking company and banking group

A 'banking company' means a person who has permission under Part 4A of the Financial Services and Markets Act 2000 to accept deposits, other than:

- A person who is not a company.
And
- A person who has such permission only for the purpose of carrying on another regulated activity in accordance with permission under that Part.

This definition is to be read with section 22 of the Financial Services and Markets Act 2000, any relevant order under that section and Schedule 2 to the Financial Services and Markets Act 2000. *[s1164(2), s1164(3)]*.

A 'banking group' means a group (i.e., a parent undertaking and its subsidiary undertakings) where the parent company is a banking company or where: *[s1164(4), s1173(1)]*

- The parent company's principal subsidiary undertakings are wholly or mainly credit institutions.
And
- The parent company does not itself carry on any material business apart from the acquisition, management and disposal of interests in subsidiary undertakings.

For the purposes of the definition of 'banking group', the 'principal subsidiary undertakings' are the subsidiary undertakings of the company whose results or financial position would principally affect the figures shown in the group accounts and the 'management of interests in subsidiary undertakings' includes the provision of services to such undertakings. *[s1164(5)]*.

A credit institution is defined as a credit institution within the meaning of Article 4(1)(1) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council, i.e., as "an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account." *[s1173(1)]*.

3.1.3 Definition of insurance company and insurance group

An 'insurance company' means:

- An authorised insurance company (i.e., a person (whether incorporated or not) who has permission under Part 4A of the Financial Services and Markets Act 2000 to effect or carry out contracts of insurance).
- Or

- Any other person (whether incorporated or not) who:
 - Carries on insurance market activity (as defined in section 316(3) of the Financial Services and Markets Act 2000).
 - Or
 - May effect or carry out contracts of insurance under which the benefits provided by that person are exclusively or primarily benefits in kind in the event of accident to or breakdown of a vehicle.

Neither definition includes a friendly society within the meaning of the Friendly Societies Act 1992.

[s1165(2), s1165(3), s1165(4)].

References to 'contracts of insurance' and 'to the effecting or carrying out of such contracts' must be read with section 22 of the Financial Services and Markets Act 2000, any relevant order under that section and Schedule 2 to the Financial Services and Markets Act 2000. [s1165(8)].

An 'insurance group' means a group (i.e., parent undertaking and its subsidiary undertakings) where the parent company is an insurance company or where: [s1165(5)]

- The parent company's principal subsidiary undertakings are wholly or mainly insurance companies.
- And
- The parent company does not itself carry on any material business apart from the acquisition, management and disposal of interests in subsidiary undertakings.

For the purposes of the definition of 'insurance group', the 'principal subsidiary undertakings' are the subsidiary undertakings of the company whose results or financial position would principally affect the figures shown in the group accounts and the 'management of interests in subsidiary undertakings' includes the provision of services to such undertakings. [s1165(6)].

3.1.4 Qualifying partnerships (not applying Section 1A)

A qualifying partnership (as defined in the *Partnerships (Accounts) Regulations 2008* (SI 2008/569), unless exempt under regulation 7 of SI 2008/569, is required to prepare annual accounts and reports as would be required, if the partnership were a company under Part 15 of CA 2006 or under the Small Companies Regulations or the Regulations.

Part 1 of the Schedule to these regulations sets out certain modifications and adaptations to be made to the Regulations and Small Companies Regulations for these purposes. In addition, modifications may be necessary to take account of the fact that partnerships are unincorporated. For the purposes of the formats, there is no requirement for the profit and loss account to show profit or loss before taxation.³³

Consequently, the requirements for qualifying partnerships preparing statutory accounts are the same (subject to the modifications and adaptations noted above) as for UK companies (see 3.1.1 above).

3.1.5 Other entities required to prepare statutory accounts in accordance with Part 15 of CA 2006

Certain other entities are required by regulations to prepare annual accounts as if the entity is a company subject to Part 15 of CA 2006 and these regulations specify the formats to be applied for the balance sheet and profit and loss account. Some examples are given below.

The Bank Accounts Directive (Miscellaneous Banks) Regulations 2008 (SI 2008/567) requires a 'qualifying bank' (as defined in those regulations) to prepare annual accounts and a directors' report as if it were a banking company (or the parent company of a banking group) in accordance with Schedule 2 to the Regulations (with certain adaptations or modifications set out in the Schedule to SI 2008/567).

Similarly, an insurance undertaking (as defined in *The Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008* (SI 2008/565)) must prepare annual accounts and a directors' report as if it were an insurance company (or the parent company of an insurance group) in accordance with Schedule 3 to the Regulations (with certain adaptations or modifications).

The entities described above would not be eligible to apply Section 1A. Such entities discussed above are generally outside the scope of this publication. However, it is important that all entities determine the statutory framework, if any, that applies to the preparation of their financial statements.

³³ Partnerships (Accounts) Regulations 2008 (SI 2008/569), para. 4 and Schedule.

3.1.6 Other entities (not applying Section 1A)

Other entities (not applying Section 1A) must apply the formats included in one of Schedules 1 to 3 to the Regulations or in the LLP Regulations, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. [FRS 102.4.1, FRS 102.4.1A, FRS 102.4.2, FRS 102.5.1, FRS 102.5.5, FRS 102.5.7]. The Basis for Conclusions to FRS 102 states that “it was concluded that all entities applying FRS 102 would be required to follow company law formats as this would promote consistency between reporting entities regardless of the legal framework under which they operate”. [FRS 102.BC.A15].

As FRS 102 does not specify which format should be used, management of such entities must apply judgement in determining the most appropriate format to apply for the circumstances of the entity concerned, where the statutory framework is not prescriptive.

3.2 Required formats - statement of financial position and statement of comprehensive income

3.2.1 Individual financial statements

An entity must present its statement of financial position and, in the statement of comprehensive income (or in the separate income statement), the items to be included in a profit and loss account in accordance with one of the following requirements for individual financial statements: [FRS 102.4.2, FRS 102.5.5, FRS 102.5.7]

- Part 1 General Rules and Formats of Schedule 1 to the Regulations - applies to companies other than banking companies (defined in section 1164) and insurance companies (defined in section 1165) [Regulations 3]
- Part 1 General Rules and Formats of Schedule 2 to the Regulations - applies to banking companies [Regulations 5]
- Part 1 *General Rules and Formats* of Schedule 3 to the Regulations - applies to insurance companies [Regulations 6]
- Part 1 *General Rules and Formats* of Schedule 1 to the LLP Regulations - applies to limited liability partnerships (LLPs) [LLP Regulations 3]

Schedule 1 to the Regulations and Schedule 1 to the LLP Regulations provide a choice of:

- Statutory formats (as set out in Section B of Part 1 of those schedules) - see 4.2, 4.3 and 5.6 below
- Or
- Adapted formats (as permitted by paragraph 1A of Schedule 1 to the Regulations and paragraph 1A of Schedule 1 to the LLP Regulations) - see 3.2.3, 4.1 and 5.5 below

Schedule 2 and Schedule 3 to the Regulations provide only for statutory formats.

The Regulations require individual accounts of a banking or insurance company to contain a statement that they are prepared in accordance with the provisions of the Regulations relating to banking or insurance companies, as relevant. [Regulations 5(3), Regulations 6(3)]. The definitions of a banking company and an insurance company are given at 3.1.2 and 3.1.3 above.

3.2.2 Consolidated financial statements

The consolidated statement of financial position and consolidated statement of comprehensive income (or consolidated income statement, where the two-statement approach is used) of a group must be presented in accordance with the requirements for a consolidated balance sheet and consolidated profit and loss account of Schedule 6 to the Regulations or Schedule 3 to the LLP Regulations. [FRS 102.4.2, FRS 102.5.5, FRS 102.5.7].

Schedule 6 to the Regulations addresses the balance sheet and profit and loss account formats applicable to group accounts of companies, modifying the formats included in the earlier schedules. The group accounts must comply, so far as practicable with the provisions of Schedule 1 to the Regulations (including the formats) as if the undertakings included in the consolidation were a single company. [Regulations 9, 6 Sch 1(1)].

The parent company of a group (other than a banking or insurance group) applies Part 1 of Schedule 6 to the Regulations. The parent company of a banking group (defined in section 1164(4)-(5)) applies Part 1 (as modified by Part 2) of Schedule 6 to the Regulations. The parent company of an insurance group (defined in section 1165(5)-(6)) applies Part 1 (as modified by Part 3) of Schedule 6 to the Regulations. [Regulations 9].

This means that the parent company of a group (other than a banking or insurance group) follows the formats in Schedule 1 to the Regulations in its group accounts. The parent of a banking group follows the formats in Schedule 2 to the Regulations in its group accounts. The parent of an insurance group follows the formats in Schedule 3 to the Regulations. In each case, Schedule 6 to the Regulations sets out the modifications required to the respective formats used in the individual accounts.

The Regulations require that the group accounts prepared by a parent of a banking or insurance group must make a statement that they are prepared in accordance with the provisions of the Regulations relating to banking groups or insurance groups, as relevant. *[Regulations 9(4)]*.

It is possible for the parent company of a banking and insurance group to be required to follow the formats in Schedule 1 to the Regulations in its individual accounts (i.e., where it is not a banking or insurance company itself).

Schedule 3 to the LLP Regulations similarly addresses the balance sheet and profit and loss formats applicable to group accounts of LLPs. *[LLP Regulations 6, 3 Sch 1 (LLP), FRS 102.4.2, FRS 102.5.5, FRS 102.5.7]*. The parent LLP follows the formats in Schedule 1 to the LLP Regulations, with certain modifications to the formats used in the individual accounts.

The modifications for group accounts for companies (other than banking and insurance companies) and LLPs are addressed at 3.5 (presentation of non-controlling interest), and in the introductory sections at 4.1 and 5.5 (adapted formats) and 4.2 and 5.6 (statutory formats) below. Where adapted formats (see 3.2.3 below) are used, the only modification is in relation to non-controlling interests.

3.2.3 Adapted formats

Adapted formats can be used by UK companies and by LLPs respectively.

Paragraph 1A of Schedule 1 to the Regulations (and paragraph 1A of Schedule 1 to the LLP Regulations) set out the adaptations to the statutory formats permitted for the balance sheet and profit and loss account. Paragraph 1A (set out in full below) refers to the formats in Section B of Part 1 of Schedule 1 to the Regulations (and Section B of Part 1 of Schedule 1 to the LLP Regulations).

A company's directors (or the members of an LLP) may adapt one of the balance sheet formats in Section B of Part 1 of Schedule 1 to the Regulations (or Section B of Part 1 of Schedule 1 to the LLP Regulations) to distinguish between current and non-current items in a different way and may adapt one of the profit and loss account formats in Section B of Part 1 of Schedule 1 to the Regulations (or Section B of Part 1 of Schedule 1 to the LLP Regulations), provided that: *[1 Sch 1A(1), 1 Sch 1A(1)(LLP)]*

- (a) The information given is at least equivalent to that which would have been required by the use of the format, had it not been adapted.

And

- (b) The presentation of those items is in accordance with generally accepted accounting principles or practice.

So far as is practicable, the General Rules to the formats (i.e., provisions of paragraphs 2 to 9A of Section A of Part 1 of Schedule 1 to the Regulations or the same paragraphs in the LLP Regulations - see 3.4 below) apply to a company's (or an LLP's) balance sheet or profit or loss account, notwithstanding any adaptation applying paragraph 1A. *[1 Sch 1A(3), 1 Sch 1A(3)(LLP)]*.

Adapted formats, as modified by Schedule 6 to the Regulations (or Schedule 3 to the LLP Regulations) (see 3.2.2 above) may also be used in group accounts of a parent company of a group (other than a banking group or insurance group) and in the group accounts of a parent LLP. *[6 Sch 1(1), 3 Sch 1 (LLP)]*. Adapted formats are not permitted to be used in the group accounts of banking groups or insurance groups because their group accounts are drawn up in accordance with Schedule 2 and Schedule 3 to the Regulations (with modifications), which do not allow for adapted formats.

Paragraph 1A provides limited guidance on the content of the adapted formats, leaving the detail to UK accounting standards. Indeed, Appendix III to FRS 102 states that "for entities within its scope, FRS 102 sets out a framework for the information to be presented by those entities choosing to adapt the formats". *[FRS 102.A3.38]*.

Entities applying adapted formats for the balance sheet and profit and loss account must, therefore, follow the requirements for adapted formats in Sections 4 and 5, which allow a presentation of the statement of financial position and the statement of comprehensive income to be much closer to IAS 1/IFRS 18³⁴. These formats might be used where IFRS is used for group reporting, but FRS 102 has been adopted in the individual accounts of group undertakings or to assist comparability with competitors.

Sections 4 and 5 specify that, at a minimum, certain line items are presented in the statement of financial position and statement of comprehensive income (or income statement, where the two-statement approach is used), with further sub-classifications of certain line items presented in the statement of financial position in the notes to the financial statements. In addition, FRS 102 sets out when additional line items must be presented and how adapted formats can be modified (see 3.4.2, 4.1 and 5.5 below). [FRS 102.4.2C, FRS 102.4.3, FRS 102.5.5C, FRS 102.5.9]. In general, few difficulties should arise over classification of line items where adapted formats are applied since the required line items are aligned with the categories of assets and liabilities discussed in FRS 102. Differences in classification are discussed at 4.1 and 5.5 below.

Schedule 1 to the Regulations (and Schedule 1 to the LLP Regulations) require supplementary information in respect of certain line items in the balance sheet and profit and loss account to be given in the notes to the accounts. This information is in respect of line items found in the statutory formats and may not align completely with the line items used, where the adapted formats are applied.

See 4.1 and 5.5 below for further discussion of adapted formats.

3.3 Changes in formats

The General Rules to the formats (see 3.4 below) require that once a company's (or an LLP's) the statement of financial position and the statement of comprehensive income has been prepared for any financial year using one of the formats (in Section B of Part 1 of Schedule 1 to the Regulations or Section B of Part 1 of Schedule 1 to the LLP Regulations), the company's directors (or the members of an LLP) must use the same format in preparing Companies Act accounts (non-IAS accounts, for an LLP) for subsequent financial years, unless in their opinion there are special reasons for a change. Particulars of any such change must be given in a note to the accounts in which the new format is first used, and the reasons for the change must be explained. [1 Sch 2, 6 Sch 1, 1 Sch 2 (LLP), 3 Sch 1 (LLP)].

There are similar rules for changes in statutory profit and loss account formats for banking companies in Schedule 2 to the Regulations. [2 Sch 3, 6 Sch 1]. There is no choice of statutory balance sheet formats in Schedule 2 to the Regulations or of statutory formats in Schedule 3 to the Regulations.

While this paragraph refers to the statutory formats, the General Rules apply so far as is practicable to adapted formats. [1 Sch 1A(3), 1 Sch 1A(3)(LLP)].

How we see it

In our view, the same requirements apply to changes in the statutory format used and to a change between statutory formats and adapted formats.

A change in the format applied is regarded as a change in accounting policy for the purposes of FRS 102 and, therefore, is applied retrospectively. Accounting policies are defined as "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements".

[FRS 102 Appendix I, FRS 102.10.2]. See Chapter 9 at 3.3 for the requirements on changes in accounting policy.

3.4 General Rules to the formats

The following discussion relates to the General Rules to the formats which apply to balance sheet and profit and loss account formats included in Schedule 1 to the Regulations (and Schedule 1 to the LLP Regulations).

The General Rules to the formats also cover changes in formats (see 4.3 above).

3.4.1 General Rules governing the form of the statutory formats

Subject to paragraph 1A (which provides for adapted formats - see 3.2.3 above) and the following provisions of the Schedule:

³⁴ On 18 February 2026, the FRC published the FRS 102 (2026) amendments, following the introduction of IFRS 18. These amendments form part of the Periodic Review 2024. However, these amendments are effective for periods on or after 1 January 2027 (see 9 below).

- Every balance sheet of a company (or an LLP) must show the items listed in either of the balance sheet formats.
And
- Every profit and loss account of a company (or an LLP) must show the items listed in either of the profit and loss account formats.

The items in the balance sheet and profit and loss account statutory formats must be shown in the order and under the headings and sub-headings given in the particular format used, but the letters or numbers assigned to that item in the format do not need to be given (and are not in practice). References in the Schedule to items listed must be read together with any of the notes following the formats in Section B which apply to those items, which may also permit alternative positions for particular items. [1 Sch 1, 1 Sch 1 (LLP)]. The individual line items in the statutory balance sheet and profit and loss account formats are discussed respectively at 4.2 and 5.6 below.

While there are two statutory formats, format 1 and format 2, available for the balance sheet, only format 1 is commonly used. Both format 1 and format 2 profit and loss accounts are commonly used. There are some differences in detail in the line items required in the LLP statutory formats compared to the company statutory formats.

See Figure 4-2 at 4.2 below for the format 1 balance sheet and Figures 5-2 to 5-5 at 5.6 below for the format 1 and format 2 profit and loss accounts for the individual accounts of a UK company and an LLP. Each of the headings and sub-headings denoted with a capital letter or Roman numeral must be presented in the balance sheet.

3.4.2 General Rules applying to statutory formats and adapted formats

The following provisions in the General Rules to the formats apply to the statutory formats and, so far as is practicable, to the adapted formats. [1 Sch 1A(3)].

The Regulations (and LLP Regulations) do not provide further guidance on how 'so far as is practicable' is to be interpreted.

How we see it

In our view, the phrase 'so far as is practicable' is needed because the General Rules have been written from the perspective of the statutory formats and refer to items given an Arabic number which may not have a direct counterpart in the adapted formats. In other cases, such as in relation to comparatives, there are no difficulties in applying the requirements. We do not consider that 'so far as is practicable' allows companies or LLPs the flexibility to regard the General Rules to the formats as optional.

Schedules 1 to the Regulations and the LLP Regulations require that every profit and loss account must show 'profit or loss before taxation' as a line item in the profit and loss account. [1 Sch 6, 1 Sch 6 (LLP)]. Previously, the line item required was 'profit or loss on ordinary activities before taxation'. This change was not in fact made to the formats in Schedule 2 and Schedule 3 to the Regulations, nor was it made to the disclosures required by Section 29 of FRS 102 (see Chapter 31 at 12.3). The line item 'profit or loss before taxation' is not required for a qualifying partnership preparing statutory accounts (see 3.1.4 above).³⁵

How we see it

In our view, for a company following Schedule 1 formats, the line item must be labelled 'profit or loss before taxation' (not 'profit or loss on ordinary activities before taxation') to align with the legal requirement in Schedules 1 to the Regulations and the LLP Regulations.

The General Rules to the formats allow any item to be shown in a company's (or an LLP's) balance sheet or profit and loss account in greater detail than required by the particular format used. The balance sheet or profit and loss account may include an item representing or covering the amount of any asset or liability, income or expenditure not otherwise covered by any of the items listed in the format used. However, preliminary expenses; the expenses of, and commission on, any issue of shares or debentures (relevant for a company only); and the costs of research may not be treated as assets in the balance sheet. [1 Sch 3, 1 Sch 3 (LLP)]. A qualifying partnership preparing statutory accounts is not subject to the above rules on which types of costs may not be treated as assets in the balance sheet.³⁶

³⁵ Partnerships (Accounts) Regulations 2008 (SI 2008/569), para. 4 and Schedule.

³⁶ Partnerships (Accounts) Regulations 2008 (SI 2008/569), para. 4 and Schedule.

Where the special nature of the company's (or the LLP's) business requires it, the company's directors (or the members of the LLP) *must* adapt the arrangement, headings and sub-headings otherwise required in respect of items given an Arabic number in the balance sheet or profit and loss account format used. The directors (or the members of the LLP) *may* combine items to which Arabic numbers are given in the formats if their individual amounts are not material to assessing the state of affairs or profit or loss of the company (or the LLP) for the financial year in question; or the combination facilitates that assessment. In the latter case, the individual amounts of any items combined must be disclosed in a note to the accounts. [1 Sch 4, 1 Sch 4 (LLP)].

FRS 102's requirements on materiality and aggregation are discussed at 8.4 below.

FRS 102 contains additional requirements that are consistent with the General Rules. Additional line items, headings and subtotals are required to be added where relevant to an understanding of the entity's financial position or financial performance (this applies both to statutory and adapted formats - see 4.1, 4.2 and 5.7 below). [FRS 102.4.3, FRS 102.5.9]. Where additional detail is provided in the statement of financial position or statement of comprehensive income, it is usual to provide a subtotal for the heading.

The heading or sub-heading required for a particular item in the balance sheet or profit and loss account format must be presented where there is an amount for that item in either the current or immediately preceding financial year; otherwise, the heading or sub-heading must be omitted. [1 Sch 5, 1 Sch 5 (SC), 1 Sch 5 (LLP SC)].

A corresponding amount (i.e., comparative) for the immediately preceding financial year must be shown for every item shown in the statement of financial position and in the statement of comprehensive income. FRS 102's requirements on comparatives are discussed at 2.4 above.

Amounts in respect of items representing assets or income may not be set off against amounts in respect of items representing liabilities or expenditure (as the case may be), or *vice versa*. [1 Sch 8, 1 Sch 8 (LLP)].

FRS 102's requirements on offsetting are discussed at 8.1.1.C below.

The company's directors (or the members of an LLP) must, in determining how amounts are presented within items in the profit and loss account and balance sheet, have regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice. [1 Sch 9, 1 Sch 9 (LLP)].

Finally, where an asset or liability relates to more than one item in the balance sheet, the relationship of that asset or liability to the relevant items must be disclosed either under those items or in the notes to the accounts. [1 Sch 9A, 1 Sch 9A (LLP)].

Examples of situations where this may be relevant include:

- Items which are partly reported in debtors: amounts falling due within one year and debtors: amounts falling due after more than one year, where reported separately on the balance sheet (in the statutory formats).
 - Items which are partly reported in creditors: amounts falling due within one year and creditors: amounts falling due after more than one year (in the statutory formats).
- And
- Items which are partly reported as current and non-current assets or liabilities (in the adapted formats).

This disclosure requirement does not appear to extend to reporting the relationship between assets and liabilities that derive from a single transaction (e.g., an asset acquired on a lease that has an impact both on fixed assets and lease creditors) nor, to identifying the associated deferred tax consequences of an asset or liability.

How we see it

Where a single asset or liability is required to be reported as more than one line item in the statement of financial position, for example, split accounting for a convertible loan between equity and liability elements, or a loan at off-market rates made by a parent to its subsidiary is split between investment and loan asset, it would seem appropriate, in our view, to disclose the relationship between these line items.

There was no need for FRS 102 to explain how the statutory formats could be amended, as this is covered in the General Rules to the formats. However, amendments to the adapted formats, which do not include Arabic-numbered items, would need to comply so far as is practicable with the General Rules to the formats. Sections 4 and 5 explain what amendments may be made to the line items required for adapted formats. An entity may amend the descriptions used, the ordering of items and the aggregation of similar

items in the statement of financial position (including the sub-classifications of certain line items required to be presented in the statement of financial position or in the notes to the financial statements), according to the nature of the entity and its transactions, to provide information relevant to an understanding of the entity's financial position, providing the information given is at least equivalent to that required by the balance sheet format, had it not been adapted. [FRS 102.4.2C]. Similarly, an entity may include additional line items in the income statement, amend the descriptions used, and the ordering of items when this is necessary to explain the elements of financial performance, providing the information given is at least equivalent to that required by the profit and loss account format had it not been adapted. [FRS 102.5.5C].

3.5 Non-controlling interests in consolidated financial statements

FRS 102, the Regulations and LLP Regulations address the presentation of non-controlling interests. These requirements are relevant to consolidated financial statements, prepared using statutory or adapted formats.

Under FRS 102, a non-controlling interest is defined as “the equity in a subsidiary not attributable, directly or indirectly, to a parent”. Equity is “the residual interest in the assets of the entity after deducting all its liabilities”. Owners (as referred to below) are ‘holders of instruments classified as equity’. [FRS 102 Appendix I].

FRS 102 requires that a non-controlling interest is presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. [FRS 102.9.20].

The statement of changes in equity (see 6.1 below) presents: [FRS 102.6.3]

- Total comprehensive income, showing separately the total amounts attributable to owners of the parent and non-controlling interests.
- And
- Since non-controlling interest is a component of equity, a reconciliation of the changes in the carrying amount of non-controlling interests.

In addition, the statement of comprehensive income (or separate income statement, where presented) shows as allocations of profit or loss and total comprehensive income: [FRS 102.5.6, FRS 102.5.7A, FRS 102.5.7B, FRS 102.5.7C, FRS 102.9.21]

- The profit or loss for the period attributable to the owners of the parent separately from the profit or loss for the period attributable to non-controlling interest.
- And
- The total comprehensive income attributable to the owners of the parent separately from the total comprehensive income attributable to non-controlling interest.

The statutory requirements for presentation of non-controlling interests (see 3.5.1 below) permit a presentation consistent with the requirements of FRS 102. In most cases, the amounts shown as non-controlling interest under FRS 102 (see Chapter 8 at 3.7) and the amounts required by the Regulations (or LLP Regulations) (see 3.5.1 below) will be the same. There is a theoretical possibility that the amounts required by FRS 102 (which has a wider definition) and the Regulations (or LLP Regulations) may differ. In that case, two totals are strictly required to be presented to meet both the requirements of FRS 102 and the Regulations (or LLP Regulations). In practice, we expect such a difference to be rare.

How we see it

In our view, the same requirements for presentation of non-controlling interests apply to adapted formats (see 3.2.3 above) because the General Rules to the formats require that any adaptations made must be ‘at least equivalent’ to the information required in the statutory formats.

3.5.1 Illustrative examples of presentation of non-controlling interests

Illustration 3-1 below illustrates the presentation of non-controlling interests in the statement of financial position for a UK company under FRS 102 and is consistent with the Regulations. The terminology ‘non-controlling interests’ in the Regulations (rather than ‘non-controlling interest’ in FRS 102) is used.

Illustration 3-1: Presentation of non-controlling interests in statement of financial position

	£'000
Capital and reserves	
Called up share capital	12,075

Share premium account	493
Capital redemption reserve	500
Merger reserve	6,250
Profit and loss account	27,882
Equity attributable to owners of the parent company	47,200
Non-controlling interests	360
	47,560

See also Figure 4-1 at 4.1 below and Illustration 4-2 at 4.1.15 below for the presentation of non-controlling interests in the statement of financial position in adapted formats.

Illustration 6-1 at 6.1.2 below illustrates the presentation of non-controlling interests in the statement of changes in equity.

FRS 102 allows the statement of comprehensive income to be shown as a single statement or using the two-statement approach (with a separate income statement). [FRS 102.5.2].

Illustration 3-2 below illustrates the allocation of profit or loss to owners of the parent and to non-controlling interests where a separate income statement is presented. Where a separate income statement is presented, an allocation of total comprehensive income between owners of the parent and the non-controlling interest would also be presented at the end of the statement of total comprehensive income.

[FRS 102.5.6, FRS 102.5.7B, FRS 102.5.7C].

See also Illustration 5-2 at 5.5.2 below which illustrates the presentation for the statement of comprehensive income (with a separate income statement) using adapted formats.

Illustration 3-2: Presentation of non-controlling interests in separate income statement	
	£'000
Profit before taxation	7,786
Tax on profit	(3,339)
Profit after taxation and profit for the financial year	4,447
Profit for the financial year attributable to:	
Owners of the parent company	4,209
Non-controlling interests	238

Where a single statement of comprehensive income is presented (see 5.3 below), these allocations of profit or loss and of total comprehensive income would both be presented as two lines below the total comprehensive income for the period. [FRS 102.5.7A, FRS 102.5.7B, FRS 102.5.7C]. See Illustration 5-1 at 5.5.2 below which illustrates this for a single statement of comprehensive income using adapted formats.

4 Statement of financial position

Section 4 applies to all entities, whether or not they report under CA 2006. Entities that do not report under CA 2006 must comply with the requirements of Section 4 and with the Regulations (or where applicable, the LLP Regulations) where referred to in Section 4, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. [FRS 102.4.1].

The statement of financial position (referred to as the balance sheet in CA 2006) presents an entity's assets, liabilities and equity at the end of the reporting period. [FRS 102.4.1].

An entity presents its statement of financial position in accordance with the requirements in Part 1 of the applicable schedule to the Regulations or Part 1 of Schedule 1 to the LLP Regulations. [FRS 102.4.2]. The formats required by different types of entity (and in consolidated financial statements) are discussed in more detail in 3.1 and 3.2 above.

Part 1 of Schedule 1 to the Regulations and Part 1 of Schedule 1 to the LLP Regulations, provide a choice of:

- One of two balance sheet statutory formats (as set out in Section B of the relevant Part)
- Or
- Adapted formats

Schedule 2 (banking companies) and Schedule 3 (insurance companies) to the Regulations require use of the statutory formats and do not allow use of adapted formats. The statutory formats for insurance companies are discussed in Chapter 38 at 8. This publication does not set out or discuss the statutory formats for banking companies.

The consolidated statement of financial position of a group must be presented in accordance with the requirements for a consolidated balance sheet in Schedule 6 to the Regulations (or, where applicable, Schedule 3 to the LLP Regulations). [FRS 102.4.2]. How adapted formats and statutory formats are applied in consolidated financial statements is further explained in 3.2.2 above and 4.1 and 4.2 below.

This part of the chapter is set out as follows:

- 4.1 - Adapted formats (including implementation issues)
- 4.2 - Statutory formats - format 1 balance sheet
- 4.3 - Implementation issues for statutory formats - format 1 balance sheet
- 4.4 - Additional disclosures in respect of share capital (or equivalent) (adapted formats and statutory formats)
- And
- 4.5 - Information on disposal groups to be presented in the notes (adapted formats and statutory formats)

Certain classification issues are highlighted in the commentary on the statutory and adapted formats. In particular, the line items in the statutory formats are not always aligned with the accounting requirements in FRS 102 (e.g., 'tangible fixed assets' in the statutory formats would include property, plant and equipment, investment properties and other items).

Some additional analyses of line items and disclosures required by the Regulations (and LLP Regulations) in the notes to the accounts are highlighted at 4.3 below. Disclosures in the Regulations and LLP Regulations (unless they derive directly from the notes to the statutory formats so only apply to the statutory formats) are also required where adapted formats are used. These disclosures are not separately noted in the discussion in 4.1 below on adapted formats.

Disclosures relating to the statement of financial position specifically required by FRS 102 are set out at 4.4 and 4.5 below. These disclosures apply for both adapted formats and statutory formats. Sections 4.4 and 4.5 below also discuss similar disclosures found in the Regulations or LLP Regulations.

4.1 Adapted formats (including application issues)

An entity choosing to apply paragraph 1A(1) of Schedule 1 to the Regulations and adapt one of the balance sheet formats (see 3.2.3 above) shall, as a minimum, include in its statement of financial position the line items presented in Figure 4-1 below, distinguishing between those items that are current and those that are non-current (see 4.1.1 and 4.1.2 below). [FRS 102.4.2A]. To comply with this requirement, an entity must present current and non-current assets and current and non-current liabilities as separate classifications. [FRS 102.4.2D].

FRS 102 refers only to the Regulations, because at the time that this paragraph was added in to FRS 102, the LLP Regulations did not permit the use of adapted formats. Since paragraph 1A(1) of Schedule 1 to the LLP Regulations now allows the use of adapted formats, this paragraph should be read as extending to LLPs.

FRS 102's presentation requirements for adapted formats for the balance sheet are similar to, but not identical to, those of IAS 1.

FRS 102 is amended effective for periods on or after 1 January 2027 to align with the requirements of IFRS 18 (see 9.1 below). Under the amendment, the presentation of goodwill as a separate line item from other intangible assets is required [FRS 102(2026).4A.4].

Figure 4-1 Adapted formats - balance sheet (effective for periods on or before 1 January 2027)

(a)	Property, plant and equipment
(b)	Investment property carried at fair value through profit and loss
(c)	Intangible assets
(d)	Financial assets (excluding amounts shown under (e), (f), (j) and (k))
(e)	Investments in associates
(f)	Investments in jointly controlled entities
(g)	Biological assets carried at cost less accumulated depreciation and impairment
(h)	Biological assets carried at fair value through profit and loss
(i)	Inventories
(j)	Trade and other receivables
(k)	Cash and cash equivalents
(l)	Trade and other payables
(m)	Provisions
(n)	Financial liabilities (excluding amounts shown under (l) and (m))
(o)	Liabilities and assets for current tax
(p)	Deferred tax liabilities and deferred tax assets (classified as non-current)
(q)	Non-controlling interest, presented within equity separately from the equity attributable to the owners of the parent#
	And
(r)	Equity attributable to the owners of the parent~
~	The LLP SORP requires a total for net assets attributable to members, and total members' interests (as a memorandum item) to be disclosed in the statement of financial position. These disclosures are retained where adapted formats are used and 'loans and other debts due to members' and 'members' other interests' (items J and K in the statutory formats for LLPs) are shown as line items in the statement of financial position. See Figure 4-4 at 4.2.1 below and the discussion below.
#	Not required in individual financial statements.

An illustrative example statement of financial position, including figures and comparatives, is included in Illustration 4-2 at 4.1.15 below.

The LLP SORP requires that, in order for the adapted formats to show the equivalent information to the statutory formats, 'loans and other debts due to members' (item J in the statutory formats) and 'members' other interests' (item K in the statutory formats) must be separately disclosed in the balance sheet. The face of the balance sheet must show the total for net assets attributable to members (i.e., the total of 'loans and other debts due to members' and 'members' other interests') and disclose total members' interests (being the total of 'loans and other debts due to members' and 'members' other interests', less any 'amounts due from members' in debtors) as a memorandum item. [LLP SORP.26C, LLP SORP.58]. Detailed guidance on issues specific to LLPs is outside the scope of this chapter.

In general, few difficulties should arise over classification of line items since the required line items are aligned with the categories of assets and liabilities discussed in FRS 102. The line items required in adapted formats and some application issues on classification are discussed at 4.1.3 to 4.1.14 below.

While line items (o) and (p) appear to combine liabilities and assets for current tax and deferred tax respectively, the assets will need to be shown separately from the liabilities. Deferred tax is always classified as non-current. Line item (q) for non-controlling interest (see 3.5 above) is only relevant where consolidated financial statements are prepared.

So far as is practicable, paragraphs 2 to 9A of the General Rules to the formats apply to the adapted formats. [1 Sch 1A(3), 1 Sch 1A(3)(LLP)].

Section 4 requires that the following sub-classifications of the line items presented must be disclosed either in the statement of financial position or in the notes: [FRS 102.4.2B]

- Property, plant and equipment in classifications appropriate to the entity
- Intangible assets and goodwill in classifications appropriate to the entity
- Investments, showing separately shares and loans
- Trade and other receivables showing separately amounts due from related parties, amounts due from other parties, prepayments and accrued income
- Inventories, showing separately, amounts of inventories:
 - Held for sale in the ordinary course of business
 - In the process of production for sale
 And
 - In the form of materials or supplies to be consumed in the production process or in the rendering of services
- Trade and other payables, showing separately amounts payable to trade suppliers, payable to related parties, deferred income and accruals
- And
 - Classes of equity, such as share capital, share premium, retained earnings, revaluation reserve, fair value reserve and other reserves

Requirements relating to additional line items, headings and subtotals and the ordering of items and aggregation of similar line items are set out in 3.4.2 above.

Other analyses of line items are specified by other sections of FRS 102 (refer to the relevant chapters of this publication) or by the Regulations (or LLP Regulations). These disclosures are not set out at 4.1 and 5.5 below (as they are covered in the relevant chapters of this publication), although some of the latter are highlighted at 4.2, 4.3 and 5.6 below in respect of the statutory formats.

The Regulations (and LLP Regulations) require supplementary information to be given in the notes to the accounts where statutory formats or the adapted formats are used. One complexity is that the information required sometimes refers to items found in the statutory formats (which may differ to the line items identified where the adapted formats are used). For example, the adapted formats do not refer to fixed assets, creditors: amounts falling due within one year, creditors: amounts falling due after more than one year, investments, land or buildings, or turnover. A UK company (or an LLP) using adapted formats in Companies Act accounts (non-IAS accounts, for an LLP) will, therefore, need to identify which of its assets, liabilities, revenue streams need to be included in the required disclosures. While the classification of non-current assets and current assets used in adapted formats differs to the fixed assets and current assets classification required in statutory formats, the statutory definition of 'fixed assets' (see 4.2.2 below) is relevant for the purposes of disclosures in respect of fixed assets in the Regulations (and the LLP Regulations).

In addition, the Regulations (and the LLP Regulations) frequently require analyses and reconciliations to be given for Arabic-numbered sub-headings in the statutory balance sheet formats. As noted above, adapted formats require various sub-classifications to be presented in the statement of financial position or notes to the financial statements. The statutory disclosures are often required for items which are combined in the balance sheet or profit or loss account in order to facilitate assessment of the state of affairs or profit or loss. Examples are the reconciliation of movements in fixed assets, or the reconciliation of movements in reserves (discussed at 6.1.1 below). In the first example, the disclosure overlaps with the reconciliations of the carrying amounts of certain assets required by FRS 102, but the Regulations (and the LLP Regulations) require separate fixed asset reconciliations for cost and cumulative provision for depreciation and diminution. See 4.2.2 below.

4.1.1 Definition of current and non-current assets (adapted formats only)

Periods commencing prior to 1 January 2027

The definitions of current and non-current assets discussed below apply only where an entity chooses to use adapted formats in accordance with paragraph 1A(1) of Schedule 1 to the Regulations (or paragraph 1A(1) of Schedule 1 to the LLP Regulations).

FRS 102 defines non-current assets. Current assets are the assets of the entity which are not non-current assets (i.e., the residual). [FRS 102 Appendix I]. This differs to IAS 1/IFRS 18 which defines current assets and non-current assets are the residual. [IAS 1.66, IFRS 18.99].

Non-current assets are defined in the FRS 102 Glossary as: Assets of the entity which: [FRS 102 Appendix I]

(a) it does not expect to realise, or intend to sell or consume, in its normal operating cycle (see 4.1.1.A below)

(b) it does not hold primarily for the purpose of trading (see 4.1.1.B below)

(c) it does not expect to realise within 12 months after the reporting period

Or

(d) are cash or cash equivalents restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

The adapted formats require that deferred tax assets are always classified as non-current. [FRS 102.4.2A(p)].

'Cash or cash equivalents' are defined in the FRS 102 Glossary and should be interpreted in a manner consistent with Section 7 (see Chapter 7 at 3.2).

IAS 1/IFRS 18 require an entity to classify an asset as current if it meets any of the conditions in (a) to (d) of paragraph 66 of IAS 1 or paragraph 99 of IFRS 18 respectively. The conditions in (a) to (d) above of FRS 102's definition of 'non-current assets' are broadly the converse of the conditions in (a) to (d) in IAS 1/IFRS 18's definition of a current asset.

FRS 102 provides no additional guidance beyond the definitions of current and non-current assets above. However, since the intention is to provide a format more aligned with IAS 1/IFRS 18, management may consider, as permitted by the hierarchy in Section 10, the requirements of IAS 1/IFRS 18 for further guidance. The guidance presented at 4.1.1.A to D below refers to IAS 1/IFRS 18's requirements, where appropriate. The current portion of non-current financial assets would be classified as current, consistent with IFRS. [IAS 1.68, IFRS 18.B95].

FRS 102 (2026) amendments for periods commencing after 1 January 2027

In February 2026, the FRC published the FRS 102 (2026) amendments, to reflect the replacement of IAS 1 with IFRS 18. The amendments align the definition of current assets (in relation to adapting the balance sheet formats) with IFRS Accounting Standards, where the current assets are now defined and the non-current assets are the residual (see 9.2 below). Entities may early adopt the FRS 102 (2026) amendments provided both definitions and associated guidance are adopted at the same time and there is disclosure of early adoption.

4.1.1.A Operating cycle

Item (a) of the definition of non-current assets above distinguishes between current and non-current based on the length of the normal operating cycle. The concept of 'operating cycle' is not further explained in FRS 102 but IAS 1/IFRS 18 states that "the operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months." [IAS 1.68, IFRS 18.B95]. IAS 1/IFRS 18 does not provide any further guidance on how to determine if an entity's operating cycle is 'clearly identifiable'. In some businesses, the time involved in producing goods or providing services varies significantly from one customer project to another. In such cases, it may be difficult to determine what the normal operating cycle is. Management must consider all facts and circumstances and use judgement to determine whether it is appropriate to consider that the operating cycle is clearly identifiable, or whether the twelve months default is to be used.

IAS 1/IFRS 18 further explains that when an entity supplies goods or services within a clearly identifiable operating cycle, separate classification of current and non-current assets and liabilities in the statement of financial position provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in long-term operations. It also highlights assets that are expected to be realised within the current operating cycle, and liabilities that are due for settlement within the same period. [IAS 1.62, IFRS 18.B90].

Current assets, therefore, include assets (such as inventories and trade receivables) that are sold, consumed or realised as part of the normal operating cycle even when they are not expected to be realised within twelve months after the reporting period. [IAS 1.68, IFRS 18.B95].

4.1.1.B Held for the purpose of trading

Current assets include assets held primarily for the purpose of trading, for example, some financial assets classified as trading in accordance with IFRS 9 - *Financial Instruments* or IAS 39 - *Financial Instruments: Recognition and Measurement*, where these standards are applied to the recognition and measurement of financial instruments.

However, consistent with IFRS practice, a classification as 'held for trading' (e.g., as required for a derivative that is not hedge accounted) does not necessarily mean the financial asset is 'held for the purpose of trading' for the purposes of current/non-current classification.

4.1.1.C Assets previously classified as non-current but subsequently held for sale

FRS 102 does not include the concept in IFRS of non-current assets and disposal groups held for sale, and the adapted formats, therefore, do not require separate presentation for such items.

FRS 102 does not address whether items such as property, plant and equipment should be reclassified as current if expected to be realised within twelve months after the reporting period.

How we see it

In our view, an entity must present property, plant and equipment which is expected to be realised within 12 months after the reporting period separately within current assets. Property, plant and equipment not expected to be disposed of within 12 months is classified as non-current.

An entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others, must transfer such assets to inventory when they cease to be rented and become held for sale, consistent with IFRS requirements. [IAS 16.68A]. See Chapter 20 at 3.9.

4.1.1.D Post-employment benefits

The question arises as to whether a current/non-current analysis needs to be made for defined benefit plan net asset balances. IAS 19 - *Employee Benefits* - does not specify whether such a split should be made, on the grounds that it may sometimes be arbitrary. [IAS 19.133, IAS 19.BC.200]. In practice, few, if any, IFRS reporters make this split.

How we see it

Where the same concern over the arbitrary nature of a split arises, in our view, FRS 102 reporters may follow the practice of some IFRS reporters and present such balances as non-current.

4.1.2 Definitions of current liabilities and non-current liabilities (adapted formats only)

Periods commencing prior to 1 January 2027

For periods commencing prior to 1 January 2027, the definition of current liabilities is as follows:

Current liabilities are defined as liabilities of the entity which:

- (a) It expects to settle in its normal operating cycle (see 4.1.2.A below)
- (b) It holds primarily for the purpose of trading (see 4.1.2.B below)
- (c) Are due to be settled within 12 months after the reporting period (see 4.1.2.C below)

Or

- (d) It does not have an unconditional right to defer settlement for at least 12 months after the reporting period (see 4.1.2.D below)

Meeting any one of (a) to (d) leads to the liability being required to be classified as current.

The adapted formats also require that deferred tax liabilities are always classified as non-current.

[FRS 102.4.2A(p)].

Non-current liabilities are "liabilities of the entity which are not current liabilities", in other words they are the residual, once current liabilities have been identified. [FRS 102 Appendix I].

FRS 102 (2026) amendments for periods commencing after 1 January 2027 (see 9.2 below)

For periods commencing after 1 January 2027, the definition of current liabilities has been updated by the FRS 102 (2026) amendments to align fully with the definition in IAS 1/IFRS 18. Specifically, 'unconditional' has been removed from the definition, so that the final part of the definition is as follows: "liabilities of the entity... for which it does not have the right at the end of the reporting period to defer settlement for at least 12 months after the reporting period".

This follows the precise wording of amendments to IAS 1 made by the IASB in 2020 and 2022 to reconcile apparent contradictions between the former wording which referred in places to an 'unconditional right' and in others to 'expects' and 'discretion'. The impact of the amended wording is discussed in 4.1.2.D below.

The FRS 102 (2026) amendments also introduce guidance in respect of each element of the definition of 'current liabilities', in a manner consistent with the requirements of IAS 1 and IFRS 18. Further discussion is set out in 4.1.2.A to 4.1.2.C below.

4.1.2.A Operating cycle

The concept of 'operating cycle' is explained at 4.1.1.A above.

FRS 102 (2026) amendments/IAS 1/IFRS 18 explain that some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the normal operating cycle and are classified as current liabilities, even if they are due to be settled more than twelve months after the reporting period. The same normal operating cycle applies to the classification of an entity's assets and liabilities and when not clearly identifiable, is assumed to be twelve months.

[FRS 102(2026).4A.9, IAS 1.70, IFRS 18.B96].

4.1.2.B Held for the purpose of trading

Current liabilities include assets held primarily for the purpose of trading, for example, some financial liabilities classified as trading in accordance with IAS 39 or IFRS 9.

However, consistent with IFRS practice, a classification as 'held for trading' (e.g., as required for a derivative, that is not hedge accounted) does not necessarily mean the financial liability is 'held for the purpose of trading' for the purposes of current/non-current classification.

4.1.2.C Due for settlement within 12 months

Some current liabilities are not settled as part of the normal operating cycle but are due for settlement within twelve months after the end of the reporting period. Examples given by the FRS 102 (2026) amendments/IAS 1/IFRS 18 include bank overdrafts, the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables.

Financial liabilities that provide financing on a long-term basis (i.e., are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the end of the reporting period are non-current liabilities. *[FRS 102(2026).4A.10, IAS 1.71, IFRS 18.B97].* As explained at 4.1.2.D below, there must be an unconditional right, as at the end of the reporting period, to defer settlement for at least twelve months thereafter, in order for a liability to be reported as non-current.

4.1.2.D No unconditional right to defer settlement

As set out in 4.1.2 above, since the application of amendments to IAS 1 for periods commencing on or after 1 January 2024, the definitions of 'current liabilities' in FRS 102 and IAS 1/IFRS 18 have not wholly aligned. Specifically, in IAS 1/IFRS 18, the criterion in (d) in 4.1.2 above no longer refers to an 'unconditional' right to defer settlement for at least 12 months after the reporting period, but simply to a 'right to defer'. Additional guidance has been added to IAS 1/IFRS 18 to illustrate the application of the 'right to defer' in the context of liabilities arising from loan arrangements which are subject to covenants. However, in February 2026, the FRC published the FRS 102 (2026) amendments, which have aligned the definitions and the requirements for the classification of loan arrangements with covenants to those in IAS 1 and IFRS 18 (see 9 below).

While the definition of a current liability in FRS 102 differs from that in IAS 1/IFRS 18 for the period between the amendments to IAS 1 (effective 1 January 2024) and the publication of the FRS 102 (2026) amendments (effective 1 January 2027), the FRC did not intend the definitions to diverge. We note that past practice indicates that some preparers had applied the same criteria as those in IAS 1 as amended, ignoring the conditionality inherent in a covenant.

Early adoption of the FRS 102 (2026) amendments is permitted, provided that the amendments relating to the classification of both current and non-current assets and liabilities are adopted simultaneously. This issue is expected to be transitional in nature and will cease to arise for periods beginning on or after 1 January 2027, when the amended classification requirements in FRS 102 are effective.

The FRS 102 (2026) amendments/IAS 1/IFRS 18 clarify that a right to defer settlement of a liability for at least twelve months must have substance and must exist at the end of the reporting period. [IAS 1.72A, IFRS 18.B99]. Often, an entity's right to defer settlement of a loan liability for at least twelve months after the reporting period is subject to the entity complying with certain conditions in the loan arrangements. Those conditions are described as covenants. For the purposes of applying the classification criterion of whether a right to defer exists, such covenants affect whether the right exists at the end of the reporting period, if the entity is required to comply with the covenant *on or before* the end of the reporting period. This is the case, even if compliance with the covenant is assessed after the reporting period. If, however, a covenant is only required to be complied with *after* the reporting period end, such a covenant is ignored for classification purposes. [FRS 102(2026).4A.13, IAS 1.72B, IFRS 18.B100(b)]

The guidance above is framed only in terms of loan arrangements and therefore other liabilities not constituting loan arrangements would need to be assessed, according to their individual facts and circumstances, to see if there is a basis for concluding that there is a right to defer settlement for at least twelve months after the reporting period end. [FRS 102(2026) Appendix I, IAS 1.69 (d), IFRS 18.101(d)].

The FRS 102 (2026) amendments/IAS 1/IFRS 18 further explain that liabilities would be non-current if an entity has the right, at the end of the reporting period, to roll over an obligation for at least twelve months after the period end under an existing loan facility, even if it would otherwise be due within a shorter period. However, if no such right exists at the end of the reporting period, the entity does not consider the potential to refinance the obligation and consequently classifies the obligation as current.

[FRS 102(2026).4A.14, IAS 1.73, IFRS 18.B101].

Under the FRS 102 (2026) amendments/IAS 1/IFRS 18, if a liability is due to be settled within 12 months after the end of the reporting period, but the entity has a right under the arrangement to roll the loan over for an extended period, the loan is classified as non-current. [FRS 102(2026).4A.14, IAS 1.73, IFRS 18.B101].

How we see it

A rollover right may exist in conjunction with a future covenant, such that the latter is to be tested before the right to roll over may be exercised. In such a case, we believe the covenant must be assessed under paragraph 4A.13 of FRS 102 (as amended in February 2026), paragraph 72B of IAS 1 or paragraph B100 of IFRS 18, separately from the rollover right assessed under paragraph 4A.14 of FRS 102 (as amended in February 2026) paragraph 73 of IAS 1 or paragraph B101 of IFRS 18. Thus, the loan is classified as non-current, unless there are other circumstances unrelated to the covenant that impact the classification assessment.

The liability is classified as non-current if the lender agreed by the period end to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment. [FRS 102(2026).4A.16, IAS 1.75, IFRS 18.103].

Conditions of breach or default at the end of the reporting period may, however, be material for disclosure in the financial statements (even if no specific disclosure applies), whether adapted formats or statutory formats are applied. A breach or default arising (or its rectification) after the end of the reporting period, while not one of the examples specifically listed in Section 32 *Events after the End of the Reporting Period*, may be a material post-balance sheet event requiring disclosure (see Chapter 34 at 3.3.1) [FRS 102.32.10, FRS 102.32.11], and may also be relevant to the going concern assessment and related disclosures (see 8.3 below).

It is important to note that management intention does not play a role in the classification of liabilities. Thus a liability meeting the definition of non-current liabilities will still be classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period, or even if the liability is settled between the end of the reporting period and the date the financial statements are authorised for issue. [FRS 102(2026).4A.17, IAS 1.75A, IFRS 18.104]. Although not explicitly required in FRS 102, it may still be appropriate to disclose information relating to the timing of the settlement in order for users of the financial statements to understand the impact of the liability on the entity's financial position. [IAS 1.75A, IFRS 18.104]. The requirement to ignore management intent in respect of classification may represent a change in practice for some entities, as previous practice may have taken into account management's expectations and the discretion afforded to management.

The FRS 102 (2026) amendments/IAS 1/IFRS 18 also set out the meaning of the 'settlement' of a liability. In the context of the FRS 102 (2026) amendments/IAS 1/IFRS 18, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. [FRS 102(2026).4A.18, IAS 1.76A, IFRS 18.B107]

Settlement by way of an entity's own equity instruments is an example of settlement that impacts the classification of a liability. A single situation is outlined in which the terms of a liability include an option held by the counterparty to trigger settlement by way of an entity's own equity instruments. If that option is separately classified by the entity as an equity instrument then in that case only, the option is ignored for classification purposes. [FRS 102(2026).4A.19, IAS 1.76B, IFRS 18.B108].

Were it not for this exception, any liability with an option held by the counterparty to settle in an entity's own equity instruments would automatically have to be classified as current, as there would be no right to defer settlement for at least 12 months after the reporting period end. The FRS 102 (2026) amendments/IAS 1/IFRS 18 clarify that the exception is limited to instruments where the option is classified as an equity instrument, recognised separately from the liability as an equity component of a compound financial instrument. Under these requirements, the transfer of equity instruments constitutes a settlement event for any obligation to transfer equity instruments classified as a liability. The requirement may change practice for certain entities because it had been perceived by some to be applicable to all convertible instruments.

Illustration 4-1 below illustrates the operation of the above requirements.

Illustration 4-1: Determining whether liabilities should be presented as current or non-current

Scenario 1

An entity has a long-term loan arrangement containing a debt covenant. The specific requirements in the debt covenant have to be met as at 31 December every year. The loan is due in more than 12 months. The entity breaches the debt covenant at or before the period end. As a result, the loan becomes payable on demand.

Scenario 2

Same as scenario 1, but the lender agreed not to demand repayment as a consequence of the breach. This agreement from the lender is obtained:

- (a) at or before the period end and is for a period of more than 12 months after the period end
- (b) at or before the period end and is for a period of less than 12 months after the period end
- (c) after the period end but before the financial statements are authorised for issue

Scenario 3

An entity has a long-term loan arrangement containing a debt covenant. The specific requirements in the debt covenant must be met quarterly. The loan is due in more than 12 months. At the period end, the debt covenants are met. However, circumstances change unexpectedly and the entity breaches the debt covenant after the period end but before the financial statements are authorised for issue.

As discussed at Chapter 15 at 4.1.2.E, Section 11 (subject to any exemption taken under the reduced disclosure framework in individual accounts of a qualifying entity) requires the following disclosures for any loans payable recognised at the reporting date, for which there is a breach of terms or default of principal, interest, sinking fund, or redemption terms that has not been remedied by the reporting date:

- Details of that breach or default.
 - The carrying amount of the related loans payable at the reporting date .
- And
- Whether the breach or default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue. [FRS 102.1.8, FRS 102.1.12(c), FRS 102.11.47].

The table below sets out whether debt is to be presented as current or non-current and whether the Section 11 disclosures above are required.

	Scenario	Scenario	Scenario	Scenario	Scenario
	1	2(a)	2(b)	2(c)	3
At the period end, does the entity have an unconditional right to defer the settlement of the liability for at least 12 months?	no	yes	no	no	yes
Classification of the liability	current	non-current	current	current	non-current
Are the above Section 11 disclosures required?	yes	no	yes	yes	no

4.1.2.E Post-employment benefits

Refer to the discussion at 4.1.1.D above. Where the same concern over the arbitrary nature of a split arises, FRS 102 reporters are able to follow the practice of some IFRS reporters and report such balances as non-current.

4.1.3 Property, plant and equipment

Where adapted formats are used, FRS 102 requires that sub-classifications of property, plant and equipment that are appropriate to the entity are presented, either in the statement of financial position or in the notes. [FRS 102.4.2B(a)].

4.1.4 Investment property

Investment property carried at fair value through profit and loss is required to be presented as a separate line item in the statement of financial position in adapted formats, (see Figure 4-1 at 4.1 above) as set out in Section 4. [FRS 102.4.2A(b)]. Section 20 also requires right-of use assets which meet the definition of investment property to be presented as investment property in the statement of financial position [FRS 102.20.75]. Investment property held by the entity and rented to another group entity is permitted to be either accounted for at fair value through profit or loss or to be transferred to property, plant and equipment and accounted for using the cost model in Section 17. In the latter case, the investment property is presented as part of property plant and equipment and not within investment property. [FRS 102.17.30A].

4.1.5 Right-of-use assets and lease liabilities (lessee presentation)

Right-of-use assets are required to be presented either separately in the statement of financial position or together with the corresponding owned assets, with disclosure of the line item in the statement of financial position that includes right-of-use assets, as set out in section 20. [FRS 102.20.74].

Right-of-use assets that meet the definition of investment property are presented as investment property (see above 4.1.4). [FRS 102.20.75].

Lease liabilities are presented either separately from other liabilities or together with other liabilities with disclosure of the line item in the statement of financial position that includes the lease liabilities. [FRS 102.20.74].

See Illustration 4-2 in 4.1.15 below for an example of the adapted format where right-of-use assets and lease liabilities are shown as separate line items.

Lease-related depreciation and lease-related interest expense are presented separately (i.e., lease-related depreciation and lease-related interest expense cannot be combined) in the statement of comprehensive income. Interest expense on the lease liability must be presented within finance costs. [IFRS 16.49]. These presentation requirements are valid for both adapted and statutory formats. For further discussion of the presentation of leases for lessees refer to Chapter 23 at 6.7.

4.1.6 Intangible assets

Where adapted formats are used, FRS 102 requires that sub-classifications of intangible assets and goodwill appropriate to the entity are presented, either in the statement of financial position or in the notes. [FRS 102.4.2B(b)].

4.1.6.A Goodwill and negative goodwill

FRS 102 does not specify that positive goodwill is shown as a separate line item in the statement of financial position in adapted formats but requires that sub-classifications of intangible assets and goodwill appropriate to the entity are presented, either in the statement of financial position or in the notes. [FRS 102.4.2A, FRS 102.4.2B(b)].

Goodwill does not strictly fall within the definition of an intangible asset since it is not identifiable; in practice it is observed that many entities disclose positive goodwill, if material, separately in the statement of financial position, applying the requirements to present additional line items, where it is relevant to an understanding of the entity's financial position. [FRS 102.4.3]. Moreover, presentation of goodwill in the statement of financial position does appear to be implied by the requirements in Section 19 - *Business Combinations and Goodwill*. Where negative goodwill arises, FRS 102 requires that it to be separately disclosed in the statement of financial position, immediately below positive goodwill, and followed by a subtotal of the net amount of the positive goodwill and the excess. [FRS 102.19.24(b)]. See Chapter 22 at 3.9.3.

4.1.7 Financial assets and financial liabilities

FRS 102 requires the following line items to be presented in the statement of financial position (see Figure 4-1 at 4.1 above): [FRS 102.4.2A]

- (d) Financial assets (excluding items shown under (e), (f), (j) and (k) below) (see Chapter 15)
- (e) Investments in associates (see Chapter 17)
- (f) Investments in jointly controlled entities (see Chapter 18)
- (j) Trade and other receivables
- (k) Cash and cash equivalents (see Chapter 7)
- (l) Trade and other payables

And

- (n) Financial liabilities (excluding items shown under (l) and (m - provisions)) (see Chapter 15)

'Cash or cash equivalents' are defined in the FRS 102 Glossary and should be interpreted in a manner consistent with Section 7 (see Chapter 7).

FRS 102 only permits investments in associates and investments in jointly controlled entities to be accounted for using the equity method in consolidated financial statements and requires them to be presented as separate line items when using adapted formats in those financial statements. FRS 102 also requires investments in associates and jointly controlled entities to be presented as separate line items in individual financial statements (when the investments are presented at either cost less impairment or fair value). This is in contrast to IAS 1/IFRS 18, which only requires associates and joint ventures accounted for using the equity method to be presented in aggregate on the balance sheet and does not require separate presentation on the balance sheet of associates and joint ventures not accounted for under the equity method.

Where adapted formats are used, FRS 102 requires further sub-classifications to be disclosed, either in the statement of financial position or in the notes, for the following line items: [FRS 102.4.2B(c), FRS 102.4.2B(d), FRS 102.4.2B(f)]

- (a) Investments, showing separately shares and loans
- (b) Trade and other receivables, showing separately amounts due from related parties (see Chapter 35 at 3.1), amounts due from other parties, prepayments and accrued income

And

- (c) Trade and other payables, showing separately amounts payable to trade suppliers, payable to related parties, deferred income and accruals

4.1.8 Biological assets

Where adapted formats are applied, an entity must present separately in the statement of financial position: [FRS 102.4.2A(g), FRS 102.4.2A(h)]

- Biological assets carried at cost less accumulated depreciation and impairment
- And
- Biological assets carried at fair value through profit and loss

4.1.9 Inventories

Where adapted formats are used, FRS 102 requires that inventories are shown in the statement of financial position. [FRS 102.4.2A(i)].

An analysis of inventories, sub-classified between (a) to (c) below, is disclosed either in the statement of financial position or in the notes. [FRS 102.4.2B(e)].

FRS 102 defines inventories as:

Extract from FRS 102

Appendix I	Assets:
	(a) held for sale in the ordinary course of business;
	(b) in the process of production for such sale; or
	(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

4.1.10 Provisions

Current and non-current provisions are reported as separate classifications in adapted formats, in contrast to balance sheet statutory formats, where there is a single line item for provisions for liabilities.

4.1.11 Current tax

Liabilities and assets for current tax must be shown as separate line items in the statement of financial position, classified as appropriate as current or non-current.

FRS 102 includes rules on offset of current tax assets and liabilities (see Chapter 31 at 11.1.1). [FRS 102.29.24].

4.1.12 Deferred tax

Deferred tax assets and liabilities must be shown as separate line items in the statement of financial position, but always classified as non-current. [FRS 102.4.2A].

FRS 102 includes rules on offset of deferred tax assets and liabilities (see Chapter 31 at 11.1.1). [FRS 102.29.24A].

Certain of the statutory disclosures in the Regulations (and LLP Regulations) may cause complexity because under the statutory formats, deferred tax is included as a line item within provisions. In particular, UK companies preparing Companies Act accounts must state the provision for deferred tax separately from any other tax provisions and reconcile movements in deferred tax (as it is a line item under provisions). [1 Sch 59, 1 Sch 60, 1 Sch 57(LLP), 1 Sch 58(LLP)]. See 4.3.11 and 4.3.13.B below.

How we see it

In our view, the reconciliation of movements in deferred tax is also required where adapted formats are used, even though deferred tax is not shown as a provision in the balance sheet.

4.1.13 Equity

Equity attributable to the owners of the parent and to non-controlling interest (see 3.5 above) must be presented as separate line items within equity.

Where adapted formats are used, separate sub-classifications for classes of equity must be disclosed, either in the statement of financial position or in the notes. This includes items such as: share capital, share premium, retained earnings, revaluation reserve, fair value reserve and other reserves. [FRS 102.4.2B(g)].

In the statutory balance sheet formats, the amount of the revaluation reserve must be shown in the balance sheet under 'Capital and reserves'. [1 Sch 35(2)]. The adapted formats do not include the same headings as the statutory formats, but because of the requirement to give equivalent information to the statutory formats, it may be necessary to present this line item.

How we see it

In our view, the requirement to give equivalent information means that the revaluation reserve must be presented in the statement of financial position, along with other equity line items required by the statutory formats.

4.1.14 Other application issues

4.1.14.A Contract assets and contract liabilities

Contract assets and contract liabilities must be presented in the statement of financial position, split as necessary between current and non-current classification. [FRS 102.23.124].

4.1.14.B Assets and disposal groups held for sale

FRS 102 does not include a concept of assets and disposal groups held for sale, comparable to that in IFRS 5 - *Non-current Assets Held for Sale and Discontinued Operations*.

FRS 102, therefore, does not require an entity to present a non-current asset classified as held for sale or the assets of a disposal group held for sale separately from other assets in the statement of financial position, nor the liabilities of a disposal group held for sale separately from other liabilities in the statement of financial position. [IFRS 5.38, IAS 1.54, IFRS 18.103].

How we see it

The absence of the concept of 'held for sale' in FRS 102 does not preclude entities presenting additional analysis in the notes to the financial statements. However, we believe it would be inappropriate to present a classification in the statement of financial position that does not exist in the standard.

4.1.14.C Post-employment benefit assets and liabilities

FRS 102, like IFRS accounting standards, does not specify where in the statement of financial position a net asset or net liability in respect of a defined benefit plan should be presented, nor whether such balances should be shown separately in the statement of financial position or only in the notes. This is left to the judgement of the reporting entity, but FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position. [FRS 102.4.3]. Classification of post-employment benefit assets and liabilities as current or non-current is discussed at 4.1.1.D above.

Employers with more than one plan may find that some are in surplus while others are in deficit. The general rules in FRS 102 prohibit offsetting of such balances. [FRS 102.2.96]. Deferred tax is presented separately from defined benefit pensions balances.

See 4.3.13.D below for discussion of disclosures also relevant to a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts).

4.1.14.D Government grants

FRS 102 does not require government grants to be presented separately in the statement of financial position but does require disclosure of the nature and amounts of grants recognised in the financial statements. [FRS 102.24.6(b)]. Some grants may be received in advance of the performance-related conditions being met. In this case, grants relating to the performance model (see Chapter 26) must be recognised as a liability. [FRS 102.24.5B(c)]. Where the accrual model is used, if part of a grant relating to an asset is deferred, it is recognised as deferred income and not deducted from the carrying amount of the asset. [FRS 102.24.5G]. FRS 102 does not address the presentation where a grant accounted for under the accrual model has been received but does not yet meet the recognition criteria.

How we see it

It would generally be appropriate for a grant accounted for under the accrual model and which has not yet met the recognition criteria, to be presented as a liability, rather than as deferred income, consistent with the requirement for the performance model.

4.1.15 Illustrative statement of financial position (adapted formats)

Illustration 4-2 shows a statement of financial position using the adapted formats. This includes some additional line items to those listed in Figure 4-1 at 4.1 above. Situations when additional line items may be or are required to be presented are explained at 4.1 above.

Illustration 4-2: Illustrative statement of financial position (adapted formats)**XYZ GROUP - STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 201Y**

	£'000 201Y	£'000 201X
ASSETS		
Non-current assets		
Property, plant and equipment	85,050	69,423
Right of use assets	1,809	1,730
Investment property carried at fair value through profit or loss	20,080	19,560
Goodwill	78,003	91,200
Other intangible assets	65,270	78,000
Investments in associates	34,000	28,800
Investments in jointly controlled assets	38,050	-
Biological assets carried at cost	44,000	56,000
Deferred tax	10,563	9,765
	<u>376,825</u>	<u>354,478</u>
Current assets		
Inventories	45,080	28,333
Trade and other receivables	38,789	45,634
Contract assets	3,257	4,178
Cash and cash equivalents	31,200	56,445
	<u>118,326</u>	<u>134,590</u>
Total assets	<u>495,151</u>	<u>489,068</u>
Liabilities		
Trade and other payables	63,566	44,289
Contract liabilities	2,596	2,003
Current portion of long-term borrowings	50,000	50,000
Current portion of Lease liability	289	276
Financial liabilities - derivatives	10,200	5,436
Provisions	14,350	-
Total current liabilities	<u>141,001</u>	<u>102,004</u>
Non-current liabilities		
Deferred tax	39,679	46,555
Long-term borrowings	150,000	200,000
Lease liability	1,733	1,693
Financial liabilities - derivatives	20,789	18,423
Provisions	27,600	-
Defined benefit pension plan	66,341	81,977
Total non-current liabilities	<u>306,142</u>	<u>348,648</u>
Total liabilities	<u>447,143</u>	<u>450,652</u>
Net assets	<u>48,008</u>	<u>38,416</u>
EQUITY		
Share capital	12,075	10,000
Share premium	500	500
Revaluation reserve	3,300	3,100
Other reserves	5,976	(774)
Fair value reserve - cash flow hedges	1,899	2,524
Retained earnings	23,929	22,944
Equity attributable to owners of the parent	<u>47,679</u>	<u>38,294</u>
Non-controlling interests	<u>329</u>	<u>122</u>
Total equity	<u>48,008</u>	<u>38,416</u>

4.2 Statutory formats - format 1 Balance Sheet

The Regulations and the LLP Regulations provide a choice of two statutory formats for the balance sheet. Format 1 is a vertical format and is adopted by virtually all UK companies and LLPs. Format 2 presents assets separately from capital, reserves and liabilities and is rarely used. [1 Sch 1, 1 Sch 1 (LLP)].

This chapter discusses only the format 1 balance sheets applicable to companies (other than banking or insurance companies) and LLPs. This publication does not discuss the formats in Schedule 2 applicable to banking companies and groups. The formats in Schedule 3 applicable to insurance companies and groups are discussed in Chapter 38 at 8. See 3.1 and 3.2 above for discussion as to which formats apply to which types of entity.

Each of the headings and sub-headings denoted with a capital letter or Roman numeral, as set out in Figure 4-2 below, must be presented in the format 1 balance sheet for the individual accounts in the order and under the headings and sub-headings given. The format 1 balance sheet includes sub-headings, denoted with an Arabic number, which though shown in Figure 4-2, can be (and often are in practice) presented in the notes to the accounts. The General Rules to the formats (see 3.4 above) explain further the presentation of line items with an Arabic number. The individual line items in the format 1 balance sheet are discussed respectively at 4.3 below.

The line items in the formats need to be read together with the notes to the formats. [1 Sch 1, 1 Sch 1 (LLP)]. See 4.2.1 below for modification of the format 1 balance sheet for LLPs.

The modifications required to format 1 in a UK company's group accounts are:

- The identification of non-controlling interests (see 3.5 above).
And
- The sub-heading 'Participating interests' (item B III.3 in format 1) is replaced by 'Interests in associated undertakings' and 'Other participating interests' (see 4.3.4.D and 4.3.4.E below). [6 Sch 17, 6 Sch 20].

The General Rules to the formats (see 3.4 above) must be complied with.

Figure 4-2 Format 1 individual balance sheet (UK company other than a banking company or insurance company)

A	Called up share capital not paid*
B	Fixed assets
I	Intangible assets
	1 Development costs
	2 Concessions, patents, licences, trade marks and similar rights and assets
	3 Goodwill
	4 Payments on account
II	Tangible assets
	1 Land and buildings
	2 Plant and machinery
	3 Fixtures, fittings, tools and equipment
	4 Payments on account and assets in course of construction
III	Investments
	1 Shares in group undertakings
	2 Loans to group undertakings
	3 Participating interests**
	4 Loans to undertakings in which the company has a participating interest
	5 Other investments other than loans
	6 Other loans

	7	Own shares#
C		Current assets
	I	Stocks
	1	Raw materials and consumables
	2	Work in progress
	3	Finished goods and goods for resale
	4	Payments on account
	II	Debtors
	1	Trade debtors
	2	Amounts owed by group undertakings
	3	Amounts owed by undertakings in which the company has a participating interest
	4	Other debtors
	5	Called up share capital not paid*
	6	Prepayments and accrued income*
	III	Investments
	1	Shares in group undertakings
	2	Own shares
	3	Other investments
	IV	Cash at bank and in hand
D		Prepayments and accrued income*
E		Creditors: amounts falling due within one year
	1	Debenture loans
	2	Bank loans and overdrafts
	3	Payments received on account
	4	Trade creditors
	5	Bills of exchange payable
	6	Amounts owed by group undertakings
	7	Amounts owed to undertakings in which the company has a participating interest
	8	Other creditors including taxation and social security
	9	Accruals and deferred income*
F		Net current assets (liabilities)
G		Total assets less current liabilities
H		Creditors: amounts falling due after more than one year
	1	Debenture loans
	2	Bank loans and overdrafts
	3	Payments received on account
	4	Trade creditors
	5	Bills of exchange payable
	6	Amounts owed by group undertakings

	7	Amounts owed to undertakings in which the company has a participating interest
	8	Other creditors including taxation and social security
	9	Accruals and deferred income*
I		Provisions for liabilities
	1	Pensions and similar obligations
	2	Taxation, including deferred taxation
	3	Other provisions
J		Accruals and deferred income*
K		Capital and reserves**
	I	Called up share capital
	II	Share premium account
	III	Revaluation reserve
	IV	Other reserves
	1	Capital redemption reserve
	2	Reserve for own shares
	3	Reserves provided for by the articles of association
	4	Other reserves, including the fair value reserve
	V	Profit and loss account
* The notes to format 1 provide alternative positions for prepayments and accrued income, and accruals and deferred income, as sub-headings at C-II.6 (for prepayments and accrued income) and at E.9 and H.9 (for accruals and deferred income). Called up share capital not paid may also be shown at C-II.5.		
** Modifications required in group accounts (see discussion above Figure 4-2)		
# This presentation would not be consistent with FRS 102 which would show own shares as a deduction from equity. [FRS 102.22.16]		

An entity is required to present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position.

[FRS 102.4.3]. Judgement is needed in determining whether additional items should be presented, where material and relevant (see discussion, including relevant IAS 1/IFRS 18 guidance at 4.1 above). Any amendments would need to comply with the General Rules to the formats (see 3.4 above).

FRS 102, like IFRS accounting standards, has accounting requirements for various items that do not have separate line items in format 1, but which would be presented separately in the statement of financial position under IAS 1/IFRS 18. Such items include investment property, goodwill (under IFRS 18 only), financial assets, biological assets, cash and cash equivalents and deferred tax. FRS 102 generally requires separate disclosures of the amounts of these items in the notes to the financial statements (and sometimes requires reconciliations of the movements in the balances of such items). As noted above, FRS 102 requires additional line items to be presented in the statement of financial position where relevant to an understanding of the entity's financial position. So, for example, a property company may distinguish its investment property from other tangible fixed assets. The presentation of additional line items might require use of boxes and subtotals in order to comply with the balance sheet statutory formats.

4.2.1 Modifications of format 1 balance sheet for LLPs

The main headings in the format 1 balance sheet in the LLP Regulations differ to those in Figure 4-2 at 4.2 above in the following respects:

- A - Called up share capital is omitted so the main headings are A - Fixed Assets to I - Accruals and deferred income

- There is an additional item J - Loans and other debts due to members. The following amounts must be shown separately under this item - the aggregate amount of money advanced to the LLP by the members by way of loan, the aggregate amount of money owed to members by the LLP in respect of profits, and any other amounts

And

- In addition, K - Capital and reserves is replaced with K - Members' other interests (with sub-headings K.I - Members' capital, K.II - Revaluation reserve and K.III - Other reserves, including the fair value reserve)

The subheadings in format 1 for LLPs are generally similar to format 1 for companies (apart from referring to LLPs and differences related to above).

As explained at 4.2 above, the format 1 balance sheet includes sub-headings denoted with an Arabic number, which though shown in Figure 4-3, can be (and often are in practice) presented in the notes to the accounts.

Figure 4-3 Format 1 individual balance sheet (for an LLP)

A	Fixed assets
I	Intangible assets
1	Development costs
2	Concessions, patents, licences, trade marks and similar rights and assets
3	Goodwill
4	Payments on account
II	Tangible assets
1	Land and buildings
2	Plant and machinery
3	Fixtures, fittings, tools and equipment
4	Payments on account and assets in course of construction
III	Investments
1	Shares in group undertakings
2	Loans to group undertakings
3	Participating interests**
4	Loans to undertakings in which the LLP has a participating interest
5	Other investments other than loans
6	Other loans
B	Current assets
I	Stocks
1	Raw materials and consumables
2	Work in progress
3	Finished goods and goods for resale
4	Payments on account
II	Debtors
1	Trade debtors
2	Amounts owed by group undertakings
3	Amounts owed by undertakings in which the LLP has a participating interest
4	Other debtors

	5	Prepayments and accrued income*
III		Investments
	1	Shares in group undertakings
	2	Other investments
IV		Cash at bank and in hand
C		Prepayments and accrued income*
D		Creditors: amounts falling due within one year
	1	Debenture loans
	2	Bank loans and overdrafts
	3	Payments received on account
	4	Trade creditors
	5	Bills of exchange payable
	6	Amounts owed by group undertakings
	7	Amounts owed to undertakings in which the LLP has a participating interest
	8	Other creditors including taxation and social security
	9	Accruals and deferred income*
E		Net current assets (liabilities)
F		Total assets less current liabilities
G		Creditors: amounts falling due after more than one year
	1	Debenture loans
	2	Bank loans and overdrafts
	3	Payments received on account
	4	Trade creditors
	5	Bills of exchange payable
	6	Amounts owed by group undertakings
	7	Amounts owed to undertakings in which the LLP has a participating interest
	8	Other creditors including taxation and social security
	9	Accruals and deferred income*
H		Provisions for liabilities
	1	Pensions and similar obligations
	2	Taxation, including deferred taxation
	3	Other provisions
I		Accruals and deferred income*
SORP		Net assets attributable to members:
		Represented by:#
J		Loans and other debts to members
K		Members' other interests**
	I	Members' capital
	II	Revaluation reserve
	III	Other reserves, including the fair value reserve

- * The notes to format 1 provide alternative positions for prepayments and accrued income, and accruals and deferred income, as sub-headings at B-II.5 (for prepayments and accrued income) and at D.9 and G.9 (for accruals and deferred income).
- ** Modifications required in group accounts (see discussion below).
- # The LLP SORP requires a total for net assets attributable to members, and total members' interests (as a memorandum item) to be disclosed in the statement of financial position. [LLP SORP 58]. See Figure 4-4 below.

The modifications required to format 1 in group accounts are:

- The identification of non-controlling interests (see 3.5 above)
- And
- The sub-heading 'Participating interests' (item A.III.3 in format 1) is replaced by 'Interests in associated undertakings' and 'Other participating interests' (see 4.3.4.D and 4.3.4.E below) [3 Sch 17 (LLP), 3 Sch 20 (LLP)]

The LLP SORP provides further guidance on members' interests and application of the statutory formats for LLPs. The LLP SORP requires that the face of the statement of financial position shows a total for net assets attributable to members. In addition, total members' interests (being the total of 'loans and other debts due to members' and 'members' other interests', i.e., the amounts in items J and K in the statutory formats, less any 'amounts due from members' in debtors) must be disclosed as a memorandum item in the statement of financial position. [LLP SORP.58].

The SORP provides illustrative examples of LLP balance sheets (using statutory formats) for different situations (depending on whether the partnership interests are classified as equity or a liability or part equity/part liability). [LLP SORP.58, Appendix I]. In these illustrative examples, a subtotal labelled 'Net assets attributable to members' is drawn in the formats before items J and K and items J and K are then presented below this subtotal, as shown in Figure 4-4 below (the capital letters for the line items are not required to be shown but are presented for convenience below). As discussed at 4.1 above, as the LLP SORP also permits adapted formats to be used, this presentation will also be required where adapted formats are used.

LLPs with no equity, e.g., because of the classification of the partnership interests in the LLP, will not have items to report for 'members' other interests' in the balance sheet.

Detailed guidance on issues specific to LLPs is outside the scope of this chapter.

Figure 4-4 Presentation of LLP balance sheet (following SORP)

		£'000
.....		
	Net assets attributable to members	<u> x </u>
	Represented by:	£'000
J	Loans and other debts due to members within one year	
	Members' capital classified as liability	x
	Other amounts	<u> x </u>
		<u> x </u>
K	Members' other interests	
	Members' capital classified as equity	x
	Members' other interests - other reserves classified as equity	<u> x </u>
		<u> x </u>
		<u> x </u>
	Total members' interests	
	Amounts due from members	(x)
	Loans and other debts due to members	x
	Members' other interests	<u> x </u>
		<u> x </u>
Based on the example in Exhibit B of Appendix 1 of the LLP SORP for an LLP (with some equity)		

4.2.2 Fixed assets and current assets

The balance sheet statutory formats distinguish between fixed assets and current assets, defining 'fixed assets' with 'current assets' as the residual.

'Fixed assets' are assets of a company (or an LLP) which are intended for use on a continuing basis in the company's (or the LLP's) activities, and 'current assets' are assets not intended for such use. FRS 102 broadens the definitions to refer to 'an entity'. [10 Sch 4, 4 Sch 3 (LLP), FRS 102 Appendix I].

Current assets include all debtors, even if they are due after more than one year. However, if the amount of debtors due after more than one year is so material in the context of the total net current assets that readers may misinterpret the financial statements in the absence of disclosure of the debtors due after more than one year in the statement of financial position, the amount must be disclosed there within current assets. The standard expects this to be rare - in most cases, it will be satisfactory to disclose the amount due after more than one year in the notes to the financial statements. [FRS 102.4.4A].

Note (5) on the balance sheet formats in the Regulations (and the equivalent requirement for LLPs)³⁷ state that the amount falling due after more than one year must be shown separately for each item included under debtors.

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must disclose the following in the notes to the accounts, for *each* category of fixed assets shown in the balance sheet (or would be so shown, if Arabic-numbered line items were not combined as permitted by paragraph 4(2)(b) of the General Rules to the formats - see 3.4 above): [1 Sch 51, 1 Sch 49 (LLP)]

- The gross cost (based on the historical cost) or valuation (using the alternative accounting rules) at the beginning and end of the financial year
- The effects on the amounts shown for gross cost/valuation of:
 - Any revaluations of any assets made during the financial year
 - Acquisitions of any assets during the financial year
 - Disposals of any assets during the financial year
 And
 - Any transfers of assets (to and from that category) during the financial year
- The cumulative amount of provisions for depreciation or diminution in value at the beginning and end of the financial year
- The amount of any provisions for depreciation and diminution made in respect of the financial year
- The amount of any adjustments to such provisions arising from the disposal of any assets
- And
- The amount of any other adjustments in respect of such provisions for depreciation and diminution

How we see it

Where the Regulations (or LLP Regulations) require disclosures in respect of fixed assets or current assets, in our view, these disclosures need to be given where statutory formats or adapted formats are used.

The above statutory requirements overlap with FRS 102's requirements to provide reconciliations of changes in the carrying amounts for each class of property, plant and equipment [FRS 102.17.31(e)] (see Chapter 20 at 3.10.1); each class of intangible asset [FRS 102.18.27(e)] (see Chapter 21 at 3.4.2); goodwill and negative goodwill (separately) [FRS 102.19.26, FRS 102.19.26A] (see Chapter 22 at 4.2); investment property at fair value through profit or loss [FRS 102.16.10(e)] (see Chapter 19 at 4.3); and biological assets (separately for each class carried under the cost model and each class carried under the fair value model) [FRS 102.34.7(c), FRS 102.34.10(e)] (see Chapter 36 at 2.7 and 2.8).

The Regulations (and LLP Regulations) require separate fixed asset reconciliations for cost and cumulative provision for depreciation and diminution, whereas FRS 102 only requires reconciliation of the carrying amounts.

³⁷ LLPs - Note 3 on the balance sheet formats in Section B of Part 1 of Schedule 1 to LLP Regulations (SI 2008/1913).

Comparatives are not required for the reconciliations required by FRS 102, the Regulations (and LLP Regulations). This is because comparatives are specifically exempted under the equivalent reconciliation requirement in FRS 102 and the Regulations and LLP Regulations do not specify whether comparatives are required for notes disclosures. See 2.4 above.

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must also give additional disclosures in the notes to the accounts where the alternative accounting rules are applied - see 2 above.

4.2.3 Creditors: amounts falling due within one year and creditors: amounts falling due after more than one year

The Regulations (and LLP Regulations) distinguish between:

- Creditors: amounts falling due within one year
- And
- Creditors: amounts falling due after more than one year

These two line items are shown in the statement of financial position in the format 1 balance sheet. In distinguishing amounts between the two categories of creditor, the deciding factor is the earliest date of payment.

FRS 102 states that an entity shall classify a creditor as due within one year when the entity does not have an unconditional right, at the end of the reporting period, to defer settlement of the creditor for at least twelve months after the reporting date. For example, this would be the case if the earliest date on which the lender, exercising all available options and rights, could require repayment or (as the case may be) payment was within twelve months after the reporting date. [FRS 102.4.7].

FRS 102's requirements are intended to be consistent with the requirements in the Regulations (and LLP Regulations) which state that a loan or advance (including a liability comprising a loan or advance) is treated as falling due for repayment, and an instalment of a loan or advance is treated as falling due for payment, on the earliest date on which the lender could require repayment or (as the case may be) payment, if they exercised all options and rights available to them. [10 Sch 9, 4 Sch 6 (LLP)]. Without the full statutory definition, the final sentence of paragraph 7 of section 4 of the standard appears confusing because it is not clear why a distinction between repayment and payment is being made. This sentence is intended to illustrate when an entity does not have an unconditional right to defer settlement of the creditor (which must be assessed as at the end of the reporting period). A loan is not classified as a creditor: amounts falling due within one year merely because the company expects to repay within twelve months of the reporting date.

The FRS (102) 2026 amendments/IAS 1/IFRS 18 also includes detailed guidance on the impact of refinancing liabilities that management may consider, as permitted by the hierarchy in Section 10. IAS 1/IFRS 18 requires classification between current and non-current liabilities, which is a different determination. [IAS 1.69(d), IFRS 18 101(d)]. See 4.1.2.D above.

4.3 Application issues for statutory formats - format 1 balance sheet

In most cases, it will be straightforward to identify in which line items to present assets and liabilities in the format 1 balance sheet. The discussion in this section provides guidance on each heading and subheading included in the format 1 balance sheet and on the related notes on the balance sheet formats and the extracts shown relate to the statutory formats. Except where indicated, the line items required are the same for LLPs (although these may have different capital letter-Roman numeral-Arabic number references - see 4.2 above).

The notes on the balance sheet formats in Section B form part of the statutory formats for the balance sheet. Therefore, entities following the statutory formats must comply with the balance sheet format adopted, including the related notes on that format. This is the case even if the entity is not a UK company or LLP subject to those statutory requirements.

Where disclosures in the Regulations (or LLP Regulations) are discussed in this section, these are not intended to be comprehensive but to highlight additional disclosures *directly* related to a specific line item. The disclosures required for the line items in the notes to the accounts highlighted here are also required in the notes to the accounts where adapted formats are used (unless they relate to the notes on the balance sheet formats in Section B, as referred above). The disclosures highlighted do not cover all the related disclosures in the Regulations or LLP Regulations.

4.3.1 Called up share capital not paid

This line item can be presented in the position of Called up share capital not paid (item A) in the statement of financial position. Alternatively, this line item can be presented either in the statement of financial position or in the notes to the accounts as item 5 within Current assets - Debtors (C.II) (see 4.3.6.D below).³⁸

'Called up' share capital and 'paid up' share capital are explained at 4.3.12.A below. Called up share capital not paid can arise, for example, because calls made on the shares have not been paid, or where the share capital is 'paid up' because the amounts are payable on a specified future date under the articles or terms of allotment or other arrangement for payment of those shares. It is therefore called up share capital, even though it has not yet been settled. [s547].

4.3.2 Intangible assets

Figure 4-5 shows the analysis required in respect of intangible assets (in the statement of financial position or in the notes to the accounts - see 3.4 above) under format 1.

Figure 4-5 Analysis of intangible assets

B Fixed assets	
I	Intangible assets
1	Development costs
2	Concessions, patents, licences, trade marks and similar rights and assets
3	Goodwill
4	Payments on account

Intangible assets are not defined in the Regulations (or LLP Regulations); they include the line items listed in Figure 4-5 above, but FRS 102 financial statements must apply the more restrictive requirements of the standard (see 4.1.6 above and Chapter 21). The balance sheet format notes (and the equivalent requirement for LLPs)³⁹ state that amounts are only included in the balance sheet as concessions, patents, licences, trade marks and similar rights and assets if either the assets were acquired for valuable consideration and are not required to be shown under goodwill, or the assets in question were created by the company (or the LLP) itself. They⁴⁰ also state that amounts representing goodwill are only included to the extent that the goodwill was acquired for valuable consideration. Therefore, consistent with FRS 102, internally generated goodwill cannot be capitalised. [FRS 102.18.8C(f)].

The Regulations and LLP Regulations do not address the presentation of negative goodwill, but FRS 102's requirements on presentation of negative goodwill, which also apply to statutory formats, are addressed at 4.1.6.A above.

The format 1 balance sheet includes a line item for payments on account, i.e., advance payments made for intangible fixed assets.

FRS 102, the Regulations (and the LLP Regulations) require reconciliations of movements in intangible assets and comparatives are not required. FRS 102 requires reconciliations of changes in the carrying amounts to be given for each class of intangible asset, for goodwill, and for negative goodwill.

[FRS 102.18.27(e), FRS 102.19.26, FRS 102.19.26A]. See Chapter 21 at 3.4.2 and Chapter 22 at 4.2. See 4.2.2 above for the requirements for reconciliations of movements in fixed assets in the Regulations (and the LLP Regulations) for UK companies preparing Companies Act accounts (and LLP accounts preparing non-IAS accounts). These disclosures apply where statutory formats or adapted formats are used.

4.3.3 Tangible fixed assets

Figure 4-6 shows the analysis required (in the statement of financial position or in the notes to the accounts - see 3.4 above) in respect of tangible fixed assets under format 1. In practice, most UK companies relegate

³⁸ Note 1 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/410.

³⁹ LLPs - Note 1 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

⁴⁰ LLPs - Note 2 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

the sub-headings within tangible assets denoted by an Arabic number to the notes to the accounts, showing only the net book value of tangible assets in the statement of financial position.

Figure 4-6 Analysis of tangible fixed assets

B	Fixed assets
II	Tangible assets
1	Land and buildings
2	Plant and machinery
3	Fixtures, fittings, tools and equipment
4	Payments on account and assets in course of construction

The Regulations (and LLP Regulations) define fixed assets (see 4.2.2 above) but not tangible fixed assets. While FRS 102 does not define the term 'tangible assets', these differ from intangible assets in that they are assets 'with physical substance'.

The distinction between fixed assets and current assets is usually clear and the statutory definition is not normally interpreted to mean that individual assets are transferred to current assets when a decision to dispose of them has been made. See 4.3.13.C below.

The format 1 balance sheet includes a line item (which can be in the notes) for payments on account; these are advance payments made for tangible fixed assets.

Tangible fixed assets include property, plant and equipment, as defined in FRS 102. The definition of property, plant and equipment and some classification issues are discussed at 4.1.3 above and in Chapter 20. Investment property is also classified within tangible fixed assets in the statutory formats (see 4.3.3.A below).

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must also disclose, in the notes to the accounts, 'land and buildings' analysed between freehold land and leasehold land, with leasehold land analysed between land held on a long lease (meaning the unexpired term at the end of the financial year is not less than 50 years) and leasehold land held on a short lease (i.e., a lease that is not a long lease). [1 Sch 53, 10 Sch 7, 1 Sch 51 (LLP)]. This disclosure applies where adapted formats or statutory formats are used.

4.3.3.A Investment property

As noted at 4.3.3 above, investment property is included within tangible fixed assets in the statutory formats. The Regulations (and LLP Regulations) do not require presentation of investment property in the statement of financial position but do permit items to be shown in greater detail. FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position (see 3.4 above). Therefore, some entities may consider it appropriate to present investment property as a separate line item in the statement of financial position.

Chapter 19 at 3.1 explains the definition of investment property. Some property may have mixed use (e.g., partly owner-occupied and partly held for rental) which may be required to be split into components for investment property and property, plant and equipment. See Chapter 19 at 3.1.7 and Chapter 20 at 3.3.4. In the statutory formats, both components would qualify to be presented as tangible fixed assets. Nevertheless, such a split would be relevant for measurement and for the purposes of FRS 102's disclosures.

4.3.3.B Right-of-use assets (lessee presentation)

The General Rules (see 3.4 above) to the formats allow any item to be shown in a company's (or an LLP's) balance sheet in greater detail than required by the particular format used. Entities using statutory balance sheet formats may therefore choose to present right-of-use assets separately from other assets (as a separate sub-heading of fixed assets in the balance sheet), or within the same line item within which the corresponding underlying asset would be presented if they were owned (i.e., within the tangible or intangible (depending on the nature of the underlying asset) sub-headings in the balance sheet)).

[FRS 102.20.74(a)].

Respective lease liabilities are required to be distinguished between:

- Creditors: amounts falling due within one year

And

- Creditors: amounts falling due after more than one year

Thus, these two line items are required to be shown in the statement of financial position when the format 1 balance sheet is used by the company. Further separate disclosure in the notes to the accounts is expected.

Paragraph 74(b) of Section 20 of the standard requires that if the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities. [FRS 102.20.74(b)].

Section 4.1.5 above explains presentation of lease-related depreciation and lease related interest expenses in the statement of comprehensive income.

4.3.4 Investments

Figure 4-7 shows the analysis required in respect of investments in the statement of financial position or in the notes to the accounts - see 3.4 above under format 1.

Figure 4-7 Analysis of investments

B	Fixed assets
III	Investments
1	Shares in group undertakings
2	Loans to group undertakings
3	Participating interests†
4	Loans to undertakings in which the company has a participating interest
5	Other investments other than loans
6	Other loans
7	Own shares*
†	In group accounts, this line item is replaced by two items: 'Interests in associated undertakings' and 'Other participating interests'
*	Line item B.III.7 is not included in format 1 in the LLP Regulations. In addition, the equivalent line item to B.III.4 refers to an LLP rather than a company.
C	Current assets
III	Investments
1	Shares in group undertakings
2	Own shares*
3	Other investments
*	Line item C.III.2 is not included in format 1 in the LLP Regulations

4.3.4.A Current assets or fixed asset investments?

The format 1 balance sheet distinguishes between fixed asset and current asset investments. It is necessary to apply the general rule that a fixed asset is one which is 'intended for use on a continuing basis in the entity's activities' and a current asset is one not intended for such use (see 4.2.2 above). However, this is an unhelpful distinction for investments which, by their nature, are not intended for use in an entity's activities at all, whether on a continuing basis or not.

Current asset investments may include cash equivalents, meaning: short-term, highly liquid investments that are readily convertible to cash (i.e., cash on hand and demand deposits) and that are subject to an insignificant risk of changes in value. [FRS 102 Appendix I]. Examples of current asset investments that may qualify as cash equivalents, but do not fall within the statutory heading 'cash at bank and in hand', include investments in money market funds. Current asset investments may also include investments that do not qualify as cash equivalents but are still of a short-term nature, and investments held for trading purposes.

Investments in shares in subsidiaries or associates or trade investments will generally be fixed asset investments. Entities frequently make loans to subsidiaries or associates, which are often repayable on demand and management will need to exercise judgement in determining whether such loans are debtors or are a fixed asset investment in nature. For example, loan financing provided for the long-term, with no intention of repayment in the foreseeable future, may be more of a fixed asset investment in nature, even where the balance is strictly repayable on demand.

Discussion of the different sub-headings required to be shown for investments is included below. Amounts owed by group undertakings must not be offset with amounts owed to the same group undertaking or other group undertakings, where the offset criteria are not met. The same principle applies to balances with undertakings in which the entity has a participating interest. Offset is required when, and only when, the entity has both a currently legally enforceable right to set off the balances and an intention either to settle on a net basis, or to realise the asset and settle the liability simultaneously. [FRS 102.11.38A, FRS 102.12.25W].

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must disclose the following in the notes to the accounts:

- The amount of listed investments included in each line item under current asset or fixed asset investments shown in the statement of financial position (or would be so shown, if line items were not combined as permitted).
 - The aggregate market value of the listed investments, where this differs from their carrying amount in the financial statements.
- And
- Both the market value and the stock exchange value of any investments (where the market value is higher than the stock exchange value). [1 Sch 54, 1 Sch 52 (LLP)].

A listed investment is an investment which has been granted a listing on a recognised investment exchange other than an overseas investment exchange (both as defined in Part 18 of the Financial Services and Markets Act 2000) or a stock exchange of repute outside the UK. [10 Sch 8, 4 Sch 5 (LLP)]. A list of recognised investment exchanges (and recognised overseas investment exchanges) is available on the Financial Conduct Authority website. AIM is not a recognised investment exchange. This disclosure applies where adapted formats or statutory formats are used.

See 4.2.2 above for the requirements for reconciliations of movements in fixed assets in the Regulations/LLP Regulations for UK companies preparing Companies Act accounts and LLP accounts preparing non-IAS accounts. The question arises as to whether comparatives are required for these reconciliations.

How we see it

We consider that the general rules on comparatives in FRS 102 apply and that comparatives are required for the reconciliation of movements in fixed asset investments. This is because FRS 102 has no comparable disclosure requirement to reconcile movements in fixed asset investments and therefore, does not provide an exemption from comparatives, as it does for some reconciliations included in FRS 102.

These disclosures above apply whether statutory formats or adapted formats are used.

4.3.4.B Group undertakings, participating interests and associated undertakings

Schedule 6, dealing with Companies Act group accounts, replaces the line item 'participating interests', applicable to individual financial statements, with two line items, 'interests in associated undertakings' and 'other participating' interests'. [6 Sch 20]. The terms 'group undertakings', 'participating interests' and 'associated undertakings' are explained at 4.3.4.C to 4.3.4.E below.

FRS 102 does not require investments in associates and jointly controlled entities to be presented in the statement of financial position in either the individual or consolidated financial statements, where the statutory formats are used.

Disclosure of the carrying amount of investments in associates is required and, separately, the carrying amount of investments in jointly controlled entities. [FRS 102.14.12(b), FRS 102.15.19(b)]. This could be presented in the notes to the financial statements, although the standard requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position. [FRS 102.4.3].

All UK companies (and LLPs) must also comply with the extensive requirements of regulation 7 and Schedule 4 to the Regulations (and the equivalent requirements for LLPs)⁴¹ in relation to information about related undertakings. This information must be presented in full in the company's (or the LLP's) accounts. These requirements apply both to Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts.

4.3.4.C Group undertakings

A 'group undertaking' means a parent undertaking or subsidiary undertaking of the reporting entity, or a subsidiary undertaking of any parent undertaking (i.e., a fellow subsidiary undertaking) of the reporting entity. [s1161(5), s1161(5)(LLP)]. Parent and subsidiary undertakings are defined in section 1162 of CA 2006. [s1162, s1162 (LLP)]. See Chapter 3 at 3.1.2 and Chapter 8 at 3.2.

FRS 102 defines a subsidiary as an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The standard goes on to explain in what circumstances control exists or can exist. [FRS 102.9.4, FRS 102.9.5, FRS 102.9.6, FRS 102.9.6AJ]. These circumstances are similar but not identical to those included in the definition of a subsidiary undertaking under section 1162.

Although there are slight differences in wording emphasis between the definition of a subsidiary undertaking in section 1162 and the requirements of Section 9 - *Consolidated and Separate Financial Statements*, we would expect to see few conflicts arising in practice between Section 9 and CA 2006 (see Chapter 8 at 3.2).

4.3.4.D Participating interest

A 'participating interest' means an interest held by, or on behalf of, an undertaking (or in group accounts, by, or on behalf of, the parent and its consolidated subsidiary undertakings) in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities (or in group accounts, the consolidated group's activities) by the exercise of control or influence arising from or related to that interest.

A holding of 20% or more of the shares of the undertaking is presumed to be a participating interest unless the contrary is shown. An interest in shares of another undertaking includes an interest which is convertible into an interest in shares and an option to acquire shares or any such interest, even if the shares are unissued until the conversion or exercise of the option.

In the context of the statutory formats, 'participating interest' does not include an interest in a group undertaking (see 4.3.4.C above). [10 Sch 11, 4 Sch 8 (LLP)].

4.3.4.E Associated undertaking

An 'associated undertaking' is an undertaking in which an undertaking included in the consolidation:

- Has a participating interest (as defined at 4.3.4.D above) and over whose operating and financial policy it exercises a significant influence.
- And
- Which is not a subsidiary undertaking of the parent company or a joint venture dealt with in accordance with paragraph 18 of Schedule 6 to the Regulations (or the equivalent requirement for LLPs).⁴² The proportional consolidation permitted by paragraph 18 of Schedule 6 is not consistent with the requirements of FRS 102, as the standard requires an associate to be accounted for using the equity method in the parent's consolidated financial statements. [6 Sch 19, FRS 102.15.9A, FRS 102.15.9B].

An undertaking holding 20% or more of the voting rights in another undertaking is presumed to exercise a significant influence over it unless the contrary is shown. Voting rights mean the rights conferred on shareholders in respect of their shares (or where the undertaking does not have a share capital, on members) to vote at general meetings of the undertaking on all, or substantially all matters. Paragraphs 5 to 11 of Schedule 7 to CA 2006 apply in determining whether 20% or more of the voting rights are held. [6 Sch 19, 3 Sch 19 (LLP)].

The term 'associated undertaking' in the Regulations and LLP Regulations will generally include both an associate (see Chapter 17 at 3.1) and a jointly controlled entity (see Chapter 18 at 3.5 and Chapter 18 at 4), as defined under FRS 102. [FRS 102.14.2, FRS 102.14.3, FRS 102.15.8, FRS 102 Appendix I].

41 LLPs - Regulation 5 and Schedule 2 to SI 2008/1913.

42 LLPs - para. 18 of Schedule 3 to SI 2008/1913.

4.3.4.F Own shares

While 'own shares' have a sub-heading under investments in the balance sheet formats, FRS 102 requires investments in own shares to be treated as treasury shares and deducted from equity. [FRS 102.22.16]. Consequently, this line item will not be used under FRS 102. The format 1 balance sheet has an alternative position 'reserve for own shares' within the capital and reserves section which will be used under FRS 102 (see 4.3.12.G below).

4.3.5 Stocks

Figure 4-8 shows the analysis required in respect of stocks in the statement of financial position or in the notes to the accounts - see 3.4 above under format 1.

Figure 4-8 Analysis of stocks

C		Current assets
I		Stocks
	1	Raw materials and consumables
	2	Work in progress
	3	Finished goods and goods for resale
	4	Payments on account

The items reported under stocks in the balance sheet formats will generally correspond with inventories under FRS 102. See also 4.1.9 above and Chapter 16 at 3.1, which discuss certain classification issues in respect of inventories, including transfers to inventories from other categories of assets; these are also relevant to classification under format 1.

Note (8) on the balance sheet formats (and the equivalent requirement for LLPs)⁴³ state that payments received on account of orders must be shown within creditors in so far as they are not shown as deductions from stocks. We would not expect payments received on account to be deducted from stock (or inventory) as this would not meet the offset requirements of FRS 102, and therefore all payments received on account must be shown within creditors.

4.3.6 Debtors (including prepayments and accrued income)

Figure 4-9 shows the analysis required in respect of debtors in the statement of financial position or in the notes to the accounts - see 3.4 above under format 1.

⁴³ LLPs - Note 6 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

Figure 4-9 Analysis of debtors

C	Current assets
II	Debtors
1	Trade debtors
2	Amounts owed by group undertakings
3	Amounts owed by undertakings in which the company has a participating interest**
4	Other debtors
5	Called up share capital not paid*
6	Prepayments and accrued income*
* Format 1 provides alternative positions for called up share capital not paid at heading A and prepayments and accrued income at heading D. In format 1 in the LLP Regulations, called up share capital is omitted and the alternative position for prepayments and accrued income is at heading C (i.e., the same as heading D in the company balance sheet formats).	
** In format 1 in the LLP Regulations, amounts owed by undertakings in which the LLP has a participating interest.	

While all debtors are reported within current assets, debtors include amounts falling due within and amounts falling due after more than one year.

As discussed at 4.2.2 above, where the amount of debtors due after more than one year is so material in the context of total net current assets that, in the absence of disclosure of the debtors due after more than one year in the statement of financial position, the financial statements may be misinterpreted, the amount must be disclosed in the statement of financial position within current assets. In most cases, it will be satisfactory to disclose the amount due after more than one year in the notes to the financial statements.

[FRS 102.4.4A].

Note (5) on the balance sheet formats (and the equivalent requirement for LLPs)⁴⁴ state that the amount falling due after more than one year must be shown separately for each item included under debtors.

For a discussion of the presentation of contract assets, see 4.3.13.A below.

4.3.6.A Trade debtors

Trade debtors are generally amounts receivable from customers, e.g., relating to amounts invoiced to customers, as well as debit balances owed by suppliers. The amounts in trade debtors are stated net of any bad debt provisions or write offs, and the effects of credit notes and other rebates.

Care must be taken not to offset any debit balances in trade debtors with trade creditors (and *vice versa*) where the offset criteria are not met.

The separate line items for 'amounts owed by group undertakings' and 'amounts owed by undertakings in which the company/LLP has a participating interest' will include trade debtors due from group undertakings and participating interests respectively (see 4.3.6.B below).

4.3.6.B Amounts owed by group undertakings, and by undertakings in which the company has a participating interest

The line items 'amounts owed by group undertakings' and 'amounts owed by undertakings in which the company has a participating interest' include all amounts owed by such undertakings, e.g., loans regarded as current assets, dividends and interest receivable, trading items such as current accounts and balances with group treasury companies. The meanings of 'group undertaking' and 'participating interest' are discussed at 4.3.4.C and 4.3.4.D above.

As noted at 4.3.4.A above, management must exercise judgement in determining whether amounts owed by group undertakings or undertakings in which the entity has a participating interest are debtors or fixed asset investments. Again, if the offset criteria in FRS 102 are not met, intercompany debtors and creditors must not be offset.

⁴⁴ LLPs - Note 3 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

4.3.6.C Other debtors

This will cover debtors other than those identified in other line items, for example, amounts receivable from a sale of property, plant and equipment.

4.3.6.D Called up share capital not paid

The format 1 balance sheet permits called up share capital not paid to be presented either within debtors or in the position of line item A, i.e., in the statement of financial position (see 4.3.1 above).

4.3.6.E Prepayments and accrued income

Prepayments and accrued income can be presented either within debtors or as a separate line item in the statement of financial position (line item D).⁴⁵

Prepayments and accrued income are not defined in FRS 102 or the Regulations (or LLP Regulations). Prepayments arise where payments are made in advance of receiving goods or services and must meet the definition and recognition criteria of an asset, including recoverability, in FRS 102 (see Chapter 4 at 3.3.1). While FRS 102 prohibits the recognition as an intangible asset of certain types of expenditure (see Chapter 21), it does not preclude recognition of a prepayment where payment for goods or services is made in advance of the delivery of the goods or rendering of the services. [FRS 102.18.8D].

While the format 1 balance sheet combines prepayments and accrued income into one line item, these two items can have separate characteristics, and they differ in nature and liquidity. As noted at 3.4 above, the balance sheet formats allow any item to be shown in greater detail and FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position.

4.3.7 Cash at bank and in hand

The Regulations and LLP Regulations do not define cash at bank and in hand. Bank deposits with notice or maturity periods may or may not meet FRS 102's definition of 'cash' (i.e., cash on hand and demand deposits) or 'cash equivalents' (i.e., short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value). [FRS 102.7.2, FRS 102 Appendix I]. See Chapter 7 at 3.2.

The standard's requirements on offset of financial assets and financial liabilities are strict. Offset of a financial asset and liability is required when, and only when, an entity currently has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. [FRS 102.11.38A, FRS 102.12.25W]. There may be group arrangements with a bank (such as cash pooling arrangements) where there are rights of offset and the contractual terms and conditions, and how these operate in practice can vary widely. A right of offset alone is insufficient to meet the requirements on offset of financial assets and financial liabilities, if there is no intention to settle net. See Chapter 13 at 8.1.

4.3.8 Creditors: amounts falling due within one year and creditors: amounts falling due after more than one year

Figure 4-10 shows the analysis required in respect of creditors (in the statement of financial position or in the notes to the accounts - see 3.4 above) under format 1.

⁴⁵ Note 6 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/410. For LLPs, the alternative position is line item C (note 4 to the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913).

Figure 4-10 Analysis of creditors: amounts falling due within one year

E	Creditors: amounts falling due within one year
1	Debenture loans
2	Bank loans and overdrafts
3	Payments received on account
4	Trade creditors
5	Bills of exchange payable
6	Amounts owed to group undertakings
7	Amounts owed to undertakings in which the company has a participating interest**
8	Other creditors including taxation and social security
9	Accruals and deferred income*
H	Creditors: amounts falling due within one year
1	Debenture loans
2	Bank loans and overdrafts
3	Payments received on account
4	Trade creditors
5	Bills of exchange payable
6	Amounts owed to group undertakings
7	Amounts owed to undertakings in which the company has a participating interest**
8	Other creditors including taxation and social security
9	Accruals and deferred income*
* Format 1 provides an alternative position for accruals and deferred income, at heading J. In format 1 in the LLP Regulations, the alternative position for accruals and deferred income is at heading I (i.e., the same as heading J in the company balance sheet formats).	
** In format 1 in the LLP Regulations, amounts owed to undertakings in which the LLP has a participating interest.	

The same line items are required for creditors: amounts falling due within one year and creditors: amounts falling due after more than one year. See 4.2.3 above for discussion of these two categories of creditors.

In addition, the General Rules to the formats (see 3.4 above) require that, in determining how amounts are presented within items in the balance sheet, the directors of the company (or the members of the LLP) must have regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice. [1 Sch 9, 1 Sch 9 (LLP)]. This provision facilitates the presentation of shares (such as certain preference shares), which are required to be classified as liabilities under accounting standards, to be shown as creditors rather than as called up share capital under the balance sheet statutory format. See Chapter 13 at 4.1. Note, however, that disclosures required by the Regulations in the notes to the accounts in relation to share capital (see, for example, the disclosures listed in 4.4.2 below) still apply, even if the shares are classified as a liability.

The General Rules to the formats permit certain adaptations to the balance sheet formats, as well as permitting line items to be shown in greater detail. These adaptations are required if the special nature of the company's business makes it necessary. FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position; this may be appropriate for the analysis of creditors. For example, it may be appropriate to present preference shares classed as a liability and other items separately from other creditors.

UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) must state in the notes to the accounts, for the aggregate of all items shown under 'creditors' in the balance sheet, the aggregate of:

- (a) The amount of any debts included under 'creditors' which are payable or repayable otherwise than by instalments and fall due for payment or repayment after the end of the period of five years beginning with the day next following the end of the financial year.

And

- (b) For debts included under 'creditors' which are payable or repayable by instalments, the amount of any instalments which fall due for payment after the end of that period. [1 Sch 61, 1 Sch 59 (LLP)].

In relation to each debt which is taken into account in (a) or (b) above, the terms of payment or repayment and rate of any interest payable on the debt must be stated. If the number of debts is such that, in the opinion of the directors (or the members of the LLP), the statement required would be of excessive length, a general indication of the terms of payment or repayment and the rates of any interest payable on the debts can be given.

For each item shown under 'creditors' in the statement of financial position, the aggregate amount of any debts included under that item in respect of which any security has been given by the company (or by the LLP), and an indication of the nature and the form of the securities given must also be stated. [1 Sch 61, 1 Sch 59 (LLP)]. This disclosure applies to both adapted formats or statutory formats.

Where any outstanding loans made under the authority of section 682(2)(b), (c) or (d) of CA 2006 (various cases of financial assistance by a company for the purchase of its own shares) are included under any item shown in the company's statement of financial position, the aggregate amount of those items must be disclosed for each item in question. [1 Sch 64(2)]. This disclosure applies where adapted formats or statutory formats are used.

For a discussion of the presentation of contract liabilities, see 4.3.13.A below.

4.3.8.A Debenture loans

The format 1 balance sheet has separate line items for debenture loans and bank loans and overdrafts. Therefore, bank loans and overdrafts need to be shown separately, even if they might also qualify as a debenture loan.

Note (7) on the balance sheet formats (and the equivalent requirement for LLPs)⁴⁶ state that the amount of any convertible loans (within debenture loans) must be shown separately.

A 'debenture' is not defined in CA 2006, except that it is stated to include 'debenture stock, bonds and other securities of a company (LLP), whether or not constituting a charge on the assets of the company.' [s738, s738 (LLP)]. In general use, a 'debenture' is a term applying to any document evidencing a loan. For the purposes of the statutory formats, this would generally mean a debt instrument issued by the company (or the LLP) with a written loan agreement, and usually giving some form of security or charge over its assets, although this is not an essential feature.

UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) must make the following disclosures in the notes to the accounts: [1 Sch 50, 1 Sch 48 (LLP)]

- If the company (or the LLP) has issued any debentures during the financial year, the classes of debentures issued during the financial year, and for each class of debentures, the amount issued and consideration received by the company (or the LLP) for the issue.
- And
- Where any of the company's (or the LLP's) debentures are held by a nominee of or trustee for the company (or the LLP), the nominal amount of the debentures and the amount at which they are stated in the company's (or the LLP's) accounting records.

This disclosure applies for both adapted formats and statutory formats.

4.3.8.B Bank loans and overdrafts

In relation to bank loans and overdrafts, care is needed with applying the requirements on offset of financial assets and financial liabilities, particularly in group arrangements with a bank (such as cash pooling arrangements) where there are rights of offset. See 4.3.7 above for discussion of offset in respect of group cash pooling arrangements.

⁴⁶ LLPs - Note 5 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

4.3.8.C Payments on account

As noted at 4.3.5 above we would not expect payments received on account to be deducted from stock (or inventory) as this would not meet the offset requirements of FRS 102.

4.3.8.D Trade creditors

Trade creditors are generally amounts payable to suppliers of goods and services, e.g., relating to amounts invoiced by suppliers and could include credit balances due to trade debtors.

Debit balances in trade debtors must not be offset with trade creditors (and *vice versa*) where the offset criteria are not met. The separate line items for 'amounts owed to group undertakings' and 'amounts owed to undertakings in which the entity has a participating interest' will include trade creditors due to group undertakings and participating interests respectively (see 4.3.8.F below).

4.3.8.E Bills of exchange

A bill of exchange is a written instrument used mainly in international trade, where one party agrees to pay an amount to another party on demand or on a specified date. The bill can often be transferred by the holder of the bill to a bank or finance house at a discount.

4.3.8.F Amounts owed to group undertakings, and to undertakings in which the company has a participating interest

The line items 'amounts owed to group undertakings' and 'amounts owed to undertakings in which the company has a participating interest' include all amounts owed by such undertakings which could include loans, dividends and interest payable, trading items such as current accounts and balances with group treasury companies. The meanings of 'group undertaking' and 'participating interest' are discussed at 4.3.4.C and 4.3.4.D above. Debtors and creditors must not be offset where the offset criteria are not met.

4.3.8.G Other creditors, including taxation and social security

Other creditors are creditors that do not belong in other line items.

Note (9) on the balance formats (and the equivalent requirement for LLPs)⁴⁷ state that the amount for creditors in respect of taxation and social security must be shown separately from the amount for other creditors. Taxation and social security creditors would include corporation tax, VAT, PAYE and National Insurance, and other taxes, including overseas taxation. This analysis can be given in the notes to the accounts.

In fact, FRS 102 does not explicitly require separate disclosure of the current tax creditor, although it requires disclosure of information that would enable users of the financial statements to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events. [FRS 102.29.25].

Deferred tax liabilities are not included in this heading but in 'Provisions for liabilities' (see 4.3.11 below).

4.3.8.H Accruals and deferred income

Accruals and deferred income can either be shown in the statement of financial position (line item J) or in the notes under creditors amounts falling due within 1 year or after one year as appropriate.⁴⁸

While the format 1 balance sheet combines accruals and deferred income into one line item, these two items can have separate characteristics, for example, they may differ in nature and liquidity. As noted at 3.4 above, the balance sheet formats allow any item to be shown in greater detail and FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position.

⁴⁷ LLPs - Note 7 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913.

⁴⁸ Note 10 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/410. For LLPs, the alternative position is line item I (note 8 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/1913).

4.3.9 Net current assets or liabilities

The format 1 balance sheet requires a subtotal to be shown for net current assets or liabilities in the statement of financial position.

Note (11) on the balance sheet formats (and the equivalent requirement for LLPs)⁴⁹ state that any amounts shown under 'prepayments and accrued income' must be taken into account in determining net current assets or liabilities, wherever shown (see 4.3.6.E above). Therefore, net current assets or liabilities for a company will represent the amounts reported at item C in format 1 plus prepayments and accrued income (at item D, if shown separately) less creditors: amounts falling due within one year (at item E). For LLPs, net current assets or liabilities is the sum of the amounts reported at item B in format 1, plus prepayments and accrued income (at item C, if shown separately) less creditors: amounts falling due within one year (at item D). See Figure 4-2 at 4.2 and Figure 4-3 at 4.2.1 above.

4.3.10 Total assets less current liabilities

The format 1 balance sheet requires a subtotal to be shown for total assets less current liabilities in the statement of financial position. This subtotal is the sum of fixed assets and net current assets or liabilities (see 4.3.9 above).

While the format 1 balance sheet does not require a net assets subtotal (with a balancing subtotal for capital and reserves), most companies present this. Sometimes companies have presented a balancing subtotal for 'capital and reserves' together with 'creditors: amounts falling due within one year', a practice not precluded by the Regulations (or LLP Regulations).

4.3.11 Provisions for liabilities

Figure 4-11 shows the analysis required, either in the statement of financial position or in the notes to the accounts - see 3.4 above, in respect of provisions for liabilities under format 1.

Figure 4-11 Analysis of provisions for liabilities

I Provisions for liabilities	
1	Pensions and similar obligations
2	Taxation, including deferred taxation
3	Other provisions

References to 'provisions for liabilities' in the Regulations and LLP Regulations are "to any amount retained as reasonably necessary for the purpose of providing for any liability the nature of which is clearly defined and which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise." [9 Sch 2, 4 Sch 10 (LLP)]. FRS 102 defines a provision more succinctly as "a liability of uncertain timing or amount." [FRS 102 Appendix I].

The General Rules to the formats (see 3.4 above) allow or, where the special nature of the company's business requires this, require certain adaptations to the balance sheet formats, as well as allowing line items to be shown in greater detail.

FRS 102 requires an entity to present a reconciliation of each class of provision (comparatives are not required) and requires further narrative disclosures for each class of provision. [FRS 102.21.14, FRS 102.21.17, FRS 102.21.17A]. See Chapter 24 at 4.1.

UK companies preparing Companies Act accounts and LLPs preparing non-IAS accounts must give:

- Particulars of each material provision included in the line item 'Other provisions' in the notes to the accounts. [1 Sch 59(3), 1 Sch 57(3) (LLP)].
- Particulars of any pension commitments included in the statement of financial position, giving separate particulars of any commitment relating wholly or partly to pensions payable to past directors of the company or past members of the LLP. [1 Sch 63(5), 1 Sch 63(4), 1 Sch 63(6), 1 Sch 60(4) (LLP)].

⁴⁹ LLPs - Note 9 on the balance sheet formats in Section B of Part 1 of Schedule 1 to LLP Regulations (SI 2008/1913).

- Where there have been transfers to provisions, or from any provisions (otherwise than for the purpose for which the provision was established) relating to any of the provisions required to be shown as separate line items in the statement of financial position or the notes (see 3.4 above), the company (or the LLP) must disclose the following in tabular form, in the notes to the accounts, in respect of the aggregate of provisions included in the same item:
 - The amount of the provisions as at the beginning and end of the financial year
 - Any amounts transferred to or from the provisions during that year
 And
 - The source and application respectively of any amounts transferred

Comparatives are not required (since these are specifically exempted under the equivalent reconciliation requirement in FRS 102). [1 Sch 59(1), 1 Sch 59(2), 1 Sch 57(1)(LLP), 1 Sch 57(2)(LLP)].

The above reconciliation required by the Regulations and LLP Regulations is similar to that required by FRS 102. However, the statutory requirement applies to movements in deferred tax provisions (see 4.3.13.B below) and pension provisions, as these are line items under 'provisions for liabilities'. In respect of pension provisions, FRS 102 already requires reconciliations of defined benefit obligations and plan assets, which provide similar information, albeit not for the net balance. [FRS 102.28.41(e), FRS 102.28.41(f)]. See Chapter 30 at 4.1.4.A.

The above disclosures apply where adapted formats or statutory formats are used.

4.3.12 Capital and reserves

Figure 4-12 shows the analysis required in respect of capital and reserves under format 1 for a UK company.

For an LLP, K - Capital and reserves is replaced with K - Members' other interests (with sub-headings K.I - Members' capital, K.II - Revaluation reserve and K.III - Other reserves, including the fair value reserve). The items shown in K - Members' other interests are equity for an LLP. However, members' interests classified as a liability would be shown in J - Loans and other debts due to members (see 4.2.1 above), which does not have an equivalent in the format 1 balance sheet for a UK company.

Figure 4-12 Analysis of capital and reserves - UK company

Analysis of capital and reserves - UK company	
K	Capital and reserves
I	Called up share capital
II	Share premium account
III	Revaluation reserve
IV	Other reserves
1	Capital redemption reserve
2	Reserve for own shares
3	Reserves provided for by the articles of association
4	Other reserves, including the fair value reserve
V	Profit and loss account
	See discussion above for the line items required for K - Members' other interests in the LLP Regulations.

The capital and reserves section of the statement of financial position includes a number of line items denoted by a Roman numeral which must be presented in the statement of financial position, with no adaptation of the order of the headings or description used permitted. The analysis of other reserves may be presented in the notes to the accounts, where permitted by the General Rules to the formats (see 3.4 above).

FRS 102's requirement to present a statement of changes in equity; the disclosures in the Regulations and LLP Regulations relating to capital and reserves, the disclosures in the LLP Regulations relating to loans and other debts due to members; and the LLP SORP's related requirement to show a reconciliation of members' interests, are discussed at 4.4 and 6 below.

4.3.12.A Called up share capital

FRS 102's requirements on recording issuances of equity instruments are consistent with the presentation of called up share capital in the Regulations (see Chapter 13 at 4.4). Called up share capital is presented as the first item in equity under format 1 and under adapted formats, it is one of the classes of equity which may be presented either in the statement of financial position or in the notes. [1 Sch 1, FRS 102.4.2B(g)].

4.3.12.B Share premium account

The share premium account is a statutory reserve that arises on the issue of share capital and under format 1 is presented under called up share capital. [1 Sch 1, FRS 102.4.2B(g)].

4.3.12.C Revaluation reserve

The revaluation reserve arises where an asset is carried at valuation using the alternative accounting rules in the Regulations (or LLP Regulations). [1 Sch 35, 1 Sch 35 (LLP)].

The amount of the revaluation reserve is presented in the position given for the item 'revaluation reserve' under capital and reserves in the balance sheet formats. The name 'revaluation reserve' must be used. [1 Sch 35(2), 1 Sch 35(2)(LLP)]. Under adapted formats, it is one of the classes of equity which may be presented either in the statement of financial position or in the notes. [FRS 102.4.2B(g)].

4.3.12.D Reserves provided for by the Articles of Association

Where the articles specifically provide for reserves to be established, this line item is used. This is not relevant to LLPs.

4.3.12.E Other reserves

The General Rules to the formats (see 3.4 above) permit, certain adaptations to the balance sheet formats, as well as allowing line items to be shown in greater detail. These adaptations are required if the special nature of the company's business makes it necessary.

FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position and this may be applicable when considering the analysis of other reserves. [FRS 102.4.3].

The sub-headings within the 'Other reserves' category are discussed at 4.3.12.F to 4.3.12.H below.

4.3.12.F Capital redemption reserve

The capital redemption reserve is a statutory reserve. [s733, s734]. If applicable, it is presented in the position of other reserves when applying the statutory formats and under the adapted formats, it is one of the 'other reserves' which may be presented either in the statement of financial position or in the notes. [1 Sch 1, FRS 102.4.2B(g)].

4.3.12.G Reserve for own shares

Note (4) on the balance sheet formats states that the nominal value of the own shares held must be shown separately in the notes to the accounts. This note strictly refers to own shares presented as an asset (which is not permitted under FRS 102), but entities commonly disclose this information even where own shares are presented in equity. Where treasury shares are held, there are further statutory disclosures (see 4.4.2 below).

This line item is not relevant for LLPs.

4.3.12.H Other reserves, including fair value reserve (item K.IV.4)

Other reserves reported at item K.IV.4 might include a reserve arising where merger relief (under sections 612 and 613) or group reconstruction relief (under section 611) is taken, but the company chooses to record a reserve equivalent to the share premium that would have been recorded but for the relief (as permitted by section 615).

Where a UK company prepares Companies Act accounts (or an LLP prepares non-IAS accounts), the fair value accounting rules in the Regulations (or LLP Regulations) have the effect that the changes in fair value: [1 Sch 40, 1 Sch 40 (LLP)]

- Of the hedging instrument in respect of cash-flow hedges and hedges of net investment in foreign operations (to the extent effective)

- Relating to exchange differences on monetary items forming part of the company's net investment in a foreign entity (see below)
- And
- Of available-for-sale financial assets

must or, in the case of available-for-sale financial assets, may be recognised in a separate statutory reserve (the fair value reserve). This is an 'Other reserve (including fair value reserve)' in the statutory formats. Available-for-sale financial assets may arise where a company chooses to apply the recognition and measurement provisions of IAS 39.

FRS 102 requires exchange differences arising on translation of a foreign operation in the financial statements that include that foreign operation, including a monetary item that forms part of the net investment in that foreign operation, to be recognised in other comprehensive income and accumulated in equity. However, there is no requirement to accumulate these in a separate reserve. [FRS 102.30.13]. See Chapter 32 at 3.6. Entities are not, however, precluded from doing so. The fair value accounting rules in the Regulations (and LLP Regulations) state that exchange differences on monetary items forming part of the company's or LLP's net investment in a foreign entity must be, accumulated within the fair value reserve. However, the fair value accounting rules apply only to a financial instrument measured at fair value. The Regulations and LLP Regulations are silent on whether that this requirement applies to a monetary item such as a loan to a foreign entity (which would usually be recorded at amortised cost).

4.3.12.I Profit and loss reserve

The profit and loss account reserve, or retained earnings, arises from the accumulation of the results for the year, and other items taken to other comprehensive income or to equity, but not classified in another reserve.

When profits are unrealised, companies may prefer to report these in a reserve other than retained earnings, so as to distinguish these from other profits that are realised. There is no separate line item for the profit and loss reserve in the LLP formats.

4.3.13 Other application issues

4.3.13.A Contract assets and liabilities

Neither the Regulations nor the LLP Regulations specifically address the presentation of contract assets or contract liabilities. Contract assets may include amounts receivable under contracts that have not yet been invoiced (and, therefore, are not recorded in trade debtors).

Contract assets and contract liabilities do not feature in the balance sheet formats. FRS 102 requires contract assets and contract liabilities to be presented in the statement of financial position, but does not specify precisely where it should be presented. [FRS 102.23.124]

How we see it

In our view, it would be appropriate to include contract assets as a line item within debtors (see 4.3.6 above). Contract liabilities are similar in nature to deferred income. The statutory formats permit a choice of locations for the deferred income line item; either in creditors falling due within one year/creditors falling due after more than one year or in the separate line item for accruals and deferred income.

4.3.13.B Deferred tax

FRS 102 requires deferred tax liabilities to be presented within 'provisions for liabilities' (see 4.3.11 above) and deferred tax assets to be presented within debtors. [FRS 102.29.23]. This means that there is no requirement to present deferred tax separately in the statement of financial position, however, entities may do so. FRS 102 includes rules on offset of deferred tax assets and liabilities (see Chapter 31 at 11.1.1). [FRS 102.29.24A].

This presentation is consistent with the statutory formats in the Regulations (and LLP Regulations) but differs from the presentation of deferred tax under the adapted formats in FRS 102 (see 4.1 above) or in IFRS accounting standards as a non-current asset and/or non-current liability shown in the statement of financial position. [IAS 1.54, IAS 1.56, IFRS 18.98, IFRS 18.101].

Deferred tax assets may include amounts due after more than one year. See 4.2.2 above for the disclosure requirements for 'debtors: amounts falling due after more than one year' in FRS 102 and the Regulations (and LLP Regulations), where statutory formats are used.

FRS 102 requires that the amount of deferred tax liabilities and deferred tax assets at the end of the reporting period for each type of timing difference and the amount of unused tax losses and tax credits is disclosed separately. [FRS 102.29.27(e)]. Therefore, while deferred tax is not required to be shown in the statutory balance sheet, this disclosure would be required in the notes. FRS 102's full disclosures for deferred tax are set out in Chapter 31 at 12.

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must state the provision for deferred tax separately from any other tax provisions. [1 Sch 60, 1 Sch 58 (LLP)]. This should not lead to additional disclosure since deferred tax will of course be shown already in the statement of financial position for adapted formats and, as noted above, FRS 102 requires disclosure of deferred tax balances in the notes.

Where there have been transfers to and from deferred tax, the amount of the provision at the beginning and end of the year, and the movements in that provision must also be disclosed in the notes to the accounts (see 4.3.11 above). [1 Sch 59, 1 Sch 57 (LLP)]. This disclosure is required where statutory formats are used.

4.3.13.C Assets and disposal groups held for sale

FRS 102 does not include a concept of assets and disposal groups held for sale, comparable to that in IFRS 5. Therefore, an entity is not required to present a non-current asset classified as held for sale and the assets of a disposal group held for sale separately from other assets in the statement of financial position and the liabilities of a disposal group held for sale separately from other liabilities in the statement of financial position. [IFRS 5.38, IAS 1.54, IFRS 18.103].

In addition, FRS 102 does not permit such presentation of disposal groups in the statement of financial position because the General Rules to the formats (see 3.4 above) do not allow the aggregation of different line items into two lines, being assets and liabilities of the disposal group, in this way. This does not preclude entities presenting additional analysis in the notes to the financial statements. See also the disclosures at 4.5 below.

As noted at 4.3.3 above, the statutory definition of a fixed asset is not normally interpreted to mean that individual assets are transferred to current assets when a decision to dispose of them has been made (but see 4.1.9 above which sets out some situations where we would expect a change in use of the asset to lead to reclassification as inventory). Nevertheless, some companies do make such transfers.

4.3.13.D Post-employment benefit assets and liabilities

FRS 102 does not explicitly address the presentation of post-employment benefit assets and liabilities.

The format 1 balance sheet includes a line item 'pensions and similar liabilities' within provisions for liabilities (see 4.3.11 above). There is no specific line item for pension assets.

How we see it

In our view, a pension asset could be presented as a separate line item within debtors. Defined benefit assets may include amounts due after more than one year.

See 4.2.2 above for the disclosure requirements in FRS 102 and in the Regulations (and LLP Regulations) for 'debtors: amounts due after more than one year'.

As FRS 102 does not specify a line item, there may be divergence in practice in the presentation of defined benefit pension surpluses and deficits. However, the related deferred tax asset or liability must be shown separately, as offsetting is not permitted. Disclosure requirements for defined benefit plans are discussed in Chapter 30 at 4.1.4.

The Regulations (and LLP Regulations) require certain disclosures in Companies Act accounts (non-IAS accounts, for an LLP) for pension commitments included in the statement of financial position (see 4.3.11 above) and for pension commitments not included in the statement of financial position (see 7.8.1 below).

Where there have been transfers to and from provisions for liabilities, which may include pension provisions, the amount of the provision at the beginning and end of the year, and the movements in that provision must also be disclosed in the notes to the accounts (see 4.3.11 above). [1 Sch 59, 1 Sch 57 (LLP)]. As noted at 4.3.11 above, FRS 102 also requires a reconciliation of movements in plan assets and plan liabilities. [FRS 102.28.41(e), FRS 102.28.41(f)].

These disclosures are relevant to adapted formats and statutory formats.

4.3.13.E Biological assets

The format 1 balance sheet does not include a line item for biological assets, which should be reported within either tangible fixed assets (e.g., an apple orchard) or stock (e.g., farmed salmon), as appropriate. FRS 102 requires reconciliations of changes in the carrying amounts to be given for biological assets (separately for each class carried under the cost model and each class carried under the fair value model) (see Chapter 36 at 2.6 and 2.7. [*FRS 102.34.7(c)*, *FRS 102.34.10(e)*]).

See 4.2.2 above for the requirements for reconciliations of movements in fixed assets in the Regulations (and the LLP Regulations) for UK companies preparing Companies Act accounts (and LLP accounts preparing non-IAS accounts). These disclosures apply where statutory formats or adapted formats are used.

Comparatives are not required for the reconciliations required by FRS 102 or the Regulations (and LLP Regulations).

4.3.13.F Financial assets and financial liabilities

The format 1 balance sheet does not include specific line items for financial assets and financial liabilities. Financial assets will generally be reported, as appropriate, within 'cash at bank and in hand', 'debtors', 'current asset investments' or 'fixed asset investments'. Financial liabilities will generally be reported, as appropriate, within 'creditors: amounts falling due within one year' and 'creditors: amounts falling due after more than one year' or 'provisions for liabilities' (e.g., contingent consideration on a business combination). FRS 102 requires further analyses of specified categories of financial assets and financial liabilities to be disclosed either in the statement of financial position or in the notes to the financial statements (see 4.1.7 above for details). The Regulations and LLP Regulations also include various disclosures, some of which have been highlighted in the relevant sections above and also in respect of financial instruments held at fair value.

4.3.13.G Government grants

FRS 102 sets out two models for recognising government grants - the accrual model and the performance model (see Chapter 26). There is no specific line for government grants in the balance sheet statutory formats.

The discussion at 4.1.14.D above on presentation and disclosure of government grants under the two models is equally applicable to statutory formats.

4.3.13.H Leases - right of use assets and lease liabilities

FRS 102 sets out presentation and disclosure requirements relating to right of use assets and lease liabilities. There is no specified line item for right of use assets and lease liabilities in the balance sheet statutory formats. For a detailed discussion of the requirements and how they interact with the requirements of the statutory formats, see Chapter 23 at 6.7.

4.4 Additional disclosures in respect of share capital (or equivalent) (adapted formats and statutory formats)

FRS 102 (see 4.4.1 below) and the Regulations (see 4.4.2 below) require similar disclosures in respect of share capital.

4.4.1 FRS 102 disclosures in respect of share capital (or equivalent)

FRS 102 requires an entity with share capital to disclose the following information, either in the statement of financial position or in the notes: [*FRS 102.4.12*]

(a) For each class of share capital:

- (i) The number of shares issued and fully paid, and issued but not fully paid
- (ii) Par value per share, or that the shares have no par value
- (iii) The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital
- (iv) Shares in the entity held by the entity or by its subsidiaries, associates or joint ventures

- (v) Shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts

And

- (b) A description of each reserve within equity

An entity without share capital, such as a partnership or trust, must disclose information equivalent to that required by (a) above, showing changes during the period in each category of equity, and the rights, preferences and restrictions attaching to each category of equity. *[FRS 102.4.13]*.

4.4.2 Information required by the Regulations in respect of share capital

Some of the FRS 102 disclosure requirements overlap with the disclosure requirements in relation to share capital included in the Regulations for UK companies preparing Companies Act accounts.

The Regulations require the following disclosures in the notes to the accounts:

- The amount of allotted share capital and, separately, the amount of called up share capital which has been paid up (this may be given in the statement of financial position or in the notes)⁵⁰
- Where shares of more than one class have been allotted, the number and aggregate nominal value of shares of each class allotted *[1 Sch 47(1)(a)]*
- Where shares are held as treasury shares, the number and aggregate nominal value of the treasury shares and, where shares of more than one class have been allotted, the number and aggregate nominal value of the shares of each class held as treasury shares *[1 Sch 47(1)(b)]*
- Where any part of the allotted share capital consists of redeemable shares: *[1 Sch 47(2)]*
 - The earliest and latest dates on which the company has power to redeem those shares
 - Whether those shares must be redeemed in any event or are liable to be redeemed at the option of the company or of the shareholder

And

 - Whether any (and if so, what) premium is payable on redemption
- If the company has allotted any shares during the financial year: *[1 Sch 48]*
 - The classes of shares allotted

And

 - For each class of shares, the number allotted, their aggregate nominal value, and the consideration received by the company for the allotment
- With respect to any contingent right to the allotment of shares in the company (i.e., any option to subscribe for shares and any other right to require the allotment of shares to any person whether arising on the conversion into shares of securities of any other description or otherwise), particulars of: *[1 Sch 49]*
 - The number, description and amount of the shares in relation to which the right is exercisable
 - The period during which it is exercisable

And

 - The price to be paid for the shares allotted
- If any fixed cumulative dividends on the company's shares are in arrear: *[1 Sch 62]*
 - The amount of the arrears

And

 - The period for which the dividends or, if there is more than one class, each class of them are in arrear

And

 - The number, description and amount of the shares in the company held by, or on behalf of, its subsidiary undertakings (except where the subsidiary undertaking is concerned as personal representative, or, subject to certain exceptions, as trustee) *[4 Sch 3]*

⁵⁰ Note 12 on the balance sheet formats in Section B of Part 1 of Schedule 1 to SI 2008/410.

The LLP Regulations do not include the above disclosures (as not relevant) although the following information is required in the notes to the accounts in respect of loans and other debts due to members: [1 Sch 47 (LLP)]

- The aggregate amount of loans and other debts due to members as at the date of the financial year
- The aggregate amounts contributed by members during the financial year
- The aggregate amounts transferred to or from the profit and loss account during that year
- The aggregate amounts withdrawn by members or applied on behalf of members during that year
- The aggregate amount of loans and other debts due to members as at the balance sheet date

And

- The aggregate amount of loans and other debts due to members that fall due after more than one year

The LLP SORP provides further guidance on this disclosure, adding further related disclosures, and requires a reconciliation of the movement in members' interests analysed between 'members' other interests' and 'loans and other debts due to members', which would meet the requirements of paragraph 13 of section 4 of the standard (see 4.4.1 above) and the statutory requirements in paragraph 47 of Schedule 1 to the LLP Regulations. [LLP SORP.60].

Detailed guidance on issues specific to LLPs is outside the scope of this chapter.

4.5 Information on disposal group to be presented in the notes (adapted formats and statutory formats)

As discussed at, FRS 102 does not include a concept of 'held for sale', comparable to that in IFRS 5 (see 4.1.14.B and 4.3.13.C above). However, FRS 102 does define a 'disposal group' (see Chapter 20 at 3.9) and requires limited disclosures where there is, at the end of the reporting period, a binding sale agreement for a major disposal of assets, or a disposal group. The entity must disclose in the notes to the financial statements: [FRS 102.4.14]

- A description of the asset(s) or the disposal group
 - A description of the facts and circumstances of the sale
- And
- The carrying amount of the assets or, for a disposal group, the carrying amounts of the assets and liabilities within the disposal group

5 Statement of comprehensive income

This part of the chapter sets out the requirements for the income statement for entities not applying Section 1A.

FRS 102 requires an entity to present its total comprehensive income for a period, i.e., its financial performance for period, in one or two statements. Financial performance is the relationship of the income and expenses of an entity as reported in the statement of comprehensive income. *[FRS 102 Appendix I]*.

This part of the chapter is set out as follows:

- 5.1 - Format of the statement of comprehensive income (adapted formats and statutory formats)
 - 5.2 - Items reported in other comprehensive income (adapted formats and statutory formats)
 - 5.3 - Single statement approach (adapted formats and statutory formats)
 - 5.4 - Two-statement approach (adapted formats and statutory formats)
 - 5.5 - Adapted formats
 - 5.6 - Statutory formats - format 1 and 2 profit and loss accounts
 - 5.7 - Requirements applicable to both approaches (adapted formats and statutory formats)
 - 5.8 - Presentation of discontinued operations (adapted formats and statutory formats)
 - 5.9 - Earnings per share (adapted formats and statutory formats)
- And
- 5.10 - Issues common to adapted and statutory formats

5.1 Format of the statement of comprehensive income (adapted formats and statutory formats)

Part 1 of Schedule 1 to the Regulations (and Part 1 of Schedule 1 to the LLP Regulations) provide a choice of:

- One of two profit and loss account statutory formats (as set out in Section B of the relevant Part)
- Or
- Use of adapted formats

Schedule 2 (banking companies) and Schedule 3 (insurance companies) to the Regulations require use of the statutory formats and do not allow use of adapted formats. The statutory formats for insurance companies are discussed in Chapter 38 at 8. This publication does not set out or discuss the statutory formats for banking companies.

The consolidated statement of comprehensive income or income statement (depending on the option taken) of a group must be presented in accordance with the requirements for a consolidated profit and loss account of Schedule 6 to the Regulations (or, where applicable, Schedule 3 to the LLP Regulations).

[FRS 102.5.5, FRS 102.5.7]. How adapted formats and statutory formats are applied in consolidated financial statements is further explained in 3.2.2 above and 5.5 and 5.6 below.

Section 5's requirements to present a statement of comprehensive income in either single statement form or in two-statement form are discussed below. The single statement form is discussed at 5.3 below and the two-statement form at 5.4 below. Items presented in other comprehensive income under both forms are discussed at 5.2 below. Adapted formats (see 5.5 below) and statutory formats (see 5.6 below) can be used under both the single statement and two-statement forms of the statement of comprehensive income. Supplementary requirements in FRS 102 relevant to the statement of comprehensive income are discussed at 5.7 to 5.9 below. The discussion at 5.1 to 5.4 and 5.7 to 5.9 below is relevant to both adapted formats and statutory formats.

An entity must present its total comprehensive income for a period either: *[FRS 102.5.2, FRS 102 Appendix I]*

- In a single statement of comprehensive income which presents all items of income and expense recognised in the period (and includes a subtotal for profit or loss).
- Or
- In two statements - an income statement (referred to as the profit and loss account in CA 2006) and a statement of comprehensive income, in which case the income statement presents all items of income and expense recognised in the period except those that are recognised in total comprehensive income outside of profit or loss as permitted or required by FRS 102.

A change from the single-statement approach to the two-statement approach, or *vice versa*, is a retrospective change in accounting policy to which Section 10 applies. [FRS 102.5.3]. See Chapter 9 at 3.3. These requirements apply both to consolidated and individual financial statements.

5.1.1 Section 408 exemption in group accounts

Where a UK company (or an LLP) prepares group accounts in accordance with CA 2006, the company (or the LLP) can take advantage of the exemption in section 408 of CA 2006 not to present the individual profit and loss account and certain related notes (providing the conditions for use of the exemption are met). See Chapter 1 at 5.3.2.

References in Part 15 to the profit and loss account include notes to the accounts giving information required by any provision of CA 2006 and that is either required or allowed by that provision to be given in a note to the company's accounts. [s472].

The section 408 exemption, where used, provides that:

- The company's (or the LLP's) individual profit and loss account need not contain the information specified in paragraphs 65 to 69 of Schedule 1 to the Regulations (or paragraphs 62 to 67 of Schedule 1 to the LLP Regulations) [Regulations 3(2), 1 Sch 65, 1 Sch 66, 1 Sch 67, 1 Sch 68, 1 Sch 69, LLP Regulations 3(2), 1 Sch 62(LLP), 1 Sch 63(LLP), 1 Sch 64(LLP), 1 Sch 65(LLP), 1 Sch 66(LLP), 1 Sch 67(LLP)]

And

- The company's (or the LLP's) individual profit and loss account must be approved by the directors (or the members of the LLP) in accordance with section 414(1) of CA 2006, but may be omitted from the company's (or the LLP's) annual accounts [s414(1), s414(1)(LLP)]

The exemption is conditional on the company's (or the LLP's) individual statement of financial position showing the company's (or LLP's) profit or loss for the financial year, determined in accordance with CA 2006 and disclosing use of the section 408 exemption in the annual accounts.

5.1.2 The distinction between income, revenue, turnover and gains

Income encompasses both revenue and gains; it is defined in FRS 102 as "increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity investors". [FRS 102 Appendix I, FRS 102.2.47].

FRS 102 defines revenue as income that arises in the course of the ordinary activities of an entity. [FRS 102 Appendix I]. It may be referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent. Section 23 addresses a subset of revenue - revenue from a contract with a customer - see Chapter 25.

Turnover is defined in section 474(1) and FRS 102 - see the discussion in 5.6.1 below. Turnover is applicable only for entities applying the statutory formats.

Gains are defined as increases in economic benefits that meet the definition of income, but are not revenue, for example, a gain on the disposal of a non-current asset. [FRS 102 Appendix I]. The definition of income also includes unrealised gains; for example, gains arising on the revaluation of investment property or property, plant and equipment. Not all gains are recognised in the statement of profit or loss, as some are required to be recognised in the statement of other comprehensive income.

As noted above, the definition of revenue includes a reference to 'ordinary activities'. Section 5 defines ordinary activities broadly, as 'any activities which are undertaken by a reporting entity as part of its business'. [FRS 102.5.10A] The purpose of this broad definition is to distinguish ordinary activities from 'extraordinary activities' - see 5.7.6 below. The Glossary to FRS 102 also uses the term 'ordinary activities' in its definition of a customer - "a party which has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities". The question arises as to what 'ordinary activities' mean in the context of revenue and, specifically, revenue from a contract with a customer.

How we see it

Despite the broad definition of 'ordinary activities' in the standard, we believe that in order to identify its revenue (and, more specifically, its revenue from contracts with customers), an entity must distinguish income generated by its primary business activities from income generated by its incidental activities. In our view, only income generated from an entity's primary business activities is presented as revenue. Income from incidental activities is not revenue and is more appropriately presented as other income.

The requirements on offsetting a gain on disposal of a fixed asset are set out in Section 2 and Section 17. If an entity's normal operating activities do not include buying and selling fixed assets, gains and losses on the disposal of such assets must be reported by deducting the carrying amount of the asset and related selling expenses from the proceeds on disposal and are presented within other income or expense. [FRS 102.2.98, FRS 102.17.28]. However, if an entity routinely sells PP&E that it has held for rental to others, this is part of its primary business activities, and the income is presented as revenue from contracts with customers. This is discussed further in Chapter 25 at 3.1.6.D.

5.2 Items reported in other comprehensive income (adapted formats and statutory formats)

Other comprehensive income means items of income and expense (including reclassification adjustments), that are not recognised in profit or loss as required or permitted by FRS 102. [FRS 102 Appendix I]. Therefore, profit and loss is the default category; all comprehensive income is part of profit and loss unless FRS 102 permits or requires otherwise.

Tax expense/(income) is recognised in other comprehensive income where the transaction or other event that resulted in the tax is recognised in other comprehensive income. [FRS 102.29.22]. See Chapter 31 at 9.

FRS 102 requires the following items to be included in other comprehensive income:

- (a) Changes in revaluation surplus relating to property, plant and equipment [FRS 102.17.15E, FRS 102.17.15F] (see Chapter 20 at 3.7.3), and changes in revaluation surplus relating to intangible assets [FRS 102.18.18G, FRS 102.18.18H] (see Chapter 21 at 3.3.2.C).
- (b) Remeasurements of the net defined benefit liability of defined benefit plans. These remeasurements comprise actuarial gains and losses, the return on plan assets excluding amounts included in net interest on the net defined benefit liability and any change in the amount of a defined benefit plan surplus that is not recoverable excluding amounts included in net interest on the net defined benefit liability [FRS 102.28.23(d), FRS 102.28.25, FRS 102.28.25A] (see Chapter 30 at 3.5.10.B).
- (c) Exchange gains and losses arising from translating the financial statements of a foreign operation, including in consolidated financial statements, exchange differences on a monetary item that forms part of the net investment in the foreign operation. However, under FRS 102, unlike IAS 21 - *The Effects of Changes in Foreign Exchange Rates*, cumulative exchange differences accumulated in equity are not reclassified to profit or loss on disposal of a net investment in a foreign operation [FRS 102.9.18A, FRS 102.30.13J] (see Chapter 32 at 3.6 and 3.7).
- (d) The effective portion of fair value gains and losses on hedging instruments in a cash flow hedge or a hedge of the foreign exchange risk in a net investment in a foreign operation. The amounts taken to equity in respect of the hedge of the foreign exchange risk in a net investment in a foreign operation are not reclassified to profit or loss on disposal or partial disposal of the foreign operation [FRS 102.12.23, FRS 102.12.24, FRS 102.12.25A] (see Chapter 14 at 4.8.3 and Chapter 14 at 4.9.2).
- (e) Fair value gains and losses through other comprehensive income, where an investor that is not a parent measures its interests in jointly controlled entities, [FRS 102.15.9(c)], and investments in associates in its individual financial statements using the fair value model [FRS 102.14.4(c), FRS 102.14.10] (see Chapter 17 at 3.2.4 and Chapter 18 at 3.5.2).
- (f) Fair value gains and losses through other comprehensive income for investments in subsidiaries, associates and jointly controlled entities in a parent's separate financial statements and in consolidated financial statements for certain excluded subsidiaries [FRS 102.9.9, FRS 102.9.26(b), FRS 102.9.26A] (see Chapter 8 at 3.4 and Chapter 8 at 4.2).

And

- (g) Any unrealised gain arising on an exchange of business or non-monetary assets for an interest in a subsidiary, jointly controlled entity or associate, [FRS 102.9.31], (see Chapter 8 at 3.8).

Of the above items, only the amounts taken to other comprehensive income in relation to cash flow hedges (at (d) above) may be reclassified to profit or loss in a subsequent period under FRS 102.

Where the entity applies the recognition and measurement requirements of IAS 39 or IFRS 9 to financial instruments, further items are reported in other comprehensive income (see 5.2.1 below).

The Regulations and LLP Regulations restrict when unrealised profits can be reported in the profit and loss account. Consequently, certain unrealised profits may be required to be reported in other comprehensive income (see 5.2.2 below).

5.2.1 Items reported in other comprehensive income where an entity chooses to apply the recognition and measurement provisions of IAS 39 or IFRS 9

Where the recognition and measurement requirements of IAS 39 or IFRS 9 are applied to financial instruments, as permitted by FRS 102, the following items would also be reported in other comprehensive income in accordance with the requirements of the applicable accounting standard:

- (a) Gains and losses on remeasuring available-for-sale financial assets (IAS 39) [IAS 39.55(b)]
- (b) Gains and losses on financial assets that are debt instruments (meeting the specified criteria) that are carried at fair value through other comprehensive income (if the entity chooses to apply IFRS 9) [IFRS 9.4.1.2A, IFRS 9.5.7.1(d), IFRS 9.5.7.10, IFRS 9.5.7.11]
- (c) Gains and losses on remeasuring investments in equity instruments designated as measured at fair value through other comprehensive income, with no recycling (IFRS 9) [IFRS 9.4.1.4, IFRS 9.5.7.1(b), IFRS 9.5.7.5, IFRS 9.5.7.6]
- (d) The effective portion of gains and losses on hedging instruments in a cash flow hedge or hedge of a net investment in a foreign operation (IAS 39 or IFRS 9) [IAS 39.95, IAS 39.96, IAS 39.97, IAS 39.98, IAS 39.99, IAS 39.100, IAS 39.101, IAS 39.102, IFRS 9.6.5.11, IFRS 9.6.5.12, IFRS 9.6.5.13, IFRS 9.6.5.14]

And

- (e) For liabilities designated as at fair value through profit or loss, fair value changes attributable to changes in the liability's credit risk, unless this would create or enlarge an accounting mismatch in profit and loss (IFRS 9) [IFRS 9.4.2.2, IFRS 9.5.7.1(c), IFRS 9.5.7.7, IFRS 9.5.7.8, IFRS 9.5.7.9, FRS 102.A3.12C]

This accounting treatment will usually require use of a 'true and fair override' for a UK company or LLP since it breaches the requirements of the Regulations, Small Companies Regulations, LLP Regulations or Small LLP Regulations)

Only items (a), (b) and the effective portion of gains and losses on hedging instruments in a cash flow hedge at (c) above may be reclassified to profit or loss in a subsequent period. The amounts recognised in other comprehensive income and accumulated in equity in respect of the hedge of the foreign exchange risk in a net investment in a foreign operation are not reclassified to profit or loss on disposal or partial disposal of the foreign operation. [FRS 102.9.18A, FRS 102.30.13].

5.2.2 Impact of realised and unrealised profits on items reported in other comprehensive income

UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) must follow the statutory requirement that "only profits realised at the balance sheet are to be included in the profit and loss account" (see 8.1.1 below). [1 Sch 13(a), 1 Sch 13(a)(LLP)].

Notwithstanding this restriction, changes in the value of a financial instrument or in the value of an investment property or a living animal or plant measured using the fair value accounting rules (in paragraphs 36, 38 and 39 of Schedule 1 to the Regulations and the same paragraphs in the LLP Regulations) must be reflected in the profit and loss account. This is subject to the requirements of paragraphs 40(3) and (4) of Schedule 1 to the Regulations (and the same paragraphs in the LLP Regulations) for available-for-sale financial assets, hedge accounting and for exchange differences on monetary items forming part of the net investment in a foreign entity, which permit or require certain movements on financial instruments to be reflected in a statutory 'fair value reserve'. [1 Sch 40(2), 1 Sch 40(3), 1 Sch 40(4), 1 Sch 40(2)(LLP), 1 Sch 40(3)(LLP), 1 Sch 40(4)(LLP)].

While UK companies and LLPs may now measure stocks at fair value using the fair value accounting rules, paragraph 40 of Schedule 1 to the Regulations does not specify where fair value changes arising on stock are presented. FRS 102 allows stock to be measured at fair value less costs to sell in restrictive circumstances; in such circumstances, the fair value changes are recognised in profit or loss. [FRS 102.13.3].

FRS 102 requires that "an entity shall recognise all items of income and expense arising in a period in profit or loss unless an FRS requires or permits otherwise or *unless prohibited by the Act*" [emphasis added]. [FRS 102.5.8].

Where the standard is explicit that it requires that a particular gain must be reported in profit or loss but this would conflict with the Regulations or LLP Regulations, the entity should consider whether a 'true and fair override' of the requirements of CA 2006 is appropriate (see 8.2 below).

How we see it

In our view, where the standard is not explicit, profit and loss is the default location for gains and losses. However, entities should consider Appendix III which highlights the company law requirements on realised profits. These company law considerations are only relevant to entities subject to the Regulations or LLP Regulations (or corresponding requirements in another statutory or regulatory framework that applies to the entity).

Whether profits are available for distribution must be determined in accordance with applicable law. Technical Release 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006* ('TECH 02/17BL') provides guidance on the determination of the profits available for distribution under CA 2006. [FRS 102.A3.29]. See Chapter 1 at 5.8.

5.3 Single-statement approach (adapted formats and statutory formats)

In the single-statement approach, an entity must present the items to be included in a profit and loss account in accordance with the requirements in Part 1 of the applicable schedule to the Regulations or Part 1 of Schedule 1 to the LLP Regulations.

The consolidated statement of comprehensive income of a group must be presented in accordance with the requirements of Schedule 6 to the Regulations (or, where applicable, Schedule 3 to the LLP Regulations). [FRS 102.5.5].

The formats required by different types of entity (and in consolidated financial statements) are discussed in more detail in 3.1, 3.2 and 5.1 above.

A subtotal for profit or loss is included in the statement of comprehensive income. [FRS 102 Appendix I].

In addition, the statement of comprehensive income must include line items that present: [FRS 102.5.5A]

- (a) Each component of other comprehensive income recognised as part of total comprehensive income outside profit or loss as permitted or required by FRS 102 classified by nature (excluding amounts in (b)). These components must be shown either net of related tax, or gross of related tax (with a single amount shown for the aggregate amount of income tax relating to those components)
 - (b) The share of the other comprehensive income of associates and jointly controlled entities accounted for using the equity method
- And
- (c) Total comprehensive income

The statement of comprehensive income must also show the allocation of profit or loss for the period and of total comprehensive income for the period attributable to non-controlling interest and owners of the parent. [FRS 102.5.6]. See 3.5 above for a discussion of how this allocation should be presented under the formats for the group profit and loss account.

See Illustration 5-1 at 5.5.2 below for an example of a single statement of comprehensive income, in this case using adapted formats.

5.4 Two-statement approach (adapted formats and statutory formats)

Under the two-statement approach, an entity must present in an income statement the items to be included in a profit and loss account in accordance with the requirements in Part 1 of the applicable schedule to the Regulations or Part 1 of Schedule 1 to the LLP Regulations.

The consolidated statement of comprehensive income of a group must be presented in accordance with the requirements of Schedule 6 to the Regulations (or, where applicable, Schedule 3 to the LLP Regulations). [FRS 102.5.7].

The formats required by different types of entity (and in consolidated financial statements) are discussed in more detail in 3.1, 3.2 and 5.1 above.

The income statement must show the allocation of profit or loss for the period attributable to non-controlling interest and owners of the parent. [FRS 102.5.7B].

The statement of comprehensive income (whether adapted formats or statutory formats are used) begins with profit or loss as its first line and then includes, as a minimum, line items that present:

- (a) Each component of other comprehensive income recognised as part of total comprehensive income outside profit or loss as permitted or required by the standard classified by nature (excluding amounts in (b)). These components must be shown either net of related tax, or gross of related tax (with a single amount shown for the aggregate amount of income tax relating to those components)
 - (b) The share of the other comprehensive income of associates and jointly controlled entities accounted for by the equity method
- And
- (c) Total comprehensive income

The statement of comprehensive income must show the allocation of total comprehensive income for the period attributed to non-controlling interest and owners of the parent. [FRS 102.5.7A, FRS 102.5.7B, FRS 102.5.7C]. See 3.5 above for a discussion of how the allocations of profit or loss and total comprehensive income should be presented under the formats for the group profit and loss account.

See Illustration 5-2 at 5.5.2 for an example statement of comprehensive income (where a two-statement form is applied).

5.5 Adapted formats

An entity choosing to apply paragraph 1A(2) of Schedule 1 to the Regulations and adapt one of the profit and loss account formats (see 3.2 above for discussion as to which formats apply to which types of entity) shall, as a minimum:

- Include in its statement of comprehensive income (under the single statement form) line items that present amounts (a) to (j) for the period (as set out in Figure 5-1 below). [FRS 102.5.5B].
- And
- Include in its income statement (under the two-statement form) line items that present amounts (a) to (g) for the period (as set out in Figure 5-1 at 5.5 below), with profit or loss as the last line. The statement of comprehensive income shall begin with profit or loss as its first line and shall display as a minimum line items (h) to (j), with total comprehensive income as its last line. [FRS 102.5.7A].

The main modification required for group profit and loss account using adapted formats is the identification of non-controlling interests (see 3.5, 5.3 and 5.4 above). [FRS 102.5.6, FRS 102.5.7A, FRS 102.5.7B, FRS 102.5.7C].

Figure 5-1 Profit and loss account - UK company (other than a banking company or insurance company) and LLP - adapted formats (effective for periods on or before 1 January 2027)

(a)	Revenue
(b)	Finance costs
(c)	Share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method
(d)	Profit or loss before taxation
(e)	Tax expense (excluding tax allocated to items (h) and (i) below or to equity)
(f)	A single amount comprising the total of:*
	(i) the post-tax profit or loss of a discontinued operation, and
	the post-tax gain or loss attributable to the impairment or on the disposal of the assets or
	(ii) disposal group(s) constituting discontinued operations
(g)	Profit or loss~
(h)	Each item of other comprehensive income classified by nature (excluding amounts in (i))
(i)	Share of other comprehensive income of associates and jointly controlled entities accounted for using the equity method
(j)	Total comprehensive income

* As set out in paragraph 5.7E (including a column for discontinued operations - see 5.8 below)

- The LLP SORP (2025) requires that LLPs using adapted formats show a line item for 'members' remuneration charged as an expense' as an additional expense.

See 9.1 below for periods beginning on or after 1 January 2027.

While FRS 102 refers to the Regulations, the same requirements apply to LLPs since paragraph 1A(2) of Schedule 1 to the LLP Regulations also allows the use of adapted formats.

The LLP SORP requires that adapted formats show a line item for 'profit or loss for the financial year before members' remuneration and profit shares' (in order to give equivalent information to the statutory formats). 'Members' remuneration charged as an expense' (which includes related employment costs) must be deducted as an additional expense, coming to the final line item of 'profit or loss for the financial year available for discretionary division among members' (which would correspond to item (g) in Figure 5-1 above). This is the same presentation in the profit or loss account (or statement of comprehensive income) as discussed for statutory formats at 5.6 below.

So far as is practicable, paragraphs 2 to 9A of the General Rules to the formats (see 3.4 above) apply to the income statement (or profit and loss account section of the single statement of comprehensive income), notwithstanding any such adaptation pursuant to paragraph 1A. [1 Sch 1A(3), 1 Sch 1A(3)(LLP)].

An entity may include additional line items in the income statement and amend the descriptions used in the line items set out in (a) to (j) and the ordering of items, when this is necessary to explain the elements of financial performance, providing the information given is at least equivalent to that required by the profit and loss account format, had it not been adapted. [FRS 102.5.5C]. The effect of paragraph 5C of section 5 of the standard is to clarify that there is flexibility in the presentation requirements where adapted formats are used.

The requirement (see 5.7.2 below) that an entity shall present additional line items, headings and subtotals in the statement of comprehensive income (and in the income statement, where presented) when such presentation is relevant to an understanding of the entity's financial performance also applies to adapted formats. [FRS 102.5.9].

5.5.1 Other implementation issues (adapted formats)

Schedule 1 to the Regulations (and Schedule 1 to the LLP Regulations) state that adapted formats may be used, provided that the information given is at least equivalent to that which would have been required by the use of the statutory format. The presentation must be in accordance with generally accepted accounting principles or practice. [1 Sch 1A(2), 1 Sch 1A(2)(LLP)].

The detail of adapted formats is left to accounting standards. The minimum items that FRS 102 requires to be presented in the statement of comprehensive income (in one or two statements), the ability to adapt the headings, and the requirement to present additional line items where relevant to an understanding of financial performance are discussed at 5.5 above.

Section 5 includes additional requirements relevant to the statement of comprehensive income (see 5.7 below) that apply to adapted formats and statutory formats. These include the presentation of turnover, guidance on operating profit (if presented under IAS 1), presentation of an analysis of expenses (see 5.5.2 and 5.7.4 below) and disclosure of the nature and amount of material items included in total comprehensive income. Note that the presentation of operating profit is mandatory under IFRS 18 [IFRS 18.69(a)] FRS 102's requirements for presentation of discontinued operations are discussed at 5.8 below, and for earnings per share (for those entities required to or choosing to present this) at 5.9 below.

These requirements are generally self-explanatory. However, adapted formats must present revenue in the income statement (or single statement of comprehensive income) (see 5.5 above). [FRS 102.5.5B]. FRS 102's requirement to present turnover in the income statement (or statement of comprehensive income, if presented) [FRS 102.5.7D] (see 5.7.1 below) implies that an additional analysis of revenue between turnover and other components of revenue (if any) is required in the income statement (or single statement of comprehensive income).

Other sections of FRS 102 require supplementary analyses of certain line items presented in the income statement (or profit or loss section of the statement of comprehensive income), which may be included in the notes to the financial statements.

The Regulations (and LLP Regulations) require UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) to give further supplementary information in respect of certain line items in the notes to the accounts. These disclosures are relevant where adapted formats or statutory formats are used. One complexity is that the information required by the Regulations (or LLP Regulations) is generally framed in respect of line items required in the statutory formats (e.g., turnover), whereas the headings used in the statutory formats may differ to those included where the adapted formats are used. Further information on certain of these statutory disclosures is given in 5.6 below.

FRS 102, the Regulations and LLP Regulations require numerous further disclosures (which may be given in the notes) concerning items recognised in profit or loss. Refer to the disclosure sections of the relevant chapters in this publication.

5.5.2 Illustrative statement of comprehensive income (adapted formats)

Illustration 5-1 below shows a single statement of comprehensive income, where the adapted formats are used. This is based on an illustrative example in IAS 1's Implementation Guidance, modified to illustrate the requirements of FRS 102. Note that this Illustration will not be applicable for reporters modifying a statement of comprehensive income under IFRS 18, as the latter standard has mandatory categories and subtotals which must be included in a statement of financial performance and are not included in the Illustration below.

Illustration 5-1: Presentation of comprehensive income in a single statement

XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 202X

	202X	202Y
	£'000	£'000
	Total	Total
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates ⁽¹⁾	35,100	30,100
Profit before taxation	161,667	128,000
Income tax expense	(40,417)	(32,000)
PROFIT FOR THE YEAR	121,250	96,000
Other comprehensive income:		
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Available-for-sale financial assets ⁽⁴⁾⁽⁵⁾	(24,000)	26,667
Exchange differences on translating foreign operations ⁽⁴⁾	5,334	10,667
Cash flow hedges ⁽⁴⁾	(667)	(4,000)
Share of gain (loss) on property revaluation of associates ⁽²⁾	400	(700)
Income tax ⁽³⁾	4,667	(9,334)
Other comprehensive income for the year, net of tax	(14,000)	28,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	107,250	124,000
Profit attributable to:		
Owners of the parent	97,000	82,900
Non-controlling interests	24,250	13,100
	121,250	96,000
Total comprehensive income attributable to:		
Owners of the parent	85,800	105,300
Non-controlling interests	21,450	18,700
	107,250	124,000

Alternatively, items of other comprehensive income could be presented in the statement of comprehensive income net of tax, as follows.

Statement of comprehensive income section (alternative presentation)

	201X £'000	201Y £'000
Other comprehensive income for the year, after tax:		
Gains on property revaluation	600	2,700
Remeasurements of defined benefit pension plans	(500)	1,000
Available-for-sale financial assets ⁽⁴⁾⁽⁵⁾	(18,000)	20,000
Exchange differences on translating foreign operations ⁽⁴⁾	4,000	8,000
Cash flow hedges ⁽⁴⁾	(500)	(3,000)
Share of gain (loss) on property revaluation of associates ⁽²⁾	400	(700)
Other comprehensive income for the year, net of tax⁽³⁾	(14,000)	28,000

(1) This means the share of associates' profit attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates.

(2) This means the share of associates' gain (loss) on property revaluation attributable to owners of the associates, i.e., it is after tax and non-controlling interests in the associates.

(3) Unlike IAS 1/IFRS 18, there is no requirement for the notes to disclose income tax relating to each item of other comprehensive income, although the aggregate current and deferred tax relating to items that recognised as items of other comprehensive income or equity is required in the notes. [FRS 102.29.27(a)].

(4) Unlike IAS 1/IFRS 18, items in other comprehensive income are not analysed between items that will be reclassified to profit and loss and items that may be reclassified subsequently to profit and loss. Exchange differences on translating foreign operations are not subsequently reclassified under FRS 102. The change in fair value of the hedging item recognised in other comprehensive income in respect of cash flow hedges and hedges of a net investment in a foreign operation and the amounts reclassified to profit or loss in respect of cash flow hedges in the period are required to be disclosed in the notes. [FRS 102.12.29(c), FRS 102.12.29(d), FRS 102.12.29A].

FRS 102 requires an analysis of other comprehensive income by item in the statement of changes in equity or in the notes to the accounts. [FRS 102.6.3A].

(5) An FRS 102 reporter will only have available-for-sale financial assets if it applies IAS 39 for recognition and measurement of financial instruments.

As a reminder,

- FRS 102 does not require separate presentation in other comprehensive income between items that will not be reclassified to profit or loss and items that may be reclassified subsequently to profit or loss.
- Earnings per share information has not been illustrated (see 5.9 below for entities required to present earnings per share information). [FRS 102.1.4].
- An analysis of expenses must be presented, either in the income statement or in the notes to the financial statements, which is equivalent to what would have been presented if statutory formats had been used (see 5.6 below). [FRS 102.5.5B].

And

- The 'share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method' is a separate line item in the adapted formats for the statement of comprehensive income (or separate income statement, where the two-statement form is used) (see 5.5 below). [FRS 102.5.5B(c), FRS 102.5.7A].

Illustration 5-2 below shows the statement of comprehensive income using the two-statement form. This is relevant for both adapted formats and statutory formats because the requirements for the statement of comprehensive income derive from Section 5 (rather than the formats in the Regulations (or LLP Regulations)). As in Illustration 5-1, the items in other comprehensive income may alternatively be presented net of tax.

The separate income statement (not presented in Illustration 5-2) would follow the requirements for adapted formats (see 5.5 above) (where permitted for use) or statutory formats (see 5.6 below) and would show the allocation of profit between owners of the parent and non-controlling interest.

Illustration 5-2 is adapted from an illustrative example in IAS 1, modified to illustrate the requirements of FRS 102. Illustration 5-2 looks the same as the latter part of the single statement of comprehensive income presented in Illustration 5-1 above but only shows the allocation of total comprehensive income between owners of the parent and non-controlling interest. The footnotes included in Illustration 5-2 relate to the same footnotes as in Illustration 5-1.

Illustration 5-2: Statement of comprehensive income illustrating the presentation of comprehensive income in two statements**XYZ Group - Statement of profit or loss and other comprehensive income for the year ended 31 December 201Y**

	201Y	201X
	£'000	£'000
Profit for the year	121,250	65,500
Other comprehensive income:		
Gains on property revaluation	933	3,367
Remeasurements of defined benefit pension plans	(667)	1,333
Available-for-sale financial assets ⁽⁴⁾⁽⁵⁾	(24,000)	26,667
Exchange differences on translating foreign operations ⁽⁴⁾	5,334	10,667
Cash flow hedges ⁽⁴⁾	(667)	(4,000)
Share of gain (loss) on property revaluation of associates ⁽²⁾	400	(700)
Income tax ⁽³⁾	4,667	(9,334)
Other comprehensive income for the year, net of tax	<u>(14,000)</u>	<u>28,000</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>107,250</u>	<u>93,500</u>
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	<u>21,450</u>	<u>18,700</u>
	<u>107,250</u>	<u>93,500</u>

5.6 Statutory formats - format 1 and format 2 profit and loss accounts

The following discussion relates only to the profit and loss account statutory formats for companies applying Schedule 1 to the Regulations and for LLPs. Section B of Part 1 of Schedule 1 to the Regulations (and Section B of Part 1 of Schedule 1 to the LLP Regulations) provide a choice of format 1 and format 2 for the profit and loss account.

The format 1 profit and loss account, which analyses expenses by function for a UK company (other than a banking company or insurance company), is presented at Figure 5-2 below.

Figure 5-2 Format 1 profit and loss account (UK company other than a banking company or insurance company)

1	Turnover
2	Cost of sales
3	Gross profit or loss
4	Distribution costs
5	Administrative expenses
6	Other operating income
7	Income from shares in group undertakings
8	Income from participating interests†
9	Income from other fixed asset investments
10	Other interest receivable and similar income
11	Amounts written off investments
12	Interest payable and similar expenses

	Profit or loss before taxation*
13	Tax on profit or loss
14	Profit or loss after taxation
19	Other taxes not shown under the above items
20	Profit or loss for the financial year
*	While not in format 1, every profit and loss account must show the amount of a company's profit or loss before taxation (1 Sch 6, Regulations).
†	See discussion below for modifications in group accounts.

The format 1 profit and loss account for an LLP is presented at Figure 5-3 below.

Figure 5-3 Format 1 profit and loss account (LLP)

1	Turnover
2	Cost of sales
3	Gross profit or loss
4	Distribution costs
5	Administrative expenses
6	Other operating income
7	Income from shares in group undertakings
8	Income from participating interests†
9	Income from other fixed asset investments
10	Other interest receivable and similar income
11	Amounts written off investments
12	Interest payable and similar expenses
	Profit or loss before taxation*
13	Tax on profit or loss
14	Profit or loss after taxation
19	Other taxes not shown under the above items
20	Profit or loss for the financial year before members' remuneration and profit shares
<i>SORP</i>	<i>Members' remuneration charged as an expense</i>
<i>SORP</i>	<i>Profit or loss for the financial year available for discretionary division among members</i>
*	While not in format 1, every profit and loss account must show the amount of an LLP's profit or loss before taxation (1 Sch 6, LLP Regulations).
†	See discussion below for modifications in group accounts.
<i>SORP</i>	Requirements for formats included in the LLP SORP rather than the LLP Regulations.

The final line in the format 1 and format 2 profit and loss accounts in the LLP Regulations is 'profit or loss for the financial year before members' remuneration and profit shares'. The LLP SORP provides further guidance on application of the statutory formats for LLPs, and requires that 'profit or loss for the financial year before members' remuneration and profit shares', 'members' remuneration charged as an expense' and 'profit or loss for the financial year available for discretionary division among members' is presented. The basis on which each element of remuneration has been treated in the accounts must be disclosed and explained by way of note. [LLP SORP.51]. The SORP provides guidance and illustrations of LLP profit or loss account for different situations. Detailed guidance on issues specific to LLPs is outside the scope of this publication. The format 2 profit and loss account, which analyses expenses by nature, for a UK company is presented at Figure 5-4 below.

Figure 5-4 Format 2 for the profit and loss account (UK company other than a banking company or insurance company)

1	Turnover
2	Change in stocks of finished goods and in work in progress
3	Own work capitalised
4	Other operating income
5	(a) Raw materials and consumables
	(b) Other external expenses
6	Staff costs
	(a) wages and salaries
	(b) social security costs
	(c) other pension costs
7	(a) Depreciation and other amounts written off tangible and intangible fixed assets
	(b) Amounts written off current assets, to the extent that they exceed write-offs which are normal in the undertaking concerned~
8	Other operating expenses
9	Income from shares in group undertakings
10	Income from participating interests†
11	Income from other fixed asset investments
12	Other interest receivable and similar income
13	Amounts written off investments
14	Interest payable and similar expenses
	Profit or loss before taxation*
15	Tax on profit or loss
16	Profit or loss after taxation
21	Other taxes not shown under the above items
22	Profit or loss for the financial year
* While not in format 2, every profit and loss account must show the amount of a company's profit or loss before taxation (1 Sch 6, Regulations).	
† See discussion below for modifications in group accounts.	

The format 2 profit and loss account for an LLP is presented at Figure 5-5 below. Additional line items are required by the SORP, as discussed above.

Figure 5-5 Format 2 for the profit and loss account (LLP)

1	Turnover
2	Change in stocks of finished goods and in work in progress
3	Own work capitalised
4	Other operating income
5	(a) Raw materials and consumables
	(b) Other external expenses

6	Staff costs
	(a) wages and salaries
	(b) social security costs
	(c) other pension costs
7	(a) Depreciation and other amounts written off tangible and intangible fixed assets
	(b) Amounts written off current assets, to the extent that they exceed write-offs which are normal in the undertaking concerned~
8	Other operating expenses
9	Income from shares in group undertakings
10	Income from participating interests†
11	Income from other fixed asset investments
12	Other interest receivable and similar income
13	Amounts written off investments
14	Interest payable and similar expenses
	Profit or loss before taxation*
15	Tax on profit or loss
16	Profit or loss after taxation
21	Other taxes not shown under the above items
22	Profit or loss for the financial year before members' remuneration and profit shares
SORP	<i>Members' remuneration charged as an expense</i>
SORP	<i>Profit or loss for the financial year available for discretionary division among members</i>
*	While not in format 2, every profit and loss account must show the amount of an LLP's profit or loss before taxation (1 Sch 6, LLP Regulations).
†	See discussion below for modifications in group accounts.
SORP	Requirements for formats included in the LLP SORP (2025) rather than the LLP Regulations.

The main modification required for group profit and loss account statutory formats is the identification of non-controlling interests (see 3.5, 5.3 and 5.4 above) and replacing 'income from participating interests' with 'income from associated undertakings' and 'income from other participating interests' (see 5.6.5 below).

The line items in the formats need to be read together with the notes to the formats in Part 1 of Section B of Schedule 1 to the Regulations (and Part 1 of Section B of Schedule 1 to the LLP Regulations). [1 Sch 1, 1 Sch 1 (LLP)]. The individual line items in the profit and loss account formats (together with the relevant notes to the statutory formats) are discussed at 5.6.1 to 5.6.14 below.

The General Rules to the formats (see 3.4 above) apply. As all line items are denoted with Arabic numbers, these allow a degree of flexibility in the profit and loss account formats. FRS 102 further requires that an entity shall present additional line items, headings and subtotals in the statement of comprehensive income (and in the separate income statement, where presented) when such presentation is relevant to an understanding of the entity's financial performance. [FRS 102.5.9]. See 5.7.2 below.

Section 5 includes additional requirements relevant to the statement of comprehensive income (see 5.7 below). FRS 102's requirements for presentation of discontinued operations are discussed at 5.8 below, and for earnings per share (for those entities required to or choosing to present this) at 5.9 below.

Other sections of FRS 102 also require supplementary analysis of certain line items presented in the income statement (or profit or loss section of the statement of comprehensive income), which may be included in the notes to the financial statements. The Regulations (and LLP Regulations) require UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) to give further supplementary information in respect of certain line items in the notes to the accounts. These disclosures are relevant where adapted formats or statutory formats are used. Some of these disclosures are highlighted in the discussion of line items at 5.6.1 to 5.6.14 below.

FRS 102, the Regulations and LLP Regulations require numerous further disclosures (which may be given in the notes to the financial statements) concerning items recognised in profit or loss. The LLP Regulations generally include similar disclosures to the Regulations. Refer to the disclosure sections of other chapters of this publication.

5.6.1 Turnover (format 1 and format 2)

Turnover, in relation to a company (or LLP), is defined as: [s474(1), s474(1)(LLP), FRS 102 Appendix I]

Extract from the Companies Act 2006

s474(1) the amounts derived from the provision of goods and services, after deduction of:

- (a) trade discounts,
- (b) value added tax, and
- (c) any other taxes based on the amounts so derived.

FRS 102 has the same definition as in section 474(1).

FRS 102 further requires that turnover is presented in the income statement (or statement of comprehensive income, if presented). [FRS 102.5.7D]. See 5.7.1 below.

Not all income reported in the statement of comprehensive income is turnover, nor is the concept of turnover synonymous with revenue. For example, a company may receive rental or interest income - while these would be types of revenue under FRS 102, these may or may not fall to be reported as turnover. Similarly, an entity whose business includes renting out properties to tenants would include rental income within turnover, but this may be 'other operating income' for another entity. An entity whose business is as a lessor and receives finance lease income would report that interest income in the position of the turnover line (although it may well be described as finance lease income), but an entity that merely receives interest income on its bank deposits or other investments would report that interest income as 'other interest receivable and similar income'.

How we see it

Where significant judgement is applied in determining which sources of revenue qualify as turnover, it may be appropriate to include an accounting policy for turnover and explain these judgements.

See 7.6 below for the segmental disclosures of turnover required in Companies Act accounts (or non-IAS accounts, for an LLP).

5.6.2 Cost of sales, distribution costs and administrative expenses (format 1)

The format 1 profit and loss account requires a functional classification of expenses - between cost of sales, distribution costs and administrative expenses. These categories of cost are not defined in the Regulations (or LLP Regulations). The allocation of costs will depend on the particular circumstances of an entity's business and must be applied consistently. Judgement may be required in allocating costs to certain functions and, where this is the case, it may be appropriate to include an accounting policy for the allocation of expenses, explaining significant judgements taken (see 7.3 below). The following discussion provides guidance for the types of items that often fall within these headings.

Cost of sales for a manufacturer would generally include production costs (including direct material, payroll and other costs and direct and indirect overheads attributable to the production function) and adjustments for opening and closing inventory. For a service provider, these would include the costs of providing the service.

Distribution costs would generally include transport and warehousing costs for the distribution of finished goods. Selling and marketing costs (such as advertising, payroll costs of the selling, marketing and distribution functions, sales commission and overheads attributable to the selling, marketing and distribution functions) are often included in this heading.

Administrative expenses would generally include payroll costs of general management and administrative staff, general overheads, property costs not classified within cost of sales or distribution costs, bad debts, professional fees and often goodwill amortisation and impairment.

Note (14) on the profit and loss account formats (format 1) (and the equivalent requirement for LLPs)⁵¹ require that cost of sales, distribution costs and administrative expenses are stated after taking into account any necessary provisions for depreciation or diminution in value of assets.

UK companies and LLPs sometimes show other line items (e.g., research and development costs) or amend or combine other line items, taking advantage of the flexibility available in the Regulations. FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial performance (see 5.7.2 below). [FRS 102.5.9].

5.6.3 Gross profit (format 1)

The format 1 profit and loss account requires gross profit or loss, i.e., turnover less cost of sales, to be shown as a separate line item.

5.6.4 Other operating income (format 1 and format 2)

Other operating income is not defined in the Regulations (or LLP Regulations). In practice, this line item often includes government grant income, operating lease income, other rental income or negative goodwill amortisation.

5.6.5 Income from shares in group undertakings and income from participating interests (format 1 and format 2)

The formats for the individual profit and loss account include 'income from shares in group undertakings' and 'income from participating interests'. Dividend income from shares in group undertakings and from participating interests are included in these line items.

For the group profit and loss account statutory formats, 'income from participating interests' is replaced with 'income from associated undertakings' and 'income from other participating interests'. Income from associated undertakings usually includes the share of the profit or loss of associates and jointly controlled entities. Income from shares in group undertakings will not arise in consolidated financial statements unless there are unconsolidated subsidiaries.

The meanings of group undertakings, participating interests and associated undertakings are explained at 4.3.4.C to 4.3.4.E above.

Incoming dividends and similar income receivable are recognised at an amount that includes any withholding tax but excludes other taxes, such as attributable tax credits. Any withholding tax suffered is shown as part of the tax charge. [FRS 102.29.19]. See 5.6.9 below.

FRS 102 requires separate disclosure of the entity's share of the profit or loss of associates accounted for using the equity method and the entity's share of any discontinued operations of such associates. [FRS 102.14.14]. The same information is required for jointly controlled entities. [FRS 102.15.20]. There is no requirement to present this information in the statement of comprehensive income (or separate income statement). However, entities may consider adapting the heading 'income from associated undertakings' to show the share of the profit or loss of investments in associates and jointly controlled entities, even if the analysis of this between investments in associates and jointly controlled entities is relegated to the notes.

FRS 102 does not address where fair value movements are presented in the profit and loss account formats when investments in subsidiaries, associates and jointly controlled entities are carried at fair value through profit and loss in consolidated and/or individual financial statements. [FRS 102.9.9B, FRS 102.14.4, FRS 102.15.9]. Chapter 8 at 3.4 and Chapter 8 at 4, Chapter 17 at 3.2.1, and Chapter 18 at 3.5.2 and Chapter 18 at 3.5.3 discuss the situations where this accounting is required or permitted.

How we see it

In our view, entities may present fair value gains and fair value losses on such investments, where material, adjacent to income from shares in group undertakings and income from participating interests (but disclosed separately).

⁵¹ LLPs - Note 12 on the profit and loss accounts (format 1) in Section B of Part 1 of Schedule 1 to SI 2008/1913.

FRS 102 requires additional line items in the statement of comprehensive income (or separate income statement), where relevant to an understanding of the entity's financial performance (see 5.7.2 below). Where this accounting is used, all the disclosures in Section 11 in respect of such investments will be required. [FRS 102.9.27B].

5.6.6 Income from other fixed asset investments, other interest receivable and similar income (format 1 and format 2)

The formats have two-line items - 'income from other fixed asset investments', and 'other interest receivable and similar income'. Note (15) on the profit and loss account formats (format 1 and format 2) (and the equivalent requirement for LLPs)⁵² state that income and interest derived from group undertakings must be shown separately from income and interest derived from other sources. For LLPs, interest receivable from members must also not be included under these line items.

Incoming dividends and similar income receivable are recognised at an amount that includes any withholding tax but excludes other taxes, such as attributable tax credits. Any withholding tax suffered is shown as part of the tax charge. [FRS 102.29.19]. See 5.6.9 below.

How we see it

In our view, entities may present fair value gains and fair value losses on other fixed asset investments, where material, adjacent to income from other fixed asset investments, but disclosed separately.

Section 28 does not specify how the net interest on the net defined benefit liability is presented in the statement of comprehensive income (see Chapter 30 at 3.5.10.A). The net interest could be either a positive or negative figure.

How we see it

In our view, net interest could be presented in either 'other finance income', 'interest payable' or another component of profit or loss provided the basis of allocation is explained.

The presentation of gains on settlement of financial liabilities is not addressed by FRS 102.

How we see it

In our view, entities may show the gains on settlement within 'other interest receivable and similar income', or where material, present the gains adjacent to interest receivable and similar income but disclosed separately.

FRS 102 requires further analyses of income, expense and net gains or net losses (including fair value changes) by specified category of financial instrument. Interest expense and interest income (calculated using the effective interest method) for financial assets and financial liabilities not at fair value, and impairment losses for each class of financial asset must also be disclosed. There are also disclosures for financial instruments at fair value through profit or loss (that are not financial liabilities held as part of a trading portfolio, nor derivatives). These can be disclosed in the notes to the financial statements.

[FRS 102.11.48, FRS 102.48A, FRS 102.12.26]. Certain of these disclosures are not required where the reduced disclosure framework is applied in individual financial statements of a qualifying entity, that is not a financial institution. [FRS 102.1.8, FRS 102.1.12(c)]. See Chapter 15 at 4.1.3.

5.6.7 Amounts written off investments (format 1 and format 2)

The line item 'amounts written off investments' is used for impairments of fixed asset investments (including investments in subsidiaries, associates and jointly controlled entities) carried at cost less impairment in the individual financial statements. It is usual to present a write-back of a previous provision under the same heading as where the provision was originally recognised (in the same way as an adjustment to reverse a bad debt provision is shown within administrative expenses).

⁵² LLPs - Note 13 on the profit and loss account formats (format 1) in Section B of Part 1 of Schedule 1 to SI 2008/1913.

The positioning of this line item between 'other interest income receivable and similar income' and 'interest payable and similar expenses' is below where many entities would position operating profit, where presented (see 5.7.3 below). FRS 102 is silent on where impairments of investments should be presented. Nevertheless, some entities may find it appropriate, based on the nature of their business, to report 'amounts written off investments' within operating profit.

FRS 102 requires disclosure of impairment losses for each class of financial asset, i.e., a grouping that is appropriate to the nature of the information disclosed and that takes into account the characteristics of the financial assets. [FRS 102.11.48(c)]. In addition, disclosure of impairment losses and reversals of impairment losses (and the line items in which those impairment losses are included) are required separately for investments in associates and investments in jointly controlled entities. [FRS 102.27.33(e), FRS 102.27.33(f)].

In addition, a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must disclose separately in a note to the accounts (if not shown separately in the statement of comprehensive income): [1 Sch 19(3), 1 Sch 20(2), 1 Sch 19(3)(LLP), 1 Sch 20(2)(LLP)]

- Provisions for diminution in value
- And
- Any amounts written back in respect of such provisions

These disclosures apply where the fixed asset investment is accounted for using the historical cost rules. The disclosures do not apply to fixed asset investments held at fair value using the fair value accounting rules.

5.6.8 Interest payable and similar expenses (format 1 and format 2)

'Interest payable and similar expenses' includes finance costs on financial liabilities (including shares classified as a financial liability or where a component of the share is classified as a financial liability).

Note (16) on the profit and loss account formats (format 1 and format 2) (and the equivalent requirement for LLPs)⁵³ states that interest payable to group undertakings must be shown separately from income and interest derived from other sources. For LLPs, interest payable to members must not be included under these line items. The LLP SORP explains how interest payable to members is treated (and when it falls to be treated as part of members' remuneration as an expense). [LLP SORP.21, LLP SORP.54].

The presentation of losses on settlement of financial liabilities is not addressed by FRS 102.

How we see it

In our view, entities may show the losses on settlement within other interest payable and similar expenses, or, where material, present the losses adjacent to other interest payable and similar expenses but disclosed separately.

Section 28 does not specify how the net interest on the net defined benefit liability should be presented in the statement of comprehensive income (see Chapter 30 at 3.5.10.A). The net interest could be either a positive or negative figure.

How we see it

In our view, net interest could be presented in either 'other finance income', 'interest payable' or another component of profit or loss provided the basis of allocation is explained.

FRS 102 requires further analyses of income, expense and net gains or net losses (including fair value changes) by specified category of financial instrument. Interest expense and interest income (calculated using the effective interest method) for financial assets and financial liabilities not at fair value, and impairment losses for each class of financial asset must also be disclosed. There are also extensive disclosures for financial instruments at fair value through profit or loss (that are not financial liabilities held as part of a trading portfolio nor derivatives). These can be disclosed in the notes to the financial statements. [FRS 102.11.48, FRS 102.48A, FRS 102.12.26]. Certain of these disclosures are not required where the reduced disclosure framework is applied in individual financial statements of a qualifying entity that is not a financial institution. [FRS 102.1.8, FRS 102.1.12(c)]. See Chapter 15 at 4.1.3.

⁵³ LLPs - Note 14 on the profit and loss account formats (format 1) in Section B of Part 1 of Schedule 1 to SI 2008/1913.

In addition, a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must state in the notes to the accounts: the amount of interest on or any similar charges in respect of:

- Bank loans and overdrafts
- And
- Loans of any other kind made to the company (or the LLP)

This analysis is not required in relation to interest or charges on loans to the company (or the LLP) from group undertakings, but applies to all other loans, whether made on security of debentures or not. [1 Sch 66, 1 Sch 63 (LLP)].

5.6.9 Tax on profit or loss (format 1 and format 2)

Tax includes current and deferred tax. In some situations, entities may need to apply judgement in determining whether a particular tax or tax credit is an income tax and whether to classify interest and penalties as tax. See Chapter 31 at 3.4. FRS 102 requires disclosures of judgements in applying accounting policies with the most significant effect on the financial statements - see 7.3 below.

Incoming dividends and similar income receivable are recognised at an amount that includes any withholding tax but excludes other taxes, such as attributable tax credits. Any withholding tax is shown as part of the tax charge. [FRS 102.29.19].

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must give further disclosures in respect of tax on profit or loss in the notes to the accounts. [1 Sch 67, 1 Sch 64 (LLP)]. FRS 102's disclosures in respect of current and deferred tax are discussed in Chapter 31 at 12.

5.6.10 Own work capitalised (format 2)

The format 2 profit and loss account includes a line item for 'own work capitalised'.

Own work capitalised may arise, for example, where an entity capitalises the directly attributable costs of constructing its own property, plant and equipment. [FRS 102.17.10]. The costs are reported in the relevant line items and a credit item is shown in own work capitalised.

5.6.11 Staff costs (format 2)

The format 2 profit and loss account has a line item for 'staff costs', to be analysed between wages and salaries, social security costs and pension costs (see 7.7 below for the definitions).

UK companies and LLPs, whether preparing Companies Act accounts (non-IAS accounts, for an LLP) or IAS accounts, must disclose information on staff numbers and on staff costs in the notes to the accounts (insofar as not stated elsewhere in the accounts). [s411, s411(LLP)]. See 7.7 below.

5.6.12 Depreciation and other amounts written off tangible and intangible fixed assets and amounts written off current assets to the extent that they exceed write-offs which are normal in the undertaking concerned (format 2)

The format 2 profit and loss account has separate line items for 'depreciation and other amounts written off tangible and intangible fixed assets' and 'amounts written off current assets to the extent that they exceed write offs which are normal in the undertaking concerned'.

Entities may also show provisions against current assets under different headings, e.g., changes in stocks/raw materials and consumables (for inventory - see 5.6.13 below) or 'other operating expenses' (e.g., this heading might be used for bad debts - see 5.6.14 below). Judgement is needed as to whether such provisions exceed write offs that are normal and fall to be presented as amounts written off current assets to the extent that they exceed write offs which are normal in the undertaking concerned.

5.6.13 Changes in stocks of finished goods and work in progress and raw materials and consumables (format 2)

The format 2 profit and loss account includes separate line items for the 'change in stocks of finished goods and work in progress' and for 'raw materials and consumables'.

'Raw materials and consumables' would include purchases of raw materials and consumables, adjusted for changes in stocks of raw materials and consumables.

5.6.14 Other external expenses and other operating expenses (format 2)

The format 2 profit and loss account includes separate line items for: 'other external expenses' and for 'other operating expenses'. The Regulations and LLP Regulations do not define these terms. There is therefore likely to be diversity in practice in the allocation of costs between these headings, but a consistent policy should be followed.

5.7 Requirements applicable to both approaches (adapted formats and statutory formats)

FRS 102 includes supplementary requirements relating to the statement of comprehensive income (beyond the requirements to follow the formats permitted by the Regulations or LLP Regulations).

5.7.1 Disclosure of turnover in the statement of comprehensive income (or separate income statement)

Turnover must be disclosed in the income statement (or statement of comprehensive income, if presented). [FRS 102.5.7D].

However, not all income reported in the statement of comprehensive income is turnover, nor is the concept of turnover synonymous with revenue. See 5.6.1 above.

5.7.2 Additional line items, headings and subtotals

An entity shall present additional line items, headings and subtotals in the statement of comprehensive income (and in the income statement, if presented) when such presentation is relevant to an understanding of the entity's financial performance. [FRS 102.5.9]. Judgement is needed in determining whether additional items should be presented, where material and relevant.

While any amendments to the income statement (or profit and loss section of the statement of comprehensive income) would need to comply with the General Rules to the formats (see 3.4 above), the statutory formats provide flexibility since the profit and loss account line items are denoted with Arabic numbers.

Where adapted formats are used, any amendments made would need to comply so far as is practicable with the General Rules to the formats. FRS 102 explains that an entity may include additional line items in the income statement and amend the descriptions used in paragraph 5B of section 5 of the standard (i.e., for the line items (a) to (j)) (see Figure 5-1 at 5.5 above) and the ordering of items, when this is necessary to explain the elements of financial performance, providing the information given is at least equivalent to that required by the profit and loss account format had it not been adapted. [FRS 102.5.5C]. The effect of this is to clarify the extent of flexibility available in the presentation requirements where adapted formats are used. For statutory formats, the General Rules to the formats clearly set out the flexibility for Arabic numbered items, but Arabic numbers do not appear in the adapted formats.

How we see it

While the requirement to present additional line items, headings and subtotals when relevant to an understanding of the entity's financial performance is included within the requirements for the single statement approach, in our view, this is intended to also apply where the two-statement approach is applied.

5.7.3 Disclosure of operating profit

FRS 102 does not require disclosure of 'operating profit'. If an entity elects to disclose operating profit, the entity must ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating', e.g., it is inappropriate to exclude items clearly related to operations (such as inventory write-downs, profit or losses on the sale of property, plant and equipment, investment property and intangible assets and restructuring and relocation expenses, because they occur irregularly or infrequently or are unusual in amount. It is also inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses. Profits or losses on the disposal of a discontinued operation must be excluded from operating profit. [FRS 102.5.9B].

The income statement (or profit and loss section of the statement of comprehensive income) identifies separate line items for the share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method in adapted formats (see 5.5 above).

How we see it

For entities presenting a measure of operating profit using the adapted formats to align with IAS 1, in our view, it is acceptable for an entity to determine which investments form part of its operating activities and include their results in that measure, with the results of non-operating investments excluded from it. Another acceptable alternative would be to exclude the results of all associates and jointly controlled entities from operating profit.

However, if an entity is using the adapted formats to align with IFRS 18, income and expenses from equity accounted associates must be excluded from the operating category and included in the investing category. If the entity has investments in associates that are not equity accounted, income and expenses from those investments are also classified in the investing category, unless the entity had a main business activity of investing in such assets - in which case the income and expenses from those investments are classified in the operating category (see 9.1 below).

5.7.4 Analysis of expenses by nature or function

The statutory formats in Schedule 1 to the Regulations (and Schedule 1 to the LLP Regulations) (see 5.6 above) require an analysis of expenses by nature (format 2 profit and loss account) or by function (format 1 profit and loss account), and where the adapted formats available in those schedules are used (see 5.5 above), FRS 102 requires an analysis of expenses to be presented either in the income statement or in the notes to the financial statements, which is equivalent to what would have been presented if the statutory formats had been adopted. [FRS 102.5.5B].

How we see it

Where an entity applies FRS 102 but is not required to prepare its accounts in accordance with CA 2006, we consider that the entity must comply with the formats (and disclosures in the notes to the statutory formats, where the statutory formats are applied) but is not required to give the other statutory disclosures.

Schedule 1 to the Regulations (and the LLP Regulations) require certain information about the nature of expenses to be provided as line items in format 2 and in the notes to the accounts where format 1 is applied:

- The format 2 profit and loss account includes line items for staff costs (see 5.6.11 above) and 'depreciation and other amounts written off tangible and intangible fixed assets' (see 5.6.12 above)
 - All UK companies (and LLPs), except companies subject to the small companies regime (and LLPs subject to the small LLPs regime) must present the analysis of staff costs in the notes to the accounts, insofar as not stated elsewhere in the accounts (see 7.7 below). This requirement applies both to Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts
- And
- Note (17) on the profit and loss account formats and the equivalent requirement for LLPs⁵⁴ state that the amount of depreciation and other amounts written off tangible and intangible fixed assets must be disclosed in a note to the accounts where the format 1 profit and loss account is used

In addition, a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must disclose separately in a note to the accounts (if not shown separately in the profit and loss account):

[1 Sch 19(3), 1 Sch 20(2), 1 Sch 19(3)(LLP), 1 Sch 20(2)(LLP)]

- Provisions for diminution in value of fixed assets
- And

- Any amounts written back in respect of such provisions

These disclosures must be given where statutory or adapted formats are used. These disclosures apply where the fixed assets in question are accounted for using the historical cost rules. The disclosures do not apply to fixed asset investments held at fair value using the fair value accounting rules.

⁵⁴ LLPs - Note 15 on the profit and loss accounts (format 1) in Section B of Part 1 of Schedule 1 to SI 2008/1913.

5.7.5 Presentation of 'exceptional items'

FRS 102 does not use the phrase 'exceptional items'. However, when items included in total comprehensive income are material, their nature and amount must be disclosed separately in the statement of comprehensive income (and in the income statement, if presented) or in the notes. [FRS 102.5.9A]. The level of prominence given to such items is left to the judgement of the entity concerned. Materiality is discussed at 8.4 below.

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must state the amount, nature and effect of any individual items of income and expenditure which are of exceptional size or incidence in the notes to the accounts. [1 Sch 69(2), 1 Sch 67(2)(LLP)].

See 5.8 below for FRS 102's requirements on presentation of discontinued operations.

5.7.6 Presentation of extraordinary items

An entity applying the adapted formats or statutory formats in Schedule 1 to the Regulations must not present or describe any items of income or expense as extraordinary items in the statement of comprehensive income (or in the income statement, if presented) or in the notes. [FRS 102.5.10]. This requirement also applies to LLPs. The concept of extraordinary items does not appear in Schedule 1 to the Regulations and Schedule 1 to the LLP Regulations, though it is referred to in Schedules 2 and 3, so theoretically the concept still exists in those schedules only.

Despite not permitting any items to be presented or described as 'extraordinary', FRS 102 provides the following definition: "extraordinary items are material items possessing a high degree of abnormality which arise from events or transactions that fall outside the ordinary activities of the reporting entity and which are not expected to recur." The additional line items required to be disclosed by paragraph 9 of section 5 of the standard (see 5.7.2 above) and material items required to be disclosed by paragraph 9A of the section 5 of the standard (see 5.7.5 above) are not extraordinary items when they arise from the entity's ordinary activities. In addition, extraordinary items do not include prior period items merely because they relate to a prior period. [FRS 102.5.10B].

Ordinary activities are defined as "any activities which are undertaken by a reporting entity as part of its business and such related activities in which the reporting entity engages in furtherance of, incidental to, or arising from, these activities. Ordinary activities include any effects on the reporting entity of any event in the various environments in which it operates, including the political, regulatory, economic and geographical environments, irrespective of the frequency or unusual nature of the events". [FRS 102.5.10A].

5.8 Presentation of discontinued operations (adapted formats and statutory formats)

FRS 102 requires an entity to disclose in the income statement (or statement of comprehensive income) an amount comprising the total of:

- (a) The post-tax profit or loss of discontinued operations (see definition at 5.8.1 below)

And

- (b) The post-tax gain or loss attributable to the impairment or on the disposal of the assets or disposal group(s) constituting discontinued operations (see 4.5 above for the definition of disposal group)

A line-by-line analysis must be presented in the income statement (or statement of comprehensive income), with columns presented for continuing operations, discontinued operations and for total operations. This requirement applies both to adapted formats (this is line item (f) - see Figure 5-1 at 5.5 above) and statutory formats. [FRS 102.5.5B, FRS 102.5.7E]. This means more detailed disclosure than is commonly seen under IFRS 5, but the line-by-line analysis is to enable compliance with the profit and loss account formats in the Regulations (or the LLP Regulations).

There is no requirement to analyse other comprehensive income between continuing and discontinued operations.

The disclosures for discontinued operations must relate to operations discontinued by the end of the reporting period for the latest period presented, with re-presentation of prior periods where applicable. [FRS 102.5.7F].

5.8.1 Definition of discontinued operation

FRS 102 defines a discontinued operation as a component of an entity (i.e., operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes from the rest of the entity) that has been disposed of and: [FRS 102 Appendix I]

- Represented a separate major line of business or geographical area of operations
- Was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations

Or

- Was a subsidiary acquired exclusively with a view to resale

The definition of discontinued operations in FRS 102 differs to that included in IFRS 5 in that it refers to “a component of an entity *that has been disposed of*” whereas IFRS 5 refers to a “component of an entity that *either has been disposed of or is classified as held for sale*” [emphasis added]. As noted at 5.8 above, the presentation of discontinued operations relates to operations disposed of at the reporting date.

IFRS 5, which has the same definition of a component as in FRS 102, clarifies that “a component of an entity will have been a cash-generating unit or a group of cash-generating units while being held for use”. [IFRS 5.31]. Under both IFRS accounting standards and FRS 102, a cash generating unit is “the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets”. [IFRS 5 Appendix A, FRS 102.27.8, FRS 102 Appendix I]. See Chapter 29 at 4.4 Management may consider IFRS 5’s guidance on a component, as permitted by the hierarchy in Section 10. [FRS 102.10.4, FRS 102.10.5, FRS 102.10.6].

FRS 102 does not clarify the phrase ‘has been disposed of’. In our view, the phrase ‘has been disposed of’ may be interpreted more widely than a sale. An entity’s management must use judgement in developing and applying an accounting policy and may consider the requirements and guidance in IFRS 5. IFRS 5’s requirements would be consistent with a view that a component meeting any of the criteria in the bullets above is discontinued if, at the end of the reporting period, the component is an abandoned operation, or the entity has partially disposed of and lost control of the operation or has distributed the operation. However, since the phrase ‘has been disposed of’ has not been explained further in FRS 102, different interpretations of what this means may arise in practice.

5.8.2 Adjustments to amounts previously presented in discontinued operations in prior periods

FRS 102 does not address adjustments to amounts previously presented in discontinued operations. Given the absence of specific requirements in FRS 102, management may consider the requirements and guidance of IFRS accounting standards in this area.

IFRS 5 requires that adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period are classified separately in discontinued operations. The nature and amount of such adjustments must be disclosed. Examples given of circumstances in which these adjustments may arise include the following: [IFRS 5.35]

- The resolution of uncertainties that arise from the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser.
- The resolution of uncertainties that arise from and are directly related to the operations of the component before its disposal, such as environmental and product warranty obligations retained by the seller.

And

- The settlement of employee benefit plan obligations, provided that the settlement is directly related to the disposal transaction.

5.8.3 Example of presentation of discontinued operations

Illustration 5-3: Presentation of discontinued operations

Statement of comprehensive income

For the year ended 31 December 202X

	202X			201Y		
	Continuing operations	Discontinued operations	Total	Continuing operation (as restated)	Discontinued operations (as restated)	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Turnover	4,200	1,232	5,432	3,201	1,500	4,701
Cost of sales	(2,591)	(1,104)	(3,695)	(2,281)	(1,430)	(3,711)
Gross profit	1,609	128	1,737	920	70	990
Administrative expenses	(452)	(110)	(562)	(418)	(120)	(538)
Other operating income	212	-	212	198	-	198
Operating profit	1,369	18	1,387	700	(50)	650
Profit on disposal of operations	-	301	301	-	-	-
Interest receivable and similar income	14	-	14	16	-	16
Interest payable and similar expenses	(208)	-	(208)	(208)	-	(208)
Profit before taxation	1,175	319	1,494	508	(50)	458
Taxation	(390)	(4)	(394)	(261)	3	(258)
Profit after taxation and profit for the financial year	785	315	1,100	247	(47)	200
Other comprehensive income						
Actuarial losses on defined benefit pension plans			(108)			(68)
Deferred tax movement relating to actuarial losses			28			18
Total comprehensive income for the year			1,020			150

The above example is taken from the Appendix to Section 5, which accompanies but is not part of that section, and provides guidance on application of paragraph 7E of Section 5 of the standard for presenting discontinued operations.

5.9 Earnings per share (adapted formats and statutory formats)

IAS 33 - *Earnings per Share* - must be followed by an entity whose ordinary shares or potential ordinary shares are publicly traded or that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market. IAS 33 also applies to an entity that chooses to disclose voluntarily earnings per share (EPS). [FRS 102.1.4].

IAS 33 requires an entity to present the basic and diluted EPS for profit or loss from continuing operations attributable to ordinary equity holders of the parent entity, and for total profit or loss attributable to ordinary equity holders of the parent entity. This must be given for each class of ordinary share that has a different right to share in profit for the period. [IAS 33.9, IAS 33.66]. Basic and diluted EPS must be presented with equal prominence in the statement of comprehensive income (or in the income statement, if presented) for every period for which a statement of comprehensive income is presented. [IAS 33.66, IAS 33.67, IAS 33.67A].

An entity may disclose basic and diluted EPS for discontinued operations *either* in the statement of comprehensive income (or in the income statement, if presented) *or* in the notes. [IAS 33.68, IAS 33.68A].

Basic and diluted EPS are presented even if the amounts are negative, i.e., a loss per share. [IAS 33.69]. If basic and diluted EPS are equal, dual presentation can be achieved in one line in the statement of comprehensive income. [IAS 33.67].

IAS 33 provides further requirements on the calculation of basic and diluted EPS and on the accompanying disclosures.

5.10 Issues common to adapted and statutory formats

5.10.1 Heritage assets

Heritage assets are tangible and intangible assets with historic, artistic, scientific, technological, geophysical or environmental qualities that are held and maintained principally for their contribution to knowledge and culture (see Chapter 36 at 5). [FRS 102 Appendix I]. FRS 102 also acknowledges that a right of use asset could in principle meet the definition of a heritage asset, but this is not expected to be common. [FRS 102.B34F.2]. All heritage assets are required to be presented separately from other assets, both in the adapted formats and the statutory formats. [FRS 102.34.54A].

5.10.2 Exploration and evaluation of mineral resources

IFRS 6 - *Exploration for and Evaluation of Mineral Resources* is applied by FRS 102 reporters, (applying both adapted and statutory formats) who operate in the exploration for and/or evaluation of mineral resources. [FRS 102.34.11]. It requires entities within its scope to classify exploration and evaluation assets as either intangible or tangible assets according to the nature of the assets acquired and apply the classification consistently. [IFRS 6.15].

For example, drilling rights must be presented as intangible assets, whereas vehicles and drilling rigs are tangible assets. A tangible asset that is used in developing an intangible asset must still be presented as a tangible asset. However, "to the extent that a tangible asset is consumed in developing an intangible asset, the amount reflecting that consumption is part of the cost of the intangible asset." For example, the depreciation of a portable drilling rig is capitalised as part of the intangible exploration and evaluation asset that represents the costs incurred on active exploration projects. [IFRS 6.16, IFRS 6.BC.33]. See Chapter 36 at 3.

5.10.3 Compound instruments

FRS 102 requires that an entity issuing a convertible or compound instrument must allocate the proceeds between the liability component and the equity component. [FRS 102.22.13]. This classification is permitted by the Regulations (and LLP Regulations) which require that, in determining how amounts are presented within items in the balance sheet, the directors of the company (or the members of the LLP) must have regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice (see 4.4 above). [1 Sch 9, 1 Sch 9 (LLP)].

Appendix 2 of TECH 02/17BL includes numerical illustrations of the treatment of compound instruments.

6 Statement of changes in equity

An entity must present a statement of changes in equity, or if certain conditions are met and an entity chooses to, a statement of income and retained earnings (see 6.2 below). [FRS 102.6.1].

Equity is the residual interest in the assets of the entity after deducting all its liabilities. It is not measured directly and equals the total of the carrying amounts of all recognised assets, less the total of the carrying amounts of all recognised liabilities. It may be sub-classified in the statement of financial position. For example, sub-classifications may include funds contributed by shareholders, retained earnings, and gains or losses recognised directly in equity. [FRS 102.2.87, FRS 102 Appendix I].

Section 22 - *Liabilities and Equity* - requires certain financial instruments - that would otherwise meet the definition of a liability - to be classified as equity because they represent the residual interest in the net assets of the entity. Puttable financial instruments, and instruments (or components of instruments) that contain obligations only on liquidation are, therefore, classified as equity providing the criteria for equity classification are met. [FRS 102.22.4].

FRS 102's requirements for the statement of changes in equity are similar to those included in IFRS accounting standards.

The Regulations and LLP Regulations do not require a statement of changes in equity to be presented but do require an analysis of movements on reserves and certain disclosures relating to dividends and appropriations. In practice, the analysis of movements in reserves could be combined with the statement of changes in equity. See 6.1 below.

6.1 Information to be presented in the statement of changes in equity

The statement of changes in equity presents an entity's profit or loss for a reporting period, other comprehensive income for the period, the effects of changes in accounting policies and corrections of material errors recognised in the period and the amounts of investments by, and dividends and other distributions to, equity investors during the period. [FRS 102.6.2].

The effects of corrections of material errors and changes in accounting policies are presented as retrospective adjustments of prior periods rather than as part of profit or loss in the period in which they arise. [FRS 102.5.8]. This is why such errors and changes in accounting policies are reported as separate line items in the statement of changes in equity (or, if presented, the statement of income and retained earnings). [FRS 102.6.3(b), FRS 102.6.5(c), FRS 102.6.5(d)]. The retrospective adjustments for material errors and changes in accounting policy are consistent with the requirements of IFRS accounting standards.

The statement of changes in equity shows: [FRS 102.6.3, FRS 102.6.3A, FRS 102 Appendix I]

- (a) Total comprehensive income for the period (the sum of profit and loss and other comprehensive income - see 6 above) showing separately the total amounts attributable to owners of the parent and to non-controlling interests (see 3.5 above)
- (b) For each component of equity, the effects of retrospective application (of accounting policies) or retrospective restatement recognised in accordance with Section 10
- And
- (c) For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
 - (i) Profit or loss
 - (ii) Other comprehensive income (which must be analysed by item, either in the statement of changes in equity or in the notes)
 - And
 - (iii) The amounts of investments by, and dividends and other distributions to, owners, showing separately issues of shares, purchase of own share transactions, dividends and other distributions to owners, and changes in ownership interests in subsidiaries that do not result in a loss of control

It can be seen that (a) above is effectively a sub-total of the sum of the items required by (c)(i) and (c)(ii). Items required to be recognised in other comprehensive income are listed at 5.2 above.

FRS 102 does not define a 'component of equity'. However, IAS 1/IFRS 18, which has a similar requirement to (c) above, states that 'components of equity' include, for example, each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings. [IAS 1.108, IFRS 18.111].

How we see it

In our view, the components presented must, as a minimum, include the components of capital and reserves relating to the headings and subheadings set out in the statutory formats (see 4.3.12 above), bearing in mind that an analysis of movements in these reserves is already required by the Regulations (or LLP Regulations).

Other components of equity might include, for example, the cash flow hedge reserve or fair value movements accumulated in equity on available-for-sale financial assets, where IAS 39 is applied. For UK companies and LLPs, these reserves would be included within the statutory fair value reserve required by the fair value accounting rules.

Where adapted formats are used, FRS 102 requires separate sub-classifications for classes of equity (such as share capital, share premium, retained earnings, revaluation reserve and fair value reserve) to be shown either in the statement of financial position or in the notes to the financial statements (see 4.1.13 above). [FRS 102.4.2B(g)]. These sub-classifications are likely to represent, at a minimum, components of equity for the purposes of the statement of changes in equity.

6.1.1 Related disclosures in the Regulations and LLP Regulations

Where there have been transfers to or from any reserves (and the reserves are shown as separate line items in the statement of financial position, or would be so shown, if Arabic-numbered line items were not combined as permitted by paragraph 4(2)(b) of the General Rules to the formats - see 3.4 above), a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must disclose, in the notes to the accounts, in respect of the aggregate of reserves included in the same item:

- The amount of the reserves at the beginning and end of the financial year
- Any amounts transferred to or from the reserve during that year
- And
- The source and application respectively of any amounts transferred

This information must be presented in tabular form. [1 Sch 59(1), 1 Sch 59(2), 1 Sch 57(1)(LLP), 1 Sch 57(2)(LLP)]. Comparatives are required under the general requirements of FRS 102 (as there is not a specific exemption). [FRS 102.3.14].

This disclosure requirement is relevant to both statutory formats and adapted formats. For statutory formats, the movements in reserves will include the headings and sub-headings listed in the statutory formats (see 4.3.12 above).

How we see it

For adapted formats, in our view, it is appropriate to present the movements in reserves for the classes of equity identified in the statement of financial position or in the notes to the financial statements (see 4.1.13 above). These are normally the same components of equity identified when presenting the statement of changes in equity.

UK companies preparing Companies Act accounts (relevant to adapted formats and statutory formats) are required to state in the notes to the accounts: [1 Sch 43]

- Any amount set aside to (or proposed to be set aside to), or withdrawn from (or proposed to be withdrawn from) reserves
- The aggregate amount of dividends paid in the financial year (other than those for which a liability existed at the immediately preceding balance sheet date)
- The aggregate amount of dividends that the company is liable to pay at the balance sheet date
- And
- The aggregate amount of dividends that are proposed before the date of approval of the accounts, and not otherwise disclosed above

The LLP Regulations only require LLPs preparing non-IAS accounts to state in the notes to the accounts any amount set aside to (or proposed to be set aside to) or withdrawn from (or proposed to be withdrawn from) reserves. [1 Sch 43 (LLP)].

Particulars must be given of the proposed appropriation of profit or treatment of loss or, where applicable, particulars of the actual appropriation of profits or treatment of the losses. [1 Sch 72B, 1 Sch 70B (LLP)].

Where an entity declares dividends to holders of its equity instruments after the end of the reporting period, those dividends are not recognised as a liability because no obligation exists at that time, but FRS 102 permits an entity to show the dividend as a segregated component of retained earnings at the end of the reporting period. [FRS 102.32.8].

FRS 102 requires an entity to *disclose* the fair value of non-cash assets distributed to its owners in the reporting period (except when the non-cash assets are ultimately controlled by the same parties before and after the distribution). [FRS 102.22.18].

6.1.2 Example of statement of changes in equity

FRS 102 does not include an illustrative statement of changes in equity. Illustration 6-1 shows the requirements below.

An analysis is required of other comprehensive income by item in the statement of changes in equity or in the notes to the accounts. [FRS 102.6.3A]. The detail in which this analysis must be presented is not specified.

Illustration 6-1: Combined statement of changes in equity

XYZ Group - Statement of changes in equity for the year ended 31 December 202X

(£'000)

	Called up share capital	Share premium account	Re-valuation reserve	Capital redemption reserve	Own shares	Merger reserve	Fair value reserve	Profit and loss account	Equity owners of parent	Non-controlling interest	Total equity
Balance at 1 January 202Y	10,000	500	3,000	-	(774)	-	3,098	16,849	32,673	85	32,758
Changes in accounting policy	-	-	-	-	-	-	-	600	600	-	600
Restated balance	10,000	500	3,000	-	(774)	-	3,098	17,449	33,273	85	33,358
Profit for the year	-	-	-	-	-	-	-	4,872	4,872	35	4,907
Other comprehensive income	-	-	100	-	-	-	(574)	(541)	(1,015)	2	(1,013)
Total comprehensive income for the year (a)	-	-	100	-	-	-	(574)	4,331	3,857	37	3,894
Dividends paid	-	-	-	-	-	-	-	(1,170)	(1,170)	-	(1,170)
Share based payment expense	-	-	-	-	-	-	-	398	398	-	398
Balance at 31 December 202Y	10,000	500	3,100	-	(774)	-	2,524	21,008	36,358	122	36,480
Profit for the year	-	-	-	-	-	-	-	4,674	4,674	235	4,909
Other comprehensive income	-	-	200	-	-	-	(665)	732	267	3	270
Total comprehensive income for the year (b)	-	-	200	-	-	-	(665)	5,406	4,941	238	5,179
Dividends paid	-	-	-	-	-	-	-	(1,400)	(1,400)	(31)	(1,431)
New shares issued	2,575	100	-	-	-	6,250	-	-	8,925	-	8,925
Share issue costs	-	(100)	-	-	-	-	-	-	(100)	-	(100)
Share buy back	(500)	-	-	500	-	-	-	(1,800)	(1,800)	-	(1,800)
Share based payment expense	-	-	-	-	-	-	-	307	307	-	307
Balance at 31 December 202X	12,075	500	3,300	500	(774)	6,250	1,859	23,521	47,231	329	47,560

- (a) The amount included in retained earnings for 202Y of £4,331,000 represents profit attributable to owners of the parent of £4,872,000 less remeasurement losses (net of tax) on defined benefit pension plans of £541,000 (gross £676,000 less tax £135,000).
The amount included in the cash flow hedge reserve for 202Y comprises a loss on cash flow hedges of £574,000 (£717,000 less tax £143,000) which represented losses (net of tax) transferred to cash flow hedge of £774,000 less reclassification of losses (net of tax) to profit and loss of £200,000. The amount included in non-controlling interest of £2,000 for 2015 relates to exchange translation gains (no attributable tax).
The amount included in the revaluation surplus of £100,000 for 202Y represents the share of other comprehensive income of associates of £100,000 (gross £120,000 less tax £20,000). Other comprehensive income of associates relates solely to gains or losses on property revaluation.
- (b) The amount included in retained earnings for 202X of £5,406,000 represents profit attributable to owners of the parent of £4,674,000 plus remeasurement gains on defined benefit pension plans of £732,000 (£915,000 less tax £183,000).
The amount included in the cash flow hedge reserve for 202X comprises a loss on cash flow hedges of £665,000 (£831,000 less tax £166,000) which represented losses (net of tax) transferred to cash flow hedge of £900,000 less reclassification of losses (net of tax) to profit and loss of £235,000. The amount included in non-controlling interest of £3,000 for 201Y relates to exchange translation gains (no attributable tax).
The amount included in the revaluation surplus of £200,000 for 202X represents the share of other comprehensive income of associates of £200,000 (gross £240,000 less tax £40,000). Other comprehensive income of associates relates solely to gains or losses on property revaluation.

Where an entity has more than one class of share capital, the entity must disclose dividends paid (in aggregate and per share) separately for each class of share capital. *[FRS 102.6.3B]*

The LLP SORP provides detailed guidance on the statement of changes in equity (and on the SORP's requirement for an LLP to present, either as a primary statement or in the notes, a reconciliation of members' interests). The SORP defines members' interests as comprising both 'other members' interests' and 'loans and other debts due to members' less any amounts due from members in debtors and specifies the format for the reconciliation of members' interests. Comparatives, i.e., the full table reconciling movements in the comparative year, are required, where this reconciliation is presented as a primary statement. *[LLP SORP.59, LLP SORP.59A, LLP SORP.59B, LLP SORP.60, LLP SORP.60A]*.

Not all LLPs have equity (e.g., if the LLP's partnership interests are classified entirely as liabilities). The LLP SORP clarifies that no statement of changes in equity is required in such circumstances (unless a reconciliation of members' interests is presented as a primary statement) but requires that a statement must be made in one of the primary statements or in the notes to the accounts that the LLP has no equity and consequently a statement of changes in equity is not given. *[LLP SORP.59A]*.

6.2 Statement of income and retained earnings

The purpose of a statement of income and retained earnings is to present an entity's profit or loss and changes in retained earnings for a reporting period.

An entity is permitted, but is not required, to present a statement of income and retained earnings in place of a statement of comprehensive income and a statement of changes in equity if the only changes to its equity in the periods for which financial statements are presented arise from: *[FRS 102.6.4]*

- Profit or loss
 - Payment of dividends
 - Corrections of prior period errors
- And

- Changes in accounting policy

In essence, this means that the statement of income and retained earnings may be presented where the entity does not have items of other comprehensive income, investments by equity investors or non-dividend distributions to equity investors in the current or comparative periods presented.

The statement of income and retained earnings shows the following items in addition to the information required in the statement of comprehensive income by Section 5: *[FRS 102.6.5]*

- Retained earnings at the beginning of the reporting period
 - Dividends declared and paid or payable during the period
 - Restatements of retained earnings for corrections of prior period material errors
 - Restatements of retained earnings for changes in accounting policy
- And
- Retained earnings at the end of the reporting period

See Illustration 6-2 which illustrates a statement of income and retained earnings.

The LLP SORP does not recommend that LLPs present a statement of income and retained earnings, on the grounds that it will be of little benefit to users of LLP financial statements in most cases. [LLP SORP.26A].

Illustration 6-2: Statement of income and retained earnings (extract)

	202X	202Y
	£'000	Restated £'000
Profit before taxation	1,494	458
Taxation	(394)	(258)
Profit after taxation and profit for the financial year	1,100	200
Retained earnings brought forward at 1 January 2X (1 January 2Y) - as originally reported	12,285	13,500
Prior period adjustment - changes in accounting policy	(1,820)	(2,235)
Prior period adjustment - correction of error	(1,900)	(1,900)
Retained earnings brought forward at 1 January 2X (1 January 2Y) - as restated	9,665	9,565
Dividends paid [or payable]	(1,500)	(1,000)
Retained earnings carried forward at 31 December 2X (31 December 2Y)	8,165	8,565

7 Notes to the financial statements

FRS 102 sets out the principles underlying the information to be presented in the notes and how to present it. Notes contain information in addition to that presented in the primary statements. Notes provide narrative descriptions or disaggregation of items presented in those statements and information about items that do not qualify for recognition in those statements. Most sections of FRS 102 require disclosures that are normally presented in the notes. [FRS 102.8.1].

UK companies preparing Companies Act accounts are required by CA 2006 (principally Part 15), the Regulations and other applicable regulations to disclose certain information in the notes to the accounts. Similarly, LLPs preparing non-IAS accounts are required by CA 2006 (as applied to LLPs by SI 2008/1911), the LLP Regulations and other applicable regulations to disclose certain information in the notes to the accounts. Certain of these statutory disclosures have been commented on in the discussion of the statutory formats at 4.3 and 5.6 above (because they represent additional analyses for line items required in the statement of financial position or in the statement of comprehensive income), but the disclosures generally apply where adapted formats are used as well.

7.1 Structure of the notes

FRS 102 requires the notes to: [FRS 102.8.2]

- (a) Present information about the basis of preparation of the financial statements and the specific accounting policies used
- (b) Disclose the information required by FRS 102 that is not presented in the primary statements
And
- (c) Provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them

The notes must, as far as practicable, be presented in a systematic manner. Each item in the financial statements must be cross-referenced to any related information in the notes. [FRS 102.8.3].

The notes are normally presented in the following order: [FRS 102.8.4]

- (a) A statement that the financial statements have been prepared in compliance with FRS 102 (see 2.6 above)
- (b) A summary of material accounting policy information (see 7.2 below)
- (c) Supporting information for items presented in the financial statements, in the sequence in which each statement and each line item is presented
And
- (d) Any other disclosures

These requirements of FRS 102 are consistent with the traditional order of financial statements. The Regulations require that the notes to the accounts of a company give the information set out in Part 3 of Schedule 1, 2 or 3 to the Regulations, as applicable, in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and in the statement of comprehensive income. [1 Sch 42(2)]. The LLP Regulations similarly require that the notes to an LLP's accounts give the information set out in Part 3 of Schedule 1 to the LLP Regulations in this same order. [1 Sch 42(2)(LLP)]. The same applies in group accounts of UK parent companies and parent LLPs. [6 Sch 1(1), 3 Sch 1 (LLP)]. This requirement is emphasised in a footnote to paragraph 4 of section 8 of the standard which states: "Company law requires the notes to be presented in the order in which, where relevant, the items to which they relate are presented in the statement of financial position and in the income statement."

7.2 Material accounting policy information

Material accounting policy information is information which, when considered together with other information included in an entity's financial statements, can reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements. The disclosure of material accounting policy information must include the measurement basis (or bases) used in preparing the financial statements. [FRS 102.8.5].

The standard explains that accounting policy information relating to immaterial transactions, events or conditions is generally immaterial and therefore does not need to be disclosed, unless the Regulations or LLP Regulations require disclosure. However, certain transactions are required to be disclosed under the Regulations or LLP Regulations, irrespective of materiality, such as disclosures relating to staff costs, development costs and directors' loans. It is possible that even if the amount of a transaction (or event or condition) is immaterial, the nature of it renders the relevant accounting policy information material. Conversely, not all accounting policy information is necessarily material just because the related transactions, events or conditions are material. [FRS 102.8.5A].

FRS 102 notes that information is more useful if it focuses on how an entity has applied the requirements of the standard to its own circumstances (that is, it is entity-specific) rather than if it is standardised information, or information that only duplicates or summarises the requirements of the standard.

[FRS 102.8.5C].

Accounting policy information is expected to be material if users of an entity's financial statements would need it to understand other material information in the financial statements. The standard presents examples of when it is likely that such information should be disclosed; that is when the information relates to material transactions, other events or conditions and: [FRS 102.8.5B]

- The entity changed its accounting policy during the reporting period and this change resulted in a material change to the information in the financial statements.
- The entity chose the accounting policy from one or more options permitted by FRS 102, for example if the entity chose to measure investment property at historical cost rather than fair value.
- The accounting policy was developed in accordance with Section 10 in the absence of a Section of FRS 102 that specifically applies (see Chapter 9).
- The accounting policy relates to an area for which an entity is required to make significant judgements or assumptions in applying an accounting policy, and the entity discloses those judgements or assumptions in accordance with paragraphs 6 and 7 of section 8 of the standard (see 7.3 below).
- The accounting required for them is complex and users of the entity's financial statements would otherwise not understand those material transactions, other events or conditions. For example, if an entity applies more than one Section of FRS 102 to a class of material transactions.

An entity's conclusion that accounting policy information is immaterial does not affect the related disclosure requirements set out in other sections of the standard. [FRS 102.8.5D].

Judgement is clearly required when determining what is material accounting policy information and the level of detail required in those disclosures. In recent years, the FRC has continued to comment on the quality of disclosure of accounting policies, particularly revenue recognition policies. The FRC's Corporate Reporting Review function has challenged companies where the information is not company-specific or is generic (including boilerplate text copied from accounting standards); and where accounting policy information, that might have been expected given the business model, was not present (e.g., if the business model includes distinct and significant revenue streams described in the business review; accounting policy information relevant to each stream would be expected). Accounting policy information must be given for material transactions, particularly if unusual or non-recurring but the FRC does not expect immaterial or irrelevant accounting policy information to be disclosed. Industry-specific accounting policy information must be clearly disclosed, avoiding industry specific jargon.⁵⁵

Disclosure of particular accounting policies is especially useful to users when those policies are selected from alternatives allowed in FRS 102 (e.g., the accrual or performance model for government grants) and the standard often explicitly requires material accounting policy information to be disclosed in such situations. In addition, disclosure is useful where it relates to significant accounting policies not specifically required to be disclosed but which have been selected by management in accordance with the hierarchy in Section 10.

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) is also required to disclose the accounting policies used in determining the amounts to be included in respect of items shown in the statement of financial position and in determining the profit or loss of the company (or the LLP), in the notes to the accounts. [1 Sch 44, 1 Sch 44 (LLP)].

⁵⁵ See, for example, the FRC's Corporate Reporting Review: Annual Report 2015 (October 2015), section 5.2.

The Regulations (and LLP Regulations) specifically require the note on accounting policies to include:

- Accounting policies with respect to depreciation and diminution in value of assets [1 Sch 44, 1 Sch 44 (LLP)]
 - The items affected and the basis of valuation adopted for each item measured using the alternative accounting rules, e.g., where property, plant and equipment is revalued [1 Sch 34(2), 1 Sch 34(2) (LLP)]
- And
- The amortisation period for capitalised development costs, together with the reasons for capitalising the development costs [1 Sch 21, 1 Sch 21 (LLP)]

While not required by the Regulations (or LLP Regulations), it is common practice to include the following required note disclosures within the disclosure of material accounting policy information:

- Where in exceptional cases the useful life of intangible assets (including goodwill) cannot be reliably estimated, the amortisation period (which must not exceed ten years) chosen by the directors (or the members of the LLP), together with the reasons for choosing that period. [1 Sch 22, 1 Sch 22 (LLP)].
- And
- The basis of translating sums denominated in foreign currencies into sterling (or the currency in which the accounts are drawn up). [1 Sch 70, 1 Sch 68 (LLP)].

Most financial statements disclose the accounting convention used in their preparation. An example is given below, although the nature of the departures from the historical cost convention will depend on an entity's accounting policies.

Illustration 7-1: Accounting convention

The financial statements are prepared in accordance with the historical cost convention, except for the revaluation of property, plant and equipment at market value under the alternative accounting rules and application of the fair value accounting rules to derivative financial assets and liabilities and hedging relationships.

7.3 Judgements in applying accounting policies

An entity's material accounting policy information or other notes must disclose the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

[FRS 102.8.6].

Examples of judgements in applying accounting policies include: for a lessor, whether a lease is classified as an operating or finance lease; whether a transaction is a business combination or an asset transaction; and whether the entity is acting as principal or agent in a revenue transaction.

Individual sections in FRS 102 may specifically require disclosure of certain judgements, although in general, there are fewer such disclosures required than under IFRS accounting standards).

7.4 Information about key sources of estimation uncertainty

The notes to the financial statements must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of their nature and their carrying amount as at the end of the reporting period. [FRS 102.8.7].

The Regulations and LLP Regulations require the notes to the accounts to include the significant assumptions underlying the valuation models and techniques used to determine financial instruments, investment property, living animals and plants and stocks measured at fair value (under the fair value accounting rules). [1 Sch 55(2)(a), 1 Sch 53(2)(a) (LLP)].

IAS 1/IAS 8 includes the same requirement as FRS 102 on disclosure of key sources of estimation uncertainty, [IAS 1.125, IAS 8 2027.31A], but contains more explanatory guidance that management may consider, as permitted by the hierarchy in Section 10, in determining how to make the above disclosure.

7.5 Other notes disclosures in the presentation sections of FRS 102

An entity shall disclose in the notes to the financial statements: [FRS 102.3.24(a), FRS 102.3.24(b)]

- The legal form of the entity, its country of incorporation and the address of its registered office (and principal place of business, if different from the registered office)

And

- A description of the nature of the entity's operations and its principal activities unless this is disclosed in the business review (or similar statement) accompanying the financial statements.

An entity's principal activities will often be explained in the strategic report as part of the business review.

The date the financial statements were authorised for issue and who gave that authorisation must be disclosed. If the entity's owners or others have the power to amend the financial statements after issue, the entity shall disclose that fact. [FRS 102.32.9]. See Chapter 34 at 3.4.1.

The above requirement overlaps with the requirements in CA 2006 for the company's directors to approve the annual accounts and for a director, on behalf of the board, to sign the company statement of financial position (with the printed name of the director signing on behalf of the board stated in published and filed copies).⁵⁶ [s414, s433, s444, s445, s446, s447]. For LLPs, the same requirements apply but the annual accounts are approved by the members of the LLP and are signed, on behalf of the members, by a designated member. [s414 (LLP), s433 (LLP), s444 (LLP), s445 (LLP), s446 (LLP), s447 (LLP)]. However, the disclosures on authorisation of the financial statements required by FRS 102 are also often included as a separate note to the financial statements.

In addition, individual and group accounts of a company (or an LLP) must state:

- The part of the UK in which the company (or the LLP) is registered
- The company's (or the LLP's) registered number
- Whether the company is a public or private company and whether it is limited by shares or by guarantee (no equivalent disclosure for LLPs)
- The address of the company's (or the LLP's) registered office

And

- Where appropriate, the fact that the company (or the LLP) is being wound up

This disclosure requirement applies to both Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts. [s396(A1), s397(1), s404(A1), s406(1), s396(A1)(LLP), s397(1)(LLP), s404(A1)(LLP), s406(1)(LLP)].

7.6 Segmental disclosures of turnover

A UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) must give the following disclosures in the notes to the accounts:

- Where the company (or LLP) has carried on business of two or more classes during the financial year that, in the opinion of the directors (or of the members of the LLP), differ substantially from each other, the amount of the turnover attributable to each class of business together with the description of the class.

And

- Where the company (or LLP) has supplied geographical markets during the financial year that, in the opinion of the directors (or of the members of the LLP), differ substantially from each other, the amount of the turnover attributable to each such market.

The directors (or the members of the LLP) should have regard to the manner in which the company's (or LLP's) activities are organised in making the above analysis. Classes of business (or markets) which, in the opinion of the directors (or of the members of the LLP), do not differ substantially from each other must be treated as one class (or market). Amounts attributable to a class of business (or market) that are not material may be included in the amount stated in respect of another class of business (or market).

Where disclosure of any of the information required would, in the opinion of the directors (or of the members of the LLP), be seriously prejudicial to the interests of the company (or the LLP), that information need not be disclosed, but the fact that any such information has not been disclosed must be stated.

[1 Sch 68, 1 Sch 65 (LLP)].

⁵⁶ The Registrars' Rules require that the filed copy of the annual accounts is also signed by a director.

For group accounts, the disclosures are given for the company (or LLP) and undertakings included in the consolidation (i.e., consolidated undertakings). [6 Sch 1(1), 3 Sch 1 (LLP)].

The above requirements do not apply for a company subject to the small companies regime or an LLP subject to the small LLPs regime.

7.7 Staff numbers and costs (and number of members of an LLP)

Company law requires a UK company or an LLP to disclose the following in respect of staff numbers and costs in the notes to the annual accounts: [s411(1), s411(2), s411(5), s411(1)(LLP), s411(2)(LLP), s411(5)(LLP)]

- (a) The average number of persons employed by the company (or the LLP) in the financial year
- (b) The average number of persons within each category of persons so employed
 - This means an analysis of (a) by category selected by the company's directors (or the members of the LLP), having regard to the manner in which the company's (or the LLP's) activities are organised
 - And
- (c) in respect of all persons employed by the company (or the LLP) during the financial year under contracts of service, the aggregate amounts of:
 - (i) Wages and salaries paid or payable in respect of the year to those persons
 - (ii) Social security costs incurred by the company (or the LLP) on their behalf
 - And
 - (iii) Other pension costs so incurred

unless stated elsewhere in the company's (or the LLP's) accounts.

This disclosure applies both to Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts. The information in (c) may already be stated elsewhere in the company's (or the LLP's) accounts where the format 2 profit and loss account is used.

Where group accounts are prepared, the information in (a) to (c) above is required both for the consolidated group (i.e., the company (or the LLP) and its consolidated subsidiary undertakings) [s411(7), s411(7)(LLP)] and for the company (or the LLP).

The average number of persons employed is determined by dividing the 'relevant annual number' by the number of months in the financial year. The relevant annual number is determined by ascertaining the number of persons employed under contracts of service by the company (or the LLP) for each month in the financial year (whether throughout the month or not - so including both part-time and full-time employees) and then adding together all the monthly numbers. The number of persons so employed in each category is determined in a similar way. [s411(3), s411(4), s411(3)(LLP), s411(4)(LLP)].

Wages and salaries, and social security costs are determined by reference to payments made or costs incurred in respect of all persons employed by the company (or the LLP) during the financial year under contracts of service. [s411(5), s411(5)(LLP), 4 Sch 12 (LLP), 10 Sch 14].

Social security costs mean any contributions by the company (or the LLP) to any state social security or pension scheme, fund or arrangement. [s411(6), s411(6)(LLP), 4 Sch 12 (LLP), 10 Sch 14].

Pension costs include any costs incurred by the company (or the LLP) in respect of any pension scheme established for the purpose of providing pensions for current or former employees; any sums set aside for the future payment of pensions directly by the company (or the LLP) to current or former employees; and any pensions paid directly to such persons without having first been set aside. [s411(6), s411(6)(LLP), 4 Sch 12 (LLP), 10 Sch 14]. Pension costs exclude contributions to a state pension scheme - these are disclosed as social security costs.

The disclosures relate to persons employed on 'contracts of service' with the company (or the LLP) (meaning an employment contract) and, therefore, exclude self-employed people such as contractors or consultants. Executive directors generally have a contract of service, but non-executive directors may have contracts for services. Where this is the case, the non-executive directors would be excluded from the above disclosure. All directors fall within the scope of statutory directors' remuneration disclosures (as noted at 8 above, these are beyond the scope of this publication).

In groups, employees with contracts of service with one entity (such as the parent or a corporate services entity) may be seconded to another group entity or paid by another entity, sometimes with costs recharged. In such cases, we recommend that entities supplement the statutory disclosures for persons with contracts of service with additional information on staff costs and staff numbers, explaining the particular situation, including the impact on the profit and loss account.

LLPs preparing non-IAS accounts must also disclose the average number of members of the LLP in the financial year. This is computed by dividing the relevant annual number (i.e., determining the number of members of the LLP for all or part of each month in the financial year, and adding together all the monthly numbers) by the number of months in the financial year. [1 Sch 66(1)(LLP), 1 Sch 66(2)(LLP)].

FRS 102 also includes disclosures in respect of share-based payment and employee benefits (see Chapter 28 at 14 and Chapter 30 at 4).

7.8 Off balance sheet arrangements

A company or LLP may be party to arrangements that are not reflected in its statement of financial position and at the reporting date, the risks or benefits arising from those arrangements may be material. If that is the case, company law requires a UK company or an LLP to disclose information in the notes to the accounts, as follows:

- (a) The nature and business purpose of the arrangements

And

- (b) The financial impact of the arrangements on the company (or the LLP)

The information need only be given to the extent necessary for enabling the financial position to be assessed.

This disclosure applies both to Companies Act accounts (non-IAS accounts, for an LLP) and IAS accounts.

In group accounts, the disclosures relate to the company and the undertakings included in the consolidation. [s410A, s410A (LLP)]. Where group accounts are prepared, the information in (a) and (b) is given for both the consolidated group and the company (or the LLP).

Section 410A implements the requirement for disclosure of 'off-balance sheet arrangements' included in Directive 2006/46/EC. Recital 9 to the EU Directive states:

"Such off-balance sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones that are not included in the balance sheet. Such off-balance sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, *inter alia*, economic, legal, tax or accounting objectives. Examples of such off-balance sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like. Appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet must be set out in the notes to the accounts or the consolidated accounts."

The examples listed in Recital 9 are not to be taken as exhaustive. FRS 102 and/or the Regulations and LLP Regulations already require disclosures about certain off-balance sheet arrangements. The Regulations and LLP Regulations also, *inter alia*, require certain disclosures including in relation to the nature and form of security given for debts (see 4.3.8 above) and in respect of guarantees, contingencies and other financial commitments (see 7.8.1 below). As discussed at 7.3 above, FRS 102 also requires significant judgements in applying accounting policies to be disclosed.

UK companies and LLPs will, however, still need to consider whether the disclosures given are sufficient to meet the requirements of section 410A and whether the entity is party to material off-balance sheet arrangements not required to be disclosed by FRS 102 that must be disclosed in accordance with section 410A. However, we consider this would rarely occur.

7.8.1 Guarantees, contingencies and commitments

Company law requires a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) to give the following information in a note to the accounts: [1 Sch 63, 1 Sch 60 (LLP)]

- (a) particulars must be given of any charge on the assets of the company (or the LLP) to secure the liabilities of any other person, including the amount secured
- (b) particulars and the total amount of any financial commitments, guarantees and contingencies that are not included in the statement of financial position must be disclosed, together with an indication of the nature and form of any valuable security given by the company (or the LLP) in respect of such commitments, guarantees and contingencies
- (c) the total amount of any pension commitments (within (b) above) that are not included in the statement of financial position must be separately disclosed

- (d) separate particulars of any pension commitment (within (c) above) relating wholly or partly to pensions payable to past directors of the company (or to past members of the LLP) must be given
- (e) the total amount of any commitments, guarantees and contingencies (within (b) above) that are not included in the statement of financial position undertaken on behalf or for the benefit of:
 - (i) any parent undertaking or fellow subsidiary undertaking of the company (or LLP)
 - (ii) any subsidiary undertaking of the company (or LLP)
 Or
 - (iii) any undertaking in which the company (or LLP) has a participating interest
 must be separately stated and those within each of paragraphs (i), (ii) and (iii) must also be stated separately from those within any other of those paragraphs
- And
- (f) particulars must also be given of any pension commitments which are included on the statement of financial position, with separate particulars given for any pension commitment relating wholly or partly to pensions payable to past directors of the company.

Part (e) above appears to require the totals for (i), (ii), (iii) (and the sum of the totals for (i) to (iii)) to be separately stated.

See 4.3.4.C and 4.3.4.D above and Chapter 3 at 3.1.2 for guidance on the relevant definitions.

Where group accounts are prepared, the disclosures are given for both the consolidated group (i.e., the company (or LLP) and its consolidated subsidiary undertakings) and the individual company (or LLP). [6 Sch 1(1), 3 Sch 1(1)(LLP)].

7.9 Directors' advances, credits and guarantees

Company law requires a UK company preparing Companies Act accounts or IAS accounts to disclose information concerning directors' advances, credits and guarantees. There is no equivalent disclosure for LLPs.

A company that does not prepare group accounts must disclose in the notes to its individual accounts: [s413(1)]

- Advances and credits granted by the company to its directors
- And
- Guarantees of any kind entered into by the company on behalf of its directors.

A parent company that prepares group accounts must disclose in the notes to the group accounts: [s413(2)]

- Advances and credits granted to the directors of the parent company, by that company or by any of its subsidiary undertakings
- And
- Guarantees of any kind entered into on behalf of the directors of the parent company, by that company or by any of its subsidiary undertakings

The details required for an advance or credit are: [s413(3), s413(5)]

- Its amount - for each advance or credit and totals in aggregate
- An indication of the interest rate
- Its main conditions
- Any amounts repaid - for each advance or credit and totals in aggregate
- Any amounts written off - for each advance or credit and totals in aggregate
- And
- Any amounts waived - for each advance or credit and totals in aggregate

The details required for a guarantee are: [s413(4), s413(5)]

- Its main terms
- The amount of the maximum liability that may be incurred by the company (or its subsidiary) - for each guarantee and totals in aggregate
- And
- Any amount paid and any liability incurred by the company (or its subsidiary) for the purpose of fulfilling the guarantee (including any loss incurred by reason of enforcement of the guarantee) - for each guarantee and also totals in aggregate

Disclosure is required: [s413(6), s413(7)]

- In respect of persons who were directors of the company at any time in the financial year to which the financial statements relate
And
- For every advance, credit or guarantee that subsisted at any time in the financial year:
 - Whenever it was entered into
 - Whether or not the person concerned was a director of the company at the time it was entered into
And
 - In relation to an advance, credit or guarantee involving a subsidiary undertaking of the company, whether or not that undertaking was a subsidiary undertaking at the time the advance, credit or guarantee was entered into

There are certain exemptions for banking companies (and the holding companies of credit institutions (see definitions at 3.1.2 above), as explained at 7.9.1 below.

The terms advances, credits, and guarantees are not defined in CA 2006 itself. The rules governing the lawfulness of transactions in Part 10 of CA 2006 refer to loans, quasi-loans (including related guarantees or provision of security) and credit transactions. While these terms do not align with the terms used in section 413, loans and quasi-loans and credit transactions would generally be considered as advances and credits; guarantees or provision of security would be disclosed as guarantees.

The requirements appear to require disclosure of each advance or credit, or guarantee made. This could be arduous in some contexts, as the definition of advances and credits could include directors' current accounts or personal purchases made using a company credit card (as well as loans and outstanding credit card balances provided by banks or finance subsidiaries of certain retailers).

7.9.1 Banking companies and holding companies of credit institutions

A banking company or the holding company of a credit institution is only required to disclose: [s413(8)]

- The total amounts of advances and credits granted by the company (or in group accounts, by the company and its subsidiary undertakings) [s413(5)(a)]
And
- The total amounts of the maximum liability that may be incurred by the company (or its subsidiary) in respect of guarantees entered into by the company (or in group accounts, by the company and its subsidiary undertakings) [s413(5)(c)]

8 General principles for preparation of financial statements

The objective of financial statements is to provide information about an entity that is useful for decision-making by a wide range of users who are not in a position to demand reports tailored to meet their particular information needs. [FRS 102.2.4]. The type of information envisaged is information about the economic resources of the entity, claims against the entity and changes in those resources and claims. It should also provide information about management's stewardship - or how efficiently and effectively an entity's management has discharged its responsibilities to use the entity's economic resources. [FRS 102.2.5].

This section addresses FRS 102's requirement for financial statements to give a true and fair view, the adoption of the going concern basis, and materiality and aggregation. There are similar requirements in the Regulations (and LLP Regulations), as highlighted at 8.1 below.

8.1 Requirements of the Regulations (and LLP Regulations)

The Regulations (and LLP Regulations) include:

- The requirement for accounts to give a true and fair view, and the concept of a 'true and fair override' (see 8.2 below)
 - General principles for the preparation of financial statements, similar to those included in FRS 102 (see 8.1.1 below)
- And
- Recognition and measurement principles, where assets and liabilities are measured under the historical cost convention, alternative accounting rules and fair value accounting rules

8.1.1 General principles for preparation of financial statements

The general principles set out in the Regulations and the LLP Regulations for the preparation of financial statements are: [1 Sch 10, 1 Sch 11, 1 Sch 12, 1 Sch 13, 1 Sch 14, 1 Sch 15, 1 Sch 15A, 1 Sch 10 (LLP), 1 Sch 11 (LLP), 1 Sch 12 (LLP), 1 Sch 13 (LLP), 1 Sch 14 (LLP), 1 Sch 15 (LLP), 1 Sch 15A (LLP), 1 Sch 40(2), 1 Sch 40(2) (LLP)]

- The company (or the LLP) is presumed to be carrying on business as a going concern (see 8.3 below)
 - Accounting policies (and measurement bases) must be applied consistently within the same accounts and from one financial year to the next (see 2.6.1 above)
 - The amount of any item must be determined on a prudent basis, and in particular:
 - Only profits realised at the balance sheet date are to be included in the profit and loss account (except where fair value changes of financial instruments, investment property or living animals or plants are required to be included in the profit and loss account by the fair value accounting rules)
 - All liabilities which have arisen in respect of the financial year to which the accounts relate or a previous financial year must be taken into account, including those which only became apparent between the balance sheet date and the date on which it is signed on behalf of the Board (or the members of the LLP) in accordance with section 414 of CA 2006
- And
- All provisions for diminution of value must be recognised, whether the result of the financial year is a profit or loss
 - All income and charges relating to the financial year to which the accounts relate must be taken into account without regard to the date of receipt or payment (i.e., accruals basis)
 - In determining the aggregate amount of any item, the amount of each individual asset or liability that falls to be taken into account must be determined separately (i.e., no offsetting)
- And
- The opening balance sheet for each financial year must correspond to the closing balance sheet for the preceding financial year

In addition, at the balance sheet date, any provision made must represent the best estimate of the expenses likely to be incurred or, in the case of a liability, of the amount required to meet that liability; and provisions must not be used to adjust the values of assets. [9 Sch 2A, 9 Sch 2B, 1 Sch 13(d) (LLP), 1 Sch 13(d) (LLP)]. This requirement has been included within the general principles in the LLP Regulations but in Schedule 9 to the Regulations.

The above principles apply in both individual and group accounts. [6 Sch 1(1), 3 Sch 1(1) (LLP)].

Schedules 2 and 3 to the Regulations (and the Small Companies Regulations, which are addressed in Chapter 5) have the same requirements. However, the prohibition on presenting unrealised profits in the profit and loss account (unless permitted by the fair value accounting rules) in Schedule 3 to the Regulations is also subject to note (9) to the profit and loss account formats in that schedule concerning the presentation of unrealised gains and losses on investments. Only the references in Schedule 1 to the Regulations and Schedule 1 to the LLP Regulations are noted below.

8.1.1.A Substance over form

Where an FRS does not specifically address a transaction, management must use its judgement in developing and applying an accounting policy that results in relevant and reliable information. *[FRS 102.10.4]*. One of the characteristics of reliable information is that the financial statements “reflect the economic substance of transactions, other events and conditions, and not merely the legal form.” *[FRS 102.10.4(b)(ii)]*. Section 2 also touches on this when describing the characteristic of faithful representation, explaining that financial information must faithfully represent the substance of the economic phenomenon that it purports to represent. In cases where the legal form is not the same as the substance, providing information only about the legal form would not faithfully represent the economic phenomenon. *[FRS 102.2.14]*.

The General Rules to the formats (see 3.4 above) require that items in the balance sheet and profit and loss account formats are presented, having regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice. *[1 Sch 9, 1 Sch 9 (LLP)]*. This requirement facilitates the presentation of certain shares as liabilities in accordance with FRS 102.

8.1.1.B Prudence

FRS 102 identifies prudence as “the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities or expenses are not understated. Equally, the exercise of prudence does not allow for the deliberate understatement of assets or income, or the overstatement of liabilities or expenses. In short, prudence does not permit bias.” *[FRS 102 Appendix I]*. The absence of bias results in a neutral depiction and this is supported by the exercise of prudence. However, exercising prudence does not mean that more persuasive evidence is needed to support the recognition of assets or income, compared to that needed for the recognition of liabilities or expenses. In other words, it does not imply a need for asymmetry, though individual sections of the standard may have asymmetric requirements if this is needed to select the most relevant information that faithfully represents what it purports to represent. *[FRS 102.2.17]*.

FRS 102 does not specifically refer to realised profits. However, a UK company preparing Companies Act accounts (or an LLP preparing non-IAS accounts) is required by the Regulations (or LLP Regulations) to determine amounts included in the profit and loss account section of the statement of comprehensive income (or separate income statement) on a prudent basis, which results in only profits realised at the balance sheet date being included in profit or loss. This is discussed in Appendix III to FRS 102.

[FRS 102.A3.25, FRS 102.A3.26, FRS 102.A3.27, FRS 102.A3.28, FRS 102.A3.29]. Consequently, UK companies preparing Companies Act accounts (and LLPs preparing non-IAS accounts) must present certain unrealised gains in other comprehensive income instead. Profit or loss and other comprehensive income, including the concept of realised profits, are discussed further at 5.2 above.

UK companies should be mindful that not all gains (even if recognised in profit or loss) may be distributable. Appendix III to FRS 102 states that entities measuring financial instruments, investment properties, and living animals and plants at fair value should note that they may transfer such amounts to a separate non-distributable reserve, instead of a transfer to retained earnings, but are not required to do so. Presenting fair value movements that are not distributable profits in the separate reserve may assist with identification of profits available for that purpose. *[FRS 102.A3.28]*. Appendix III further notes that the determination of profits available for distribution is a complex area where accounting and company law interface and that companies may refer to TECH 02/17BL, or any successor document, to determine profits available for distribution. *[FRS 102.A3.29]*.

8.1.1.C Offset

The standard explains that offsetting occurs when an entity recognises both an asset and liability as separate units of account, but presents them as a single net amount in the statement of financial position. As this means classifying dissimilar items together, it is generally not appropriate. [FRS 102.2.95]. FRS 102 prohibits offset of assets and liabilities, or income and expenses, unless required or permitted by an FRS (meaning, at present, FRS 102 itself or FRS 103, where applied). [FRS 102.2.96]. See Chapter 4 at 3.8.2. For the avoidance of doubt, the standard clarifies that measuring assets net of valuation allowance - for example, allowances for inventory obsolescence and uncollectible receivables is not offsetting. [FRS 102.2.97]. The rules on offsetting are similar to the requirement in the General Rules to the formats (see 3.4 above) that amounts in respect of items representing assets or income may not be set off against amounts in respect of items representing liabilities or expenditure (as the case may be), or *vice versa*. [1 Sch 8, 1 Sch 8 (LLP)].

FRS 102 sets out when financial assets and liabilities [FRS 102.11.38A, FRS 102.12.25B] (see Chapter 15 at 3.3), employee benefits [FRS 102.28.3(a), FRS 102.28.14, FRS 102.28.30] (see Chapter 30 at 3.5.1 and Chapter 30 at 3.7.2), current tax, and deferred tax [FRS 102.29.24, FRS 102.29.24A], (see Chapter 31 at 11.1.1) must be offset. Where the offset criteria are met, FRS 102 is saying that there is effectively a single asset or liability.

In respect of the profit and loss account, if an entity's normal operating activities do not include buying and selling fixed assets (including investments and operating assets), gains and losses on disposal of fixed assets (net of related selling expenses) are reported. [FRS 102.2.98]. Expenses for a provision are permitted to be shown net of the amount recognised for reimbursement of the provision. [FRS 102.21.9].

FRS 102 also permits cash flows from operating, investing and financing activities to be presented on a net basis where specified criteria are met. [FRS 102.7.10A, FRS 102.7.10B, FRS 102.7.10C, FRS 102.7.10D].

Appendix III to FRS 102 explains how the requirements on reimbursement of provisions (offsetting permitted in profit and loss account only) and financial assets (offsetting required when, and only when the criteria are met) are consistent with the Regulations. [FRS 102.A3.22, FRS 102.A3.23].

8.2 True and fair view and compliance with FRS 102

The FRC's *Foreword to Accounting Standards* (January 2022) explains that accounting standards are applicable to the financial statements of a reporting entity that are required to give a true and fair view of its financial position at the reporting date and of its profit or loss (or income and expenditure) for the reporting period. The whole essence of accounting standards is to provide for recognition, measurement, presentation and disclosure for specific aspects of financial reporting in a way that reflects economic reality and hence provides a true and fair view. The *Foreword to Accounting Standards* refers to information about 'true and fair' on the FRC's website (e.g., the guidance *True and Fair* issued in June 2014). [Foreword.4-6].

True and Fair notes, *inter alia*, that accounting standards are developed after full due process and "these processes should result in accounting standards that, in the vast majority of cases, are complied with when presenting a true and fair view." Where the accounting standards clearly address an issue, but the requirements are insufficient to fully explain the issue, the solution is normally additional disclosure. However, a company must depart from a particular accounting standard where required in order to meet the requirement for the accounts to give a true and fair view. The guidance notes that these circumstances are more likely to arise when the precise circumstances were not contemplated during the development of the relevant standard.

The FRC expects preparers, those charged with governance and auditors to stand back and ensure that the financial statements as a whole give a true and fair view, provide additional disclosures where compliance with an accounting standard is insufficient to give a true and fair view, to use the true and fair override where compliance with the standards does not result in the presentation of a true and fair view and to ensure that the consideration they give to these matters is evident in their deliberations and documentation.⁵⁷

8.2.1 True and fair view - requirements of FRS 102 and the Regulations

FRS 102 requires that financial statements shall give a true and fair view of the assets, liabilities, financial position, financial performance and, when required to be presented, cash flows of an entity. [FRS 102.3.2, FRS 102 Appendix I].

⁵⁷ True and Fair, FRC, June 2014.

Section 393 of CA 2006 also requires that the directors of a UK company or the members of an LLP must not approve the annual accounts unless they are satisfied that they give: *[s393, s393 (LLP)]*

- In the case of the individual accounts, a true and fair view of the assets, liabilities, financial position and profit or loss of the company or LLP
And
- In the case of the group accounts (if any), a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included in the consolidation as a whole, so far as concerns members of the company or LLP

The 'undertakings included in the consolidation' means the parent company or the parent LLP and its consolidated subsidiary undertakings and is referred to as 'the group' below.

Companies Act accounts (or non-IAS accounts, for an LLP) must include:

- A balance sheet that gives a true and fair view of the company's or LLP's state of affairs (and, where applicable, the group's state of affairs, so far as concerns members of the company or LLP) as at the end of the financial year
And
- A profit and loss account that gives a true and fair view of the company's or LLP's profit or loss (and, where applicable, the group's profit or loss, so far as concerns members of the company or LLP) for the financial year

The accounts must comply with regulations made by the Secretary of State as to the form and content of the individual (and where applicable, the consolidated) balance sheet and profit and loss account, and additional information to be provided by way of notes to the accounts. *[s396(1), s396(2), s396(3), s404(1), s404(2), s404(3), s396(1)(LLP), s396(2)(LLP), s396(3)(LLP), s404(1)(LLP), s404(2)(LLP), s404(3)(LLP)]*.

Application of FRS 102, with additional disclosure when necessary, is presumed to result in financial statements that give a true and fair view of the financial position, financial performance and, when required to be presented, cash flows of entities within the scope of the standard. *[FRS 102.3.2(a)]*.

All paragraphs of FRS 102 have equal authority. Some sections include appendices containing implementation guidance or examples, some of which are an integral part of the standard and others provide application guidance (each specifies its status). We would generally expect that entities follow the implementation guidance unless there is a valid reason. The presumption that application of FRS 102 (with any necessary additional disclosure) results in a true and fair view is subject to the override set out in paragraph 4 of section 3 of the standard (and for entities preparing financial statements subject to CA 2006, the true and fair override). *[FRS 102.3.4]*. See 8.2.2 below.

The additional disclosures referred to in paragraph 2(a) of section 3 of the standard are necessary when compliance with the specific requirements in the standard is insufficient to enable users to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. *[FRS 102.3.2]*.

This is consistent with the statutory requirement that if compliance with the regulations, and any other provisions made by or under CA 2006, as to matters to be included in a company's or an LLP's individual accounts (and, where applicable, group accounts) or in notes to those accounts would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or in a note to them. *[s396(4), s404(4), s396(4)(LLP), s404(4)(LLP)]*.

8.2.2 The 'true and fair override' - requirements of FRS 102 and the Regulations

In special circumstances when management concludes that compliance with any requirement of FRS 102 or applicable legislation (only when it allows for a true and fair override) is inconsistent with the requirement to give a true and fair view, the entity shall depart from that requirement in the manner set out in paragraph 5 of section 3 of the standard. *[FRS 102.3.4]*.

When an entity departs from a requirement of FRS 102, or from a requirement of applicable legislation, it shall disclose:

- (a) That management has concluded that the financial statements give a true and fair view of the entity's financial position, financial performance and, when required to be presented, cash flows.
- (b) That it has complied with FRS 102 or applicable legislation, except that it has departed from a particular requirement of the standard or applicable legislation to the extent necessary to give a true and fair view.

And

- (c) The nature and effect of the departure including the treatment that FRS 102 or applicable legislation would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in Section 2 (see 9 above), and the treatment adopted. *[FRS 102.3.5]*.

When an entity has departed from a requirement of FRS 102 or applicable legislation in a prior period and that departure affects the amounts recognised in the financial statements for the current period, it shall make the disclosures set out in (c) above. *[FRS 102.3.6]*.

These disclosures are consistent with the statutory disclosures that: if in special circumstances, compliance with any of those provisions is inconsistent with the requirement to give a true and fair view, the directors must depart from that provision to the extent necessary to give a true and fair view. Particulars of any such departure, the reasons for it and its effect must be given in a note to the accounts. *[s396(5), s404(5), s396(5)(LLP), s404(5)(LLP)]*.

How we see it

FRS 102 does not explain what is required by the 'effect' of the departure from the requirement to give a true and fair view, but in our view, this means 'financial effect'.

In the absence of guidance in FRS 102, management may consider the requirements of IFRS accounting standards. Where there is a departure from the standards in the current period (or a departure was made in a previous period which impacts the amounts recognised in the financial statements in the current period), IAS 1/IAS 8 requires disclosure, for each period presented, of the financial impact of the departure on each item in the financial statements that would have been reported in complying with the requirement.

[IAS 1.20(d), IAS 1.21, IAS 8 (2027).6F].

In addition, where it appears to the directors of the company (or members of the LLP) that there are special reasons for departing from any of the general principles (see 8.1.1 above) in preparing the company's (or the LLP's) accounts for the financial year, the particulars of the departure, the reasons for it and its effect must be disclosed in a note to the accounts. *[1 Sch 10(2), 1 Sch 10(2)(LLP)]*. Appendix III to FRS 102 highlights certain instances where the requirements of FRS 102 result in a departure from the requirements of the Regulations in order to give a 'true and fair view'. These examples, which are not exhaustive, are relevant to UK companies preparing Companies Act accounts. They are also relevant to LLPs preparing non-IAS accounts- except that the conditions for merger accounting differ for UK companies and LLPs.

Large and medium-sized companies (and LLPs) must state in the notes to the accounts (see 2.6.1 above) whether the accounts have been prepared in accordance with applicable accounting standards, giving particulars of any material departures from those standards and the reasons. *[1 Sch 45, 1 Sch 45 (LLP)]*.

Medium-sized companies (and LLPs) are exempt from making this statement in individual accounts.

[Regulations 4(2A), LLP Regulations 4(2A)]. It is appropriate for this statement to either include or cross refer any disclosures of the true and fair override.

8.3 Going concern

FRS 102 requires management, when preparing financial statements, to make an assessment of an entity's ability to continue as a going concern. An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue. *[FRS 102.3.8, FRS 102 Appendix I]*.

When an entity does prepare its financial statements on a going concern basis, it must disclose that fact, along with confirmation that management has considered future information relating to at least twelve months (or longer) from the date of authorisation, as described above. If the entity has made significant judgements in its assessment of its ability to continue as a going concern, those judgements must also be disclosed (see section 7.3 above). *[FRS 102.3.8A]*

When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties must be disclosed in the financial statements. *[FRS 102.3.9]*.

When financial statements are not prepared on a going concern basis, that fact must be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern. *[FRS 102.3.9]*.

FRS 102 states that an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading or that it has no realistic alternative but to do so. Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is no longer appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that a fundamental change in the basis of accounting is required, rather than an adjustment to the amounts recognised within the original basis of accounting and therefore the disclosure requirements in paragraph 9 of section 3 of the standard, as described above, apply. [FRS 102.32.7A, FRS 102.32.7B].

FRS 102 provides no further guidance on the impact on the financial statements if it is determined that the going concern basis is not appropriate. Accordingly, entities will need to consider their individual circumstances to arrive at an appropriate basis.

FRS 102's requirements are supplemented by the FRC's February 2025 *Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks)* ('2025 FRC Guidance').⁵⁸ This guidance is intended for all companies with the exception of small and micro entities and for entities which apply The UK Corporate Governance Code, either because they are required to or because they apply the Code voluntarily. It is equally applicable to those entities that do not apply the Code. See 8.3.1 below.

8.3.1 2025 FRC Guidance on Going Concern

The 2025 FRC Guidance replaces all previous guidance on going concern. It integrates requirements from company law, accounting and auditing standards, listing rules, the UK Corporate Governance Code and other regulations relating to reporting on the going concern basis of accounting and on solvency and liquidity risk. It incorporates recent developments in the corporate reporting framework and auditing standards, evolving reporting practice, and the FRC's continued focus on encouraging high-quality reporting within the annual report.⁵⁹

The 2025 FRC Guidance is non-mandatory best practice guidance which aims to serve as a proportionate and practical guide for directors of all companies within its scope (including *UK Corporate Governance Code* (the Code) companies) to assist them with the application of the applicable legal and regulatory requirements to:

- Assess and make disclosures related to the going concern basis of accounting and any material uncertainties in their financial statements.
- And
- Disclose principal risks and uncertainties, which may include risks that might impact solvency and liquidity, within their strategic report.

While the 2025 FRC Guidance refers to directors and companies for simplicity, the guidance notes that it is also likely to be relevant to other entities, such as partnerships. It outlines the responsibilities of the auditor in connection with the directors' assessment of the company's ability to continue to adopt the going concern basis of accounting and the related disclosures in the financial statements or annual report.

The FRC's factsheet containing guidance on the going concern basis of accounting for small and micro-companies is discussed in Chapter 5 at 3.3.5.

The term 'going concern' refers to the going concern basis of preparation in the financial statements. However, the 2025 FRC Guidance further:

- Encourages directors to take a broader view, over a longer term, of the principal risks and uncertainties that goes beyond the specific requirements in accounting standards.
 - Acknowledges that companies have risk management and control processes in place that underpin the assessment and that the degree of formality of these processes and the level of analysis applied depends on the size, complexity, and the particular circumstances of the company.
- And
- Acknowledges that the amount of information disclosed should be proportionate to the uncertainties to which the company is exposed and to its financial and liquidity position⁶⁰.

⁵⁸ This version of the guidance has superseded previous *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risk - Guidance for directors of companies that do not apply The UK Corporate Governance Code*, issued on April 2016.

⁵⁹ *Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks)*, February 2025, FRC, Summary and para 1.6.

⁶⁰ *Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks)*, February 2025, FRC, para 1.7.

8.3.1.A Overview of approach

A company faces many risks. In making their assessment of principal risks, directors are encouraged to consider a broad range of business risks, including both financial and non-financial (for example, operational, competitive, market or regulatory factors, which may ultimately impact on solvency or liquidity).

The principal risks and uncertainties, i.e., those matters that could significantly affect the development, performance, position and future prospects of the company, are required to be disclosed in the strategic report. These will generally be the matters that the directors regularly monitor and discuss because of their likelihood, the magnitude of their potential effect, or a combination of the two.

Some of the principal risks may have the potential to threaten the company's ability to continue in operation because of their impact on solvency, i.e., the risk that a company will be unable to meet its liabilities in full, and liquidity, i.e., the risk that a company will be unable to meet its liabilities as they fall due. Insolvency is likely to be preceded by a lack of liquidity. An example of a principal risk that could have an impact on solvency or liquidity may be if a company is dependent on a single customer. If the customer ceased purchasing the company's products or services or became unable to pay its debts to the company, the company may be unable to meet its liabilities as they fall due. In an extreme case, the loss of the customer might have the potential to render the company insolvent.⁶¹

Material uncertainties arising from significant solvency and liquidity risks must be disclosed in accordance with the requirements of the accounting standards and provisions of the Code. In extreme circumstances, such risks may crystallise, thus making liquidation of the company inevitable and the going concern basis of accounting inappropriate.⁶²

The guidance summarises the process for determining which disclosures are necessary as follows:

- Identification of risks and uncertainties, including those relating to solvency and liquidity and other potential threats to the company's ability continue in operation
- Determining which of the identified risks and uncertainties are 'principal' and thereby require disclosure in the strategic report [s414C(2)(b)]
- Considering whether it is appropriate to adopt the going concern basis of accounting and provide disclosures about the basis adopted in the financial statements
- Considering whether there are material uncertainties that require disclosure in the financial statements [FRS 102.3.8, FRS 102.3.8A, FRS 102.3.9]
- In extreme circumstances, considering whether it is appropriate to adopt the going concern basis of accounting [FRS 102.3.9]

And

- Considering whether disclosures additional to those explicitly required by law, regulation or accounting standards are necessary for the financial statements to comply with overarching disclosure requirements (including disclosures about significant judgements made) and to provide a true and fair view⁶³ [s393]

The guidance covers:

- Factors for directors to consider when determining whether the going concern basis of accounting is appropriate (and whether significant judgements about material uncertainties should be identified)
 - Making an assessment of the solvency and liquidity risks that might constitute principal risks for a company requiring disclosure in the strategic report
 - Guidance on the assessment periods for the going concern basis of accounting and those risks
 - Guidance on the assessment process
- And
- Summaries of the related reporting requirements (including auditor reporting)

61 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 2.3, 4.1-4.7.

62 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para 2.3.

63 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para 2.4.

It also addresses the application of the guidance to half-yearly financial reports and preliminary announcements.⁶⁴ It is beyond the scope of this publication to set out the guidance in full but some of its considerations are set out below. Auditor reporting is not covered here.

8.3.1.B The assessment process - principal risks and going concern basis of accounting

Section 5 of the 2025 FRC Guidance provides further factors to consider and techniques that may be applied in:

- Assessing whether the going concern basis of accounting is appropriate
- Whether there are material uncertainties that may cast significant doubt on the going concern basis
- And
- Identifying principal risks and uncertainties to disclose in the strategic report, including risks that might impact solvency and liquidity

The factors discussed include:

- Forecasts and budgets
- The timing of cash flows
- Sensitivity analysis
- Products, services and markets
- Inflation
- Geopolitical and economic events
- Financial and operational risk management
- Borrowing facilities
- Alternative sources of finance (including government support schemes)
- Contingent liabilities
- And
- Acquisitions, disposals and restructuring; and group considerations (covered in section 7 of the 2025 Guidance)

For companies that apply the Code, these factors and techniques may also be relevant for the assessment of prospects (viability statement) under the Code and the UK Listing Rules.

The directors should assess which factors are likely to be relevant to their company, which will depend on the size, complexity and particular circumstances of the company, its industry and the general economic environment. Some factors will be more relevant for the assessment of the principal risks disclosures in the strategic report (or the assessment of prospects for Code companies) and others more relevant for the assessment of the going concern basis of accounting. The level of detail and the time horizon of the assessment may also differ for these purposes as longer-term assessments, such as for the strategic report disclosures, are likely to be performed at a higher, more aggregated level.⁶⁵

The assessment of solvency and liquidity risks should consider the likelihood and possible effects of those risks materialising. The period of assessment for solvency and liquidity risks, in the context of the requirement to disclose principal risks and uncertainties in the strategic report is a matter of judgement for the directors based on the particular facts and circumstances of the company. This will usually be longer than twelve months from the date the financial statement were authorised for issue, and will depend on the nature of the business, its stage of development, debt maturities, investment and planning time horizons.

Similarly, the extent of the assessment process, will be a matter of judgement for the directors based on the size, complexity and particular circumstances of the company. Given the forward-looking nature of the assessment, the level of detail and accuracy of the information available relating to the future will vary.⁶⁶

In making their assessment, the directors should consider all available information about the future at the date they approve the financial statements, such as the information from budgets and forecasts. The guidance recommends that the assessment should be documented in sufficient detail to explain the

⁶⁴ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para 2.5.

⁶⁵ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 5.1-5.7.

⁶⁶ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 4.10-4.12.

directors' conclusion with respect to the going concern basis of accounting at the date of approval of the financial statements.⁶⁷

The going concern assessment may result in four possible outcomes:

- The going concern basis of accounting is appropriate and there are no material uncertainties
- The going concern basis is appropriate and there are no material uncertainties but reaching this conclusion involves significant judgement
- The going concern basis is appropriate but there are material uncertainties. Reaching that conclusion may or may not involve significant judgement

Or

- The going concern basis of accounting is not appropriate

In the first three cases, the going concern basis of accounting is adopted.⁶⁸

The guidance explains that the threshold for departing from the going concern basis of accounting is very high as there are often realistic alternatives to liquidation or cessation of operations, even if they depend on uncertain future events.⁶⁹

However, events or conditions might result in the going concern basis of accounting becoming inappropriate in future accounting periods. The directors, in performing their assessment, should consider all available information about the future, the realistically possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to the directors. Uncertainties relating to such events or conditions are considered material if their disclosure could reasonably be expected to affect the economic decisions of shareholders and other users of the financial statements, which is a matter of judgement. In making this judgement, the directors should consider the uncertainties arising from their assessment, both individually and in combination with others.

The guidance highlights that key focus areas to consider include:

- The magnitude of the potential impacts of the uncertain future events or changes in conditions on the company and the likelihood of their occurrence
 - The realistic availability and likely effectiveness of any mitigating actions that the directors could take to avoid, or reduce the impact or likelihood of, the uncertain future events or changes in conditions
- And
- Whether these uncertain future events or changes in conditions are unusual, rather than occurring with sufficient regularity for the directors to make predictions about them with a high degree of confidence

The guidance states that uncertainties should not usually be considered material if the likelihood that the company will not be able to continue to use the going concern basis of accounting is assessed to be remote, however significant the assessed potential impact.⁷⁰

8.3.1.C Going concern disclosures

Except for the explicit statement about the adoption of the going concern basis of accounting [FRS 102.3.8A], there are no other specific disclosure requirements where the going concern basis of accounting is adopted and no material uncertainties are identified and/or no significant judgement is involved in reaching that conclusion.

The disclosures set out in paragraphs 8A and 9 of section 3 of the standard (see 8.3 above) must be given where:

- The going concern basis of accounting is appropriate but material uncertainties have been identified
 - There are no material uncertainties but reaching that conclusion involved significant judgement
- And
- The going concern basis of accounting is not appropriate

⁶⁷ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 3.4 - 3.7.

⁶⁸ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para. 3.23.

⁶⁹ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para. 3.3.

⁷⁰ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 3.10-3.13.

The 2025 FRC Guidance recommends as best practice that: where material uncertainties are identified, the financial statements should disclose clearly the existence and nature of the material uncertainty, including a description of the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and the directors' plans to deal with these events or conditions. Disclosures about material uncertainties must be company specific. Directors may also wish to bear in mind the obligation of the auditor to report if an appropriate level of clarity in the disclosure of material uncertainties has not been achieved.⁷¹

Paragraphs 8A of section 3 and 6 of section 8 of the standard require disclosure of judgements made in applying the company's accounting policies that have the most significant effect on amounts recognised in the financial statements (significant judgements). This applies to situations when significant judgement has been applied in determining whether the going concern basis of accounting is appropriate or a material uncertainty in respect of going concern exists. [FRS 102.3.8A, FRS 102.8.6].

The FRC 2025 Guidance provides examples of situations that could involve significant judgement in determining whether the going concern basis of accounting is appropriate or whether a material uncertainty exists (if they have a significant effect on the overall assessment either individually or when considered together with other factors), as follows:

- When a significant borrowing facility may need to be restructured or renewed
- When a waiver of a covenant by a lender of a significant borrowing facility may be needed
- And
- If other types of significant business restructuring, asset disposals or cost reductions are planned during the assessment period and these have been assumed in the assessment based on the directors' expectations of achieving them⁷²

Disclosures about significant judgements related to going concern assessments must be company specific and must clearly identify the judgement made. The same approach is relevant for the disclosures about assumptions used by the directors as those should provide sufficient information about the directors' basis for their assessment. This allows users to understand how the company might be affected by changes in factors and to assess whether the assumptions are consistent with those applied in other areas of the financial statements (such as impairment reviews) unless another accounting standard permits or requires otherwise in specific circumstances.⁷³

However, in all cases, additional disclosures may be required to give a true and fair view and the appropriateness of disclosures required will depend on facts and circumstances.

The Regulations also require disclosures in the directors' report providing an indication of the company's financial risk management objectives and policies (including the policy for hedging each major type of forecasted transaction for which hedge accounting is used) and the exposure of the company to price risk, credit risk, liquidity risk and cash flow risk, where material. [7 Sch 6].

The guidance recommends as best practice that the principal risks and uncertainties are described in a clear, concise and understandable way and must include a description of how the principal risks and uncertainties are managed or mitigated.

When the directors identify solvency or liquidity risks as principal risks, they must explain the particular economic or operational conditions that give rise to those principal risks and uncertainties, and the potential impact on specific aspects of the business. Issues that may require disclosure depend on individual facts and circumstances may include:

- Uncertainties about current financing arrangements (whether committed or uncommitted)
- Potential changes in financing arrangements such as critical covenants and any need to increase borrowing levels
- Counterparty risks arising from current credit arrangements (including the availability of insurance when relevant) with either customers or suppliers
- A dependency on key suppliers and/or customers
- And

71 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras 3.28-3.29.

72 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras 3.33.

73 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras 3.32-3.35.

- Uncertainties posed by the potential impact of the economic outlook on business activities⁷⁴

The guidance includes a reminder that the principal risks identified must only include those risks that are material to an understanding of the business. Immaterial information obscures key messages and detracts from the understandability of the information provided in the annual report.⁷⁵

Where relevant, the description of the principal risks and uncertainties (together with their potential impact on the business, management and mitigation) should also highlight any linkage with the disclosures relating to the going concern basis of accounting, material uncertainties and risks in the financial statements.⁷⁶

To facilitate the effective communication of going concern information, the guidance notes that it is helpful to group together similar or related disclosure requirements arising from different legal or regulatory requirements. Where law or regulation sets out the location, and the information is presented outside the specified component of the annual report (such as the strategic report, or the financial statements), the information will need to be included as an integral part of the specified component by way of cross referencing identifying the nature and location of the required information. A component is not complete without the information that is cross referenced and the cross-referenced information must be included in the annual report. This differs from 'signposting' which helps users locate complementary information within or outside the annual report. A component must meet its legal and regulatory requirements without reference to signposted information.⁷⁷

8.3.2 Companies that are applying the Code

As noted at 8.3.1 above, companies applying the Code are subject to more onerous requirements under the Code and for listed companies, under the Listing Rules. Those requirements in relation to going concern are now incorporated in 2025 FRC Guidance. While most companies applying the Code are likely to be IFRS reporters, some entities applying FRS 102 (that are not required to prepare group accounts) are listed companies and others may choose voluntarily to apply the Code. Some brief remarks on the Code and the requirements in the Listing Rules are included below, although entities should refer to the 2025 FRC Guidance for more detail.

The Listing Rules (UKLR 6.6.6R(6a-b)) require companies with a listing in the commercial companies and closed-ended investment funds listing categories, to state how it has applied the main principles of the Code and to:

- Make a statement of compliance
- Explain the code provisions, if any, which it has not complied with
- The period, if any, for which it did not comply (where those code provisions are of a continuing nature) And
- The reasons for non-compliance⁷⁸

In addition, the Listing Rules require the directors to make the statements in the annual financial report on:

- The appropriateness of adopting the going concern basis of accounting (containing the information set out in Provision 30 of the Code) And
- Their assessment of the prospects of the company (containing the information set out in Provision 31 of the Code)

prepared in accordance with the Corporate Governance Code (2024) and guidance issued by the FRC in January 2024.⁷⁹

The Code (2024) itself contains a main principle that the Board should determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives. The Board must establish procedures to manage risks and oversee the internal control framework.

⁷⁴ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para. 4.13-4.14.

⁷⁵ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 6.6-6.7.

⁷⁶ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para. 4.15.

⁷⁷ Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, paras. 6.9-6.16.

⁷⁸ UK Listing Rules, FCA, UKLR 6.6.6R(6).

⁷⁹ Listing Rules, FCA, UKLR 6.6.6R(3).

This main principle is supported by a number of interrelated Code provisions. This then informs the Board's assessment of the longer-term viability of the company as well as the Board's assessment of whether the going concern basis of preparation remains appropriate, identifying any material uncertainties and/or significant judgements. When relevant, the description of the principal risks and uncertainties facing the entity should highlight any linkage with disclosures in the financial statements relating to the going concern basis of accounting, material uncertainties and risks, and any other related disclosures in the annual report (such as impairment reviews or, for Code companies, the viability statement).⁸⁰

The Board is also responsible for monitoring and reviewing (on an ongoing basis) the effectiveness of the risk management and internal control systems. The aim is that the above processes will be integrated with the Board's ongoing business planning and risk management processes and the disclosures required in the annual report and financial statements will be informed by these processes.

The key, related provisions in the 2024 version of the Code are as follows:

- The board must carry out a robust assessment of the company's emerging and principal risks⁸¹ and confirm in the annual report that it has completed this assessment; the latter must include a description of its principal risks, and an explanation of how these are being managed or mitigated, as well as an explanation of what procedures are in place to identify and manage emerging risks (Code provision 28).
- The board must monitor the company's risk management and internal control framework and, at least annually, carry out a review of its effectiveness. The monitoring and review should cover all material controls, including financial, operational, reporting and compliance controls. The board must disclose in the annual report:
 - A description of how the board has monitored and reviewed the effectiveness of the framework
 - A declaration of effectiveness of the material controls as at the balance sheet date
 - And
 - A description of any material controls which have not operated effectively as at the balance sheet date, the action taken, or proposed, to improve them and any action taken to address previously reported issues⁸² (Code provision 29)
- In annual and interim financial statements, the board must state whether it considers it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements (Code provision 30).
- Taking account of the company's current position and principal risks, the board must explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board must state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary (Code provision 31).

Companies required to apply DTR 7.2 must include in the corporate governance statement a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process. In group accounts, this covers the undertakings included in the consolidation, taken as a whole.⁸³

The 2024 FRC Code Guidance summarises the Board's responsibilities for risk management and internal control; the establishment, monitoring and review of risk management and internal control systems; and the Board's related business and financial reporting responsibilities. It is beyond the scope of this publication to cover this guidance in detail.

Further guidance on adoption of the going concern basis of accounting (including disclosures on material uncertainties and/or significant judgement) in the financial statements, as well as reporting on principal risks and uncertainties (in the strategic report) are now covered in 2025 FRC Guidance, discussed above.

80 Guidance on the Going Concern Basis of Accounting and Related Reporting (including Solvency and Liquidity Risks), February 2025, FRC, para. 4.15

81 Principal risks should include, but are not necessarily limited to, those that could result in events or circumstances that might threaten the company's business model, future performance, solvency or liquidity and reputation. In deciding which risks are principal risks companies should consider the potential impact and probability of the related events or circumstances, and the timescale over which they may occur.

82 This Provision will apply for financial years beginning on or after 1 January 2026. Until then, Provision 29 of the 2018 UK Corporate Governance Code applies.

83 Disclosure and Transparency Rules, FCA, DTR 7.2.5 and DTR 7.2.10.

8.4 Materiality and aggregation

Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. *[FRS 102.3.16]*.

FRS 102 reporters must comply with the balance sheet and profit and loss account formats set out in the Regulations (or LLP Regulations) (see 3.1 and 3.2 above for which formats apply to which entity). FRS 102 requires an entity to present additional line items, headings and subtotals where relevant to an understanding of the financial position or financial performance. *[FRS 102.4.3, FRS 102.5.5C, FRS 102.5.9]*.

The extent of aggregation versus detailed analysis is clearly a judgemental one, with either extreme eroding the usefulness of the information. FRS 102 resolves this issue with the concept of materiality (see Chapter 4 at 3.3.1.B). 'Material' is defined as follows: "Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of general purpose financial statements make on the basis of those financial statements, which provide information about a specific reporting entity." The latter concept is important, as the standard further explains that materiality is an entity specific aspect of relevance that depends on the nature or magnitude of the information, or both. The assessment of whether an item is material is assessed in the context of the financial statements as a whole. *[FRS 102.2.11, FRS 102.2.12, FRS 102 Appendix I]*.

How we see it

While it is not explicitly stated in the standard, we believe that the guidance in IAS 8 and Practice Statement 2 about the inappropriateness of making, or leaving uncorrected, immaterial departures from IFRS to achieve a particular presentation is relevant to FRS 102 reporters.

The standard explains further what it means by 'obscuring' and focusses on the effect - if the effect of the information for users is similar to omitting or misstating, then the information has been obscured. Examples are given, such as the use of vague or unclear language, inappropriate aggregation of dissimilar information or the disaggregation of similar information and hiding material information using immaterial information. *[FRS 102.2.13]*.

FRS 102 requires each material class of similar items to be presented separately and items of a dissimilar nature or function to be presented separately unless they are immaterial. *[FRS 102.3.15]*. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that may not warrant separate presentation in those financial statements may warrant separate presentation in the notes. The standard states that an entity should decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which includes the notes. An entity must not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions. *[FRS 102.3.16, FRS 102.3.16A]*.

The General Rules to the formats (see 3.4 above) allow the directors of a company (or members of an LLP) to combine items denoted with Arabic numbers in the statutory balance sheet and profit and loss account formats if their individual amounts are not material to assessing the state of affairs or profit or loss of the company (or of the LLP) for the financial year in question, or where the combination facilitates that assessment (in which case, the individual amounts of the line items combined must be disclosed in the notes). *[1 Sch 4(2), 1 Sch 4(2)(LLP)]*.

FRS 102 states that an entity need not provide a specific disclosure required by the standard if the information resulting from that disclosure is not material, and this is the case even if FRS 102 contains a list of specific requirements or describes them as minimum requirements. *[FRS 102.3.16B]*. UK companies preparing Companies Act accounts must also comply with the disclosure requirements of the Regulations. The Regulations permit that "amounts which in the particular context of any provision of Schedules 1, 2 or 3 to these Regulations are not material may be disregarded for the purposes of that provision." *[10 Sch 10]*. However, certain disclosures required by the Act must be given regardless of materiality, such as information on subsidiary undertakings. *[FRS 102.3.16B]*. The LLP Regulations have the same requirements in respect of Schedule 1 to the LLP Regulations. *[4 Sch 7 (LLP)]*.

9 Amendments relating to the adapted formats effective for periods on or after 1 January 2027

In February 2026, the FRC published the FRS 102 (2026) amendments, to reflect the replacement of IAS 1 with IFRS 18. The amendments introduce requirements which enable FRS 102 preparers applying the adapted formats to align with the requirements of IFRS 18. They also clarify the definition of current liabilities and align the requirements for the classification of loan arrangements with covenants to those in IAS 1 and IFRS 18.

The amendments to FRS 102 relating to the adapted formats will be effective for accounting periods beginning on or after 1 January 2027, to match the effective date of IFRS 18. Early adoption is permitted, subject to the following:

- All the amendments are applied at the same time.
- Or
- Only the amendments relating to the classification of current and non-current assets and liabilities are applied at the same time (see 9.2 below). [FRS 102(2026).A.87].

9.1 Minimum required line items

9.1.1 Adapted formats – balance sheet

As discussed above in 4.1 above, the minimum required line items in the statement of financial position are updated to require presentation of goodwill as a separate line item from other intangible assets.

[FRS 102(2026).4A.4].

Figure 9-1 Adapted formats - balance sheet (effective for periods on or after 1 January 2027)

(a)	Property, plant and equipment
(b)	Investment property carried at fair value through profit and loss
(c)	Intangible assets other than goodwill
(d)	Goodwill
(e)	Financial assets (excluding amounts shown under (e), (f), (j) and (k))
(f)	Investments in associates
(g)	Investments in jointly controlled entities
(h)	Biological assets carried at cost less accumulated depreciation and impairment
(i)	Biological assets carried at fair value through profit and loss
(j)	Inventories
(k)	Trade and other receivables
(l)	Cash and cash equivalents
(m)	Trade and other payables
(n)	Provisions
(o)	Financial liabilities (excluding amounts shown under (l) and (m))
(p)	Liabilities and assets for current tax
(q)	Deferred tax liabilities and deferred tax assets (classified as non-current)
(r)	Non-controlling interest, presented within equity separately from the equity attributable to the owners of the parent#
	And
(s)	Equity attributable to the owners of the parent~

- ~ The LLP SORP requires a total for net assets attributable to members, and total members' interests (as a memorandum item) to be disclosed in the statement of financial position. These disclosures are retained where adapted formats are used and 'loans and other debts due to members' and 'members' other interests' (items J and K in the statutory formats for LLPs) are shown as line items in the statement of financial position. See Figure 4-4 at 4.2.1 above and the discussion in 4.1.
- # Not required in individual financial statements.

9.1.2 Adapted formats – profit and loss account

The minimum line items are significantly amended for the profit and loss account formats to align with the requirements in IFRS 18. Two new mandatory subtotals are introduced:

- Operating profit or loss
And
- Profit or loss before financing and taxation

An entity is not permitted to present 'profit or loss before financing and taxation' where finance income and/or finance expenses included within operating profit do not relate to providing financing to customers. [FRS 102(2026).5A.5].

An entity which uses the adapted formats must present operating profit. Entities using the statutory formats may choose to disclose or present operating profit. When an entity presents or discloses operating profit it must ensure that the amount disclosed is representative of activities that would be regarded as 'operating'. For example, it is inappropriate to exclude items clearly related to operations (such as inventory write-downs, profit or losses on sale of property, plant and equipment and intangible assets and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it is inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses. Profits or losses on the disposal of a discontinued operation must be excluded from operating profit. [FRS 102(2026).5.9B]. Prior to the FRS 102 (2026) amendments, the standard included 'profits or losses on the sale of investment property' in the list of items that it would be inappropriate to exclude from the 'operating profit' subtotal. Under IFRS 18, in certain circumstances, the profit or loss on the sale of investment property is included in the investing category (and therefore outside operating profit). Therefore 'investment property' has been removed from the list of examples to avoid constraining those entities choosing to adapt the profit and loss account formats. [FRS 102(2026).BC.B5.9].

'Finance costs' was a required line item under IAS 1, but is not under IFRS 18. The FRS 102 (2026) amendments retain finance costs as a minimum required line item, located between the 'profit or loss before financing and taxation' and the 'profit or loss before taxation' subtotals, in order to meet the requirements of the Regulations. Therefore, if an entity classifies any finance income or expenses within operating profit, it may be necessary to present further information in the notes, such as a summary of finance income or expenses. [FRS 102(2026).BC.B5.8].

Although the line items and subtotals have been amended to enable alignment with IFRS 18, the full category-based income statement classification requirements are not incorporated into FRS 102. The standard does not include most of the detailed requirements of IFRS 18 which explain how income and expenses are allocated between the operating, investing and financing categories. Therefore, diversity in the presentation and classification of income and expenses between those categories may arise. Nevertheless, preparers may consider the requirements of IFRS Accounting Standards, applying the FRS 102 GAAP hierarchy, where FRS 102 is silent on a particular transaction, event or condition. Therefore, an entity may consider the requirements in IFRS 18 in determining how items of income and expenses are presented and classified, when applying the adapted formats to the profit or loss account.

Figure 9-2 Profit and loss account - UK company (other than a banking company or insurance company) and LLP - adapted formats (effective for periods on or after 1 January 2027)

(a)	Revenue
(b)	Operating expenses, analysed using one or both of the following characteristics: (i) The nature of the expenses, or (ii) The function of the expenses within the entity
(c)	Operating profit or loss
(d)	Share of the profit or loss of investments in associates and jointly controlled entities accounted for using the equity method
(e)	Profit or loss before financing and taxation
(f)	Finance costs
(g)	Profit or loss before taxation
(h)	Tax expense (excluding tax allocated to items (k) and (l) below or to equity)
(i)	An amount comprising the total of:* (i) the post-tax profit or loss of a discontinued operation, and - the post-tax gain or loss attributable to the impairment or on the disposal of the assets or (ii) disposal group(s) constituting discontinued operations
(j)	Profit or loss~
(k)	Each item of other comprehensive income classified by nature (excluding amounts in (l)), with each component presented either: (i) net of related tax effects, or - before the related tax effects with one amount shown for the aggregate amount of (ii) income tax relating to these components
(l)	Share of other comprehensive income of associates and jointly controlled entities accounted for using the equity method
(m)	Total comprehensive income

* As set out in paragraph 5.7E (including a column for discontinued operations - see 5.8 above)

- The LLP SORP (2025) requires that LLPs using adapted formats show a line item for 'members' remuneration charged as an expense' as an additional expense.

In determining the disclosures relating to an entity's material accounting policy information, an entity may consider including its election to adapt the balance sheet and profit or loss account formats. An entity may also consider disclosing accounting policy information relating to the classification of items presented in the income statement. [FRS 102(2026).4A.7, FRS 102(2026).5A.8].

9.2 Definition of current and non-current assets and liabilities

The FRS 102 (2026) amendments update the definitions of current and non-current assets and liabilities to mirror the wording in IAS 1 and IFRS 18. Under the revised definition of 'current liability', a liability is classified as current when the entity does not have the right, as at the reporting date, to defer settlement for at least twelve months after that date. Previously, the definition referred to an 'unconditional' right to defer settlement. The 2026 amendments introduce guidance for each part of the definition, including extensive guidance on the classification of loan arrangements with covenants. This is consistent with the requirements introduced in the suite of amendments made to IAS 1 from 2020 to 2022 (effective for IFRS Accounting Standards reporters for periods on or after 1 January 2024). The main objective of the 2020/2022 amendments was to provide clearer guidance on how covenants relating to a loan arrangement affect an entity's right to defer settlement of those liabilities and consequently whether those liabilities are classified as current or non-current.

While the definition of a current liability in FRS 102 differs from that in IAS 1/IFRS 18 for the period between the amendments to IAS 1 (effective 1 January 2024) to the publication of the FRS 102 (2026) amendments (effective 1 January 2027), the FRC never intended the definitions to diverge. We note that past practice indicates that some preparers had aligned their considerations with those in IAS 1 as amended, ignoring the conditionality inherent in a covenant.

Early adoption of the FRS 102 (2026) amendments is permitted, provided that the amendments relating to the classification of both current and non-current assets and liabilities are adopted simultaneously. We consider that, even if applying the unamended standard, it is appropriate to refer to the guidance added into IAS 1/IFRS 18, applying the hierarchy. Where an entity refers to this IAS 1/IFRS 18 guidance in determining whether liabilities are current or non-current for periods on or before 1 January 2027, this has the practical effect of early adopting the FRS 102 (2026) amendments to the current and non-current assets and liabilities classification requirements (see 9.2 below) and therefore disclosure of that fact is required.

Prior to the amendments to FRS 102, current assets were defined as assets of the entity which are not non-current (i.e., the residual). This differed to IAS 1/IFRS 18 which defines current assets and non-current assets are the residual. [*IAS 1.66, IFRS 18.99*]. The amendments now align the definition of current assets (in relation to adapting the balance sheet formats) with IFRS Accounting Standards.

Current assets (for the purposes of adapting the profit or loss accounts formats) are defined in the amended FRS 102 glossary as:

Assets of an entity which:

- (a) it expects to realise, or intends to sell or consume, in its normal operating cycle (see 4.1.1.A above)
- (b) it holds primarily for the purpose of trading (see 4.1.1.B above)
- (c) it expects to realise within 12 months after the reporting period; or
- (d) are cash or cash equivalents, unless the asset is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

No changes were made to the definition of non-current liabilities. See 4.1.1 and 4.1.2 above for further discussion of the amendments.

10 Summary of differences between FRS 102 and IFRS

For simplicity, the comparison below is for a UK company preparing its financial statements in accordance with Schedule 1 to the Regulations or an LLP. Other UK companies and certain other entities are subject to similar statutory requirements (but there may be some differences, particularly in relation to the formats applied).

All relevant schedules in the Regulations (or LLP Regulations) apply to the statutory accounts of a UK company (or an LLP) prepared in accordance with FRS 102 - which are Companies Act accounts (or non-IAS accounts, for an LLP). Only certain schedules in the Regulations (or LLP Regulations) apply to statutory accounts prepared by UK companies (or LLPs) in accordance with UK-adopted IFRS, which are IAS accounts. Therefore, many of the requirements in the Regulations referred to in the FRS 102 columns do not apply to IAS accounts (although they do apply to FRS 101 financial statements).

FRS 102 requires all entities to follow the applicable formats for the profit and loss account and balance sheet set out in the Regulations (or LLP Regulations), except to the extent that these conflict with the entity's statutory framework. While UK companies applying Schedule 1 to the Regulations and LLPs are able to follow adapted or statutory formats, banking and insurance companies (and groups) must follow the applicable statutory formats in Schedules 2 and 3 to the Regulations (which differ). The other disclosure requirements of the Regulations (or LLP Regulations) only apply to entities subject to these statutory requirements.

	FRS 102	IFRS
Complete set of financial statements	A complete set of financial statements includes a: ▪ Statement of financial position ▪ Statement of comprehensive income (either as a single statement or as a separate income statement and statement of comprehensive income) ▪ Statement of cash flows (unless exempt) ▪ Statement of changes in equity And ▪ Related notes In certain circumstances, a statement of income and retained earnings can be presented as an alternative to a statement of changes in equity and a statement of comprehensive income. Comparatives must be presented. FRS 102 includes guidance on comparatives for narrative as well as numerical information.	IFRS has the same components for a complete set of financial statements as FRS 102. There is more extensive guidance on comparatives. However, there are no exemptions from presenting a cash flow statement, and a statement of income and retained earnings is not available as an alternative primary statement.
Application of company law formats for profit and loss account and balance sheet	The income statement (or profit and loss section of statement of comprehensive income) and statement of financial position of all entities must comply with the applicable profit and loss account and balance sheet formats set out in the Regulations or the LLP Regulations, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. FRS 102 permits use of adapted formats (which are similar to IAS 1 formats, note that these do not reflect	The statement of financial position and statement of comprehensive income follow the requirements of IAS 1/IFRS 18 which sets out minimum line items to be presented in these primary statements. The formats in the Regulations and the LLP Regulations do not apply. The statutory requirements on only including realised profits (with certain exceptions) in profit or loss do not apply. IAS 1 also requires additional line items, headings and subtotals to be

	FRS 102	IFRS
	the requirements of IFRS 18) as an alternative to statutory formats where Schedule 1 to the Regulations or the LLP Regulations are applied. Additional line items, headings and subtotals must be presented when relevant to an understanding of the financial position or financial performance. The General Rules to the formats (and FRS 102) explain the flexibility available to amend line items. Per the statutory requirements, only realised profits (with certain exceptions) may be included in profit or loss. The LLP SORP also has additional requirements relevant to the presentation of FRS 102 financial statements of LLPs.	presented when relevant to an understanding of the financial position or financial performance. IFRS 18 has a similar requirement, requiring additional line items, headings and subtotals to be presented when necessary to provide a useful structured summary. IAS 1/IFRS 18 includes more guidance on the use of additional line items, including reconciliation of additional subtotals presented with the subtotals and totals required by IFRS.
Definition of discontinued operations	Discontinued operations are defined as a component of an entity that has been disposed of by the reporting date and: ▪ Represented a separate major line of business or geographical area of operations - Or ▪ Was part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations Or ▪ Was a subsidiary acquired exclusively with a view to resale. This is different to IFRS when a discontinued operation does not have to be disposed of at the reporting date. There is no further guidance on the definition of discontinued operations and there is no concept of held for sale in FRS 102.	IFRS 5 has the same criteria as FRS 102 for a discontinued operation but the definition of discontinued operation also includes operations which are classified as held for sale (i.e., not disposed of at the reporting date). FRS 102 does not have a concept of 'held for sale' (see below). IFRS 5 includes extensive guidance on the definition. It is explicit that discontinued operations include sales of operations leading to loss of control, operations held for distribution (or distributed) and abandoned operations (in the period of abandonment).
Presentation of discontinued operations	FRS 102 requires a columnar line-by-line analysis of continuing, discontinued and total operations to be presented in the statement of comprehensive income (or separate income statement) down to an amount that comprises the total of post-tax profit or loss of discontinued operations and the post-tax gain or loss attributed to the impairment or on the disposal of the assets or disposal group(s) constituting discontinued operations.	IFRS requires a one line presentation of discontinued operations comprising the total of post-tax profit or loss of discontinued operations and the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation. No columnar analysis of each line item is permitted. Additional analysis of this subtotal and other disclosures regarding discontinued operations are required in the notes.

	FRS 102	IFRS
Operating profit subtotal	An operating profit subtotal is not required but FRS 102 includes guidance, if operating profit is presented.	Like FRS 102, IAS 1 does not require an operating profit subtotal to be presented. Its basis of conclusions includes similar guidance to FRS 102 on operating profit, where this is presented. Operating profit will be a required subtotal when IFRS 18 replaces IAS 1 from 1 January 2027.
Exceptional items	FRS 102 does not use the term 'exceptional items' (although the term is used in the Regulations and LLP Regulations). FRS 102 requires separate disclosure (in the notes or in the statement of comprehensive income/income statement) of the nature and amount of material items included in total comprehensive income.	IAS 1 has the same requirements regarding the separate disclosure of the nature and amount of material items as FRS 102, although the requirements of the Regulations or LLP Regulations do not apply. IFRS 18 does not use the term 'exceptional' and has more detailed guidance on aggregation and disaggregation of items based on shared characteristics. It requires additional line items to be presented where this is necessary to provide a useful structured summary of an entity's income and expenses.
Extraordinary items	Extraordinary items are not permitted where Schedule 1 to the Regulations or the LLP Regulations are applied.	IAS 1/IFRS 18 does not have a concept of an extraordinary item.
Current and fixed assets (balance sheet statutory formats)	<i>Statutory formats</i> The statutory formats in Schedule 1 to the Regulations and the LLP Regulations distinguish between current and fixed assets. Fixed assets are defined as assets of a company which are intended for use on a continuing basis in the company's activities, and current assets are assets not intended for such use. Receivables are presented as current assets regardless of when contractually due, unless a loan is determined to be a fixed asset investment in nature. Current assets include debtors, even if these include items expected to be realised after more than one year. The definition of current and fixed assets differs to that for current and non-current assets in IAS 1. FRS 102 requires disclosure of the amounts of debtors due after more than one year in the statement of financial position where the amounts are so material in the context of net current assets, that the financial statements may otherwise be	IAS 1/IFRS 18 distinguishes between current assets (defined) and non-current assets (the residual), which are separate classifications on the statement of financial position. If there is an expectation that the receivable (that is contractually repayable on demand), will not be repaid within twelve months, then under IAS 1/IFRS 18 it must be classified as non-current, unless it satisfies one of the other criteria in IAS 1 paragraph 66, i.e., it is expected to be realised in the entity's normal operating cycle or held primarily for the purpose of trading. A presentation based on liquidity can be used where it provides reliable and more relevant information. Line items containing amounts expected to be settled no more than 12 months after the reporting period and more than 12 months after the reporting period must be separately analysed in the notes.

FRS 102	IFRS
	misinterpreted. The analysis of amounts due within and after more than one year must be presented for each line item in debtors in the notes (if not in the statement of financial position).
Creditors: amounts falling due within and after more than one year (balance sheet statutory formats)	<i>Statutory formats</i> The statutory formats in Schedule 1 to the Regulations and the LLP Regulations distinguish between Creditors: amounts falling due within one year and Creditors: amounts falling due after more than one year. These differ from the definitions of current and non-current liabilities in IAS 1/IFRS 18. For example, under IAS 1/IFRS 18, an item which is not due for settlement within 12 months is reported as a current liability if the entity expects to settle it in its operating cycle.
Adapted balance sheet formats in Schedule 1 to the Regulations	<i>Adapted formats</i> Where adapted formats in Schedule 1 to the Regulations or the LLP Regulations are applied, the statement of financial position must show the headings specified in Section 4 (similar to IAS 1/IFRS 18), with separate classifications for current assets, non-current assets, current liabilities and non-current liabilities. FRS 102 specifies a supplementary analysis of certain headings to be given in the statement of financial position or in the notes.
Provisions	<i>Statutory formats</i> There is a single heading 'provisions for liabilities' in the balance sheet formats in Schedule 1 to the Regulations and the LLP Regulations.

	FRS 102	IFRS
	<i>Adapted formats</i> Where adapted formats in Schedule 1 to the Regulations or the LLP Regulations are applied, the presentation of provisions is consistent with IAS 1/IFRS 18.	
Deferred tax	<i>Statutory formats</i> Deferred tax is shown as a debtor or within provisions for liabilities under the balance sheet formats in Schedule 1 to the Regulations and the LLP Regulations. <i>Adapted formats</i> Where adapted formats in Schedule 1 to the Regulations or the LLP Regulations are applied, the presentation of deferred tax is consistent with IAS 1/IFRS 18.	IAS 1/IFRS 18 requires deferred tax to be shown as a separate line item in the statement of financial position, classified as a non-current asset or non-current liability.
Retirement benefits	<i>Statutory formats</i> The presentation of assets and liabilities under defined benefit schemes is not addressed by FRS 102. An asset would generally be presented as a debtor and a liability as a provision, under Schedule 1 to the Regulations or LLP Regulations. An alternative is to apply the presentation previously used in FRS 17 (applicable standard pre-FRS 102), where the defined benefit asset or liability is presented separately (but not net of deferred tax) on the statement of financial position after other net assets. <i>Adapted formats</i> Where adapted formats in Schedule 1 to the Regulations or the LLP Regulations are applied, there is no specified line item for defined benefit scheme assets or liabilities. Presentation is likely to be similar to IFRS practice (although FRS 102 is silent on the analysis between current and non-current).	IFRS does not require assets and liabilities under defined benefit schemes to be analysed between current and non-current. Many IFRS reporters show such assets and liabilities as non-current in practice.
Assets and disposal groups held for sale	<i>Statutory and adapted formats</i> FRS 102 does not have a concept of held for sale. FRS 102 requires disclosures where, at the reporting date, an entity has a binding sale agreement for a major disposal of assets or a disposal group.	IAS 1/IFRS 18 requires separate presentation in the statement of financial position of: ▪ The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5 And

FRS 102	IFRS
	Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5. Additional information is required in the notes.
Presentation of non-controlling interest in consolidated financial statements	<i>Statutory and adapted formats</i> FRS 102 requires presentation of non-controlling interest as a separate component of equity in the consolidated statement of financial position. The profit or loss and total comprehensive income for the period attributable to non-controlling interest must be shown in the statement of comprehensive income. Schedule 6 to the Regulations and Schedule 3 to the LLP Regulations require presentation of non-controlling interest, meaning the amount of capital and reserves (and profit or loss) attributable to shares in subsidiary undertakings held by or on behalf of persons other than the parent and its subsidiary undertakings. This amount will usually be the same as non-controlling interest under FRS 102.
Statement of changes in equity (SOCIE) and Statement of Income and Retained Earnings	Where the only movements in equity arise from profit or loss, dividends, corrections of errors or changes in accounting policy, a statement of income and retained earnings can be presented instead of the SOCIE and a statement of comprehensive income. The SOCIE can be combined with the analysis of movements in reserves required by Schedule 1 to the Regulations or the LLP Regulations.
Items to be reported in other comprehensive income	Items reported in other comprehensive income include <i>inter alia</i>: - revaluations of property, plant and equipment - revaluations of investments in subsidiaries, associates and jointly controlled entities (at fair value through other comprehensive income) - remeasurement gains and losses on defined benefit schemes - exchange gains and losses on retranslation of foreign operations and - cash flow hedges and net investment hedges
	IAS 1/IFRS 18 has the same presentational requirement for non-controlling interest as FRS 102. The requirements of Schedule 6 to the Regulations and Schedule 3 to the LLP Regulations do not apply. IAS 1/IFRS 18 has the same requirements as FRS 102 except that there is no alternative to present a statement of income and retained earnings. While the analysis of the reserves required by Schedule 1 to the Regulations or the LLP Regulations is not required under IFRSs, similar information is presented in the SOCIE. Items reported in other comprehensive income relating to financial instruments may differ to FRS 102 (where Sections 11 and 12 are applied) principally because of different accounting requirements for financial instruments under IFRSs - for example, there will be no cost of hedging reserve if the entity is applying Section 12 or IAS 39. Unlike FRS 102, the items must be grouped on the statement of comprehensive income between: Items that may not be reclassified to profit and loss in a subsequent period And

	FRS 102	IFRS
	Further categories of other comprehensive income arise where IAS 39 or IFRS 9 is applied. Exchange gains and losses on retranslation of foreign operations are not subsequently reclassified to profit or loss on 'disposal'/loss of control. Schedule 1 to the Regulations and the LLP Regulations require that only realised profits are included in profit or loss (except for fair value movements in profit or loss, where the fair value accounting rules are applied).	Items that may be reclassified subsequently to profit and loss (which, unlike FRS 102, include exchange gains and losses on retranslation of foreign operations).
Prior year adjustments	Prior year adjustments are required for retrospective correction for material errors, changes in accounting policies and reclassifications of items. The adjustment is shown as an item in the statement of changes in equity (or where presented, statement of income and retained earnings).	IAS 1/IFRS 18's requirements are the same as FRS 102 (except there is no statement of income and retained earnings). IAS 1/IFRS 18 additionally requires presentation of a third statement of financial position at the beginning of the comparative period, where there is a restatement of comparatives.
Presentation of associates and jointly controlled entities	<i>Statutory formats</i> Schedules 1 and 6 to the Regulations and the LLP Regulations only require fixed asset investments to be presented as a main heading in the statement of financial position. In group accounts, income from associated undertakings - which would generally include both associates and jointly controlled entities accounted by the equity method - is a line item in the profit and loss account formats. <i>Adapted formats</i> Where adapted formats in Schedule 1 to the Regulations or the LLP Regulations are applied: - Investments in associates and investments in jointly controlled entities are separate line items in the statement of financial position (the line items do not distinguish whether the investments are accounted for by the equity method) - And - A single line for the share of profits or losses of investments in jointly controlled entities and associates accounted for by the equity method is shown in the statement of comprehensive income	IAS 1's presentational requirements for investments in associates and joint ventures in the primary statements are similar to those for investments in associates and jointly controlled entities where adapted formats are applied in FRS 102. However, the statement of financial position only has a single line item for investments accounted for using the equity method. IFRS 18 introduces mandated categories in the statement of performance. Associates and joint ventures accounted for applying the equity method will be presented in the investing category. IFRS generally has more extensive disclosures for associates and joint arrangements (including joint ventures), including financial information on individually material investments in joint ventures and associates (unless an exemption applies).

FRS 102	IFRS
<i>FRS 102 supplementary requirements (applicable to both statutory and adapted formats)</i> ▪ The share of other comprehensive income of associates and jointly controlled entities accounted for by the equity method (combined) is a line item in the statement of comprehensive income ▪ The carrying amounts of investments in associates and the carrying amounts of investments in jointly controlled entities are disclosed (this can be in the notes) ▪ The share of profits or losses of investments (and the share of any discontinued operations) of jointly controlled entities accounted for by the equity method; and of associates accounted for by the equity method are disclosed (this can be in the notes) There are other disclosures, but generally less extensive than IFRS.	
Reduced disclosure framework (and other disclosure exemptions)	<i>Reduced disclosure framework</i> The reduced disclosure framework is available in individual financial statements of qualifying entities only, where the conditions for its use are met. The reduced disclosure framework allows for exemption from preparing a cash flow statement and certain disclosures in the following areas: ▪ Financial instruments (for non-financial institutions) ▪ Share-based payment ▪ Lease disclosures Revenue from contracts with customers And ▪ Disclosure of key management personnel compensation Entities taking advantage of the exemption from preparing a cash flow statement have an exemption from disclosing information applicable to supplier finance disclosures, provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included. The share-based payment and financial instruments disclosure exemptions require 'equivalent disclosures' to be
	IFRS 19 <i>Subsidiaries without Public Accountability: Disclosures</i>, effective from 1 January 2027, provides a reduced disclosure framework for eligible entities. Entities applying FRS 101 are not permitted to apply IFRS 19.

FRS 102	IFRS	
included in the publicly available consolidated financial statements in which the qualifying entity is consolidated. <i>Related party transactions - all entities</i> FRS 102 does not require disclosure of intra-group related party transactions (providing that any subsidiary that is party to the transaction is wholly owned by a member of the group). <i>Cash flow exemptions</i> FRS 102 does not require the following entities to prepare a cash flow statement: ▪ Mutual life assurance companies ▪ Retirement benefit plans ▪ Investment funds that meet certain conditions (i.e., that substantially all of the entity's investments are highly liquid and are carried at fair value and a statement of changes in net assets is provided) ▪ A small entity (applying Section 1A or the full version of FRS 102) SORPs may restrict use of this exemption, e.g., the Charities SORP (FRS 102), Update Bulletin 1 only allows small charities below a lower size threshold to omit a cash flow statement.		
Notes: judgements and estimation uncertainty	FRS 102 requires disclosure of: ▪ Judgements, apart from those involving estimations, in applying accounting policies and ▪ Key assumptions and sources of estimation uncertainty at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year	Same requirement as FRS 102 but IAS 1/IAS 8 2027 provides more guidance on disclosure of judgements and key assumptions and sources of estimation uncertainty.
Notes: sources of disclosure requirements	FRS 102 and the CA 2006, the Regulations or LLP Regulations (and other applicable regulations) include disclosure requirements for the notes. The LLP SORP also has additional disclosure requirements relevant to FRS 102 financial statements of LLPs.	IFRS's disclosures are more extensive than those required by FRS 102. The disclosures required by Schedules 1 to 3, and 6 to the Regulations or Schedules 1 and 3 to the LLP Regulations do not apply to IAS accounts.

FRS 102		IFRS
		However, IAS accounts must comply with disclosures in the Companies Act 2006, and other applicable schedules of the Regulations or LLP Regulations (and other applicable regulations).
Statement of compliance	A statement of compliance that the financial statements are prepared in accordance with FRS 102 (and where applicable, FRS 103) is required. Where an entity is a public benefit entity, a statement to this effect must also be included. The Regulations (and the LLP Regulations) require large and medium-sized companies (and LLPs) to state that the accounts have been prepared in accordance with applicable accounting standards, giving particulars of any departures. Medium-sized companies (and LLPs) do not need to give this statement in their individual accounts.	A statement of compliance that the financial statements are prepared in accordance with IFRSs (or UK-adopted international accounting standards or EU-adopted IFRS where applicable) is required. The requirements in the Regulations (and the LLP Regulations) to state that the accounts have been prepared in accordance with applicable accounting standards do not apply.

Appendix A - Defined terms

Extract from FRS 102 Appendix 1 Glossary

Glossary

Term	Definition
current assets*	Assets of the entity which: (a) for an entity choosing to apply paragraph 1A(1) of Schedule 1 to the Regulations are not non-current assets*; or (b) for all other entities, are not fixed assets.
current liabilities for the purposes of an entity applying paragraph 1A(1) of Schedule 1 to the Regulations*	Liabilities of the entity which: (a) it expects to settle in its normal operating cycle; (b) it holds primarily for the purpose of trading; (c) are due to be settled within 12 months after the reporting period; or (d) it does not have an unconditional right to defer settlement for at least 12 months after the reporting period.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
expenses	Decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
performance	The relationship of the income and expenses of an entity, as reported in the statement of comprehensive income.
financial position	The relationship of the assets, liabilities, and equity of an entity as reported in the statement of financial position.
financial statements	Structured representation of the financial position, financial performance and cash flows of an entity. [General purpose financial statements (generally referred to simply as financial statements) are financial statements directed to the general financial information needs of a wide range of users who are not in a position to demand reports tailored to meet their particular information needs.]
fixed assets	Assets of an entity which are intended for use on a continuing basis in the entity's activities.
income	Increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity investors.
income statement	Financial statement that presents all items of income and expense recognised in a reporting period, excluding the items of other comprehensive income (referred to as the profit and loss account in the Act).
LLP Regulations	The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913).

material	Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.
non-current assets*	Assets of the entity which: (a) it does not expect to realise, or intend to sell or consume, in its normal operating cycle; (b) it does not hold primarily for the purpose of trading; it does not expect to realise within 12 months after the reporting period; or (c) are cash or cash equivalents restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.
non-current liabilities*	Liabilities of the entity which are not current liabilities.
other comprehensive income	Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by this FRS or by law.
profit or loss (or income and expenditure)	The total of income less expenses, excluding the components of other comprehensive income. NB In the not-for-profit sector, this may be known as income and expenditure (and the profit and loss account, as an income and expenditure account). [s474(2)].
reporting period	The period covered by financial statements or by an interim financial report.
Regulations	The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).
Small Companies Regulations	The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409).
small entity	A small entity is: (a) a company meeting the definition of a small company as set out in section 382 or 383 of CA 2006 and not excluded from the small companies regime by section 384; (b) an LLP qualifying as small and not excluded from the small LLPs regime, as set out in LLP Regulations; or (c) any other entity that would have met the criteria in (a) had it been a company incorporated under company law.
Small LLP Regulations	The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912).
Statement of Recommended Practice (SORP)	An extant Statement of Recommended Practice developed in accordance with Policy on Developing Statements of Recommended Practice (SORPs). SORPs recommend accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.
statement of comprehensive income	A financial statement that presents all items of income and expense recognised in a period, including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income. If an entity chooses to present both an income statement and a statement of comprehensive income, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income.

total comprehensive income	The change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions from equity participants (equal to the sum of profit or loss and other comprehensive income).
turnover	The amounts derived from the provision of goods and services, after deduction of: (a) trade discounts; (b) value added tax; and (c) any other taxes based on the amounts so derived.

* The definitions of non-current assets and non-current liabilities are relevant where an entity applies paragraph 1A(1) of Schedule 1 to the Regulations or paragraph 1A(1) of Schedule 1 to the LLP Regulations (i.e., uses adapted formats).

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Overview

This chapter addresses the requirements of Section 7 *Statement of Cash Flows*.

The chapter discusses the definition of cash and cash equivalents, the difficulties commonly encountered when applying these definitions, the practical issues and judgements that frequently arise when attempting to classify cash flows under operating, investing and financing activities, and the disclosure requirements of Section 7.

It is important to note that the principles of Section 7 are consistent with IAS 7. However, there are some significant differences in the detail of the requirements. See 2 below for more details.

What you need to know

- FRS 102 allows the following entities an exemption from preparing a statement of cash flows:
 - Qualifying entities
 - Mutual life assurance companies
 - Retirement benefit plans
 - Investment funds that meet certain conditions
 - Small entities (although it must be noted that a small entity may be required to prepare a statement of cash flows by an applicable Statement of Recommended Practice (SORP))
- All other entities are required to prepare a statement of cash flows
- Qualifying entities exempted from preparing a statement of cash flows will only be exempt from the supplier finance disclosure requirements if equivalent disclosures are included in the consolidated financial statements in which the entity is incorporated.
- A statement of cash flows prepared under FRS 102 provides the following:
 - Reconciles the movement in cash and cash equivalents (not just cash) year on year
 - Groups cash flows into three headings - cash flows from operating, investing and financing activities in a manner that is most appropriate to the business of the entity
 - Requires the preparation of three main supporting notes - a breakdown of the components that make up cash and cash equivalents, an analysis of changes in net debt, and disclosures about supplier finance arrangements
- Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

Non-cash transactions must be excluded from the statement of cash flows.

1 Introduction

A statement of cash flows provides useful information about an entity's activities in generating cash to repay debt, distribute dividends or reinvest to maintain or expand operating capacity; about its financing activities, both debt and equity; and about its investing and spending of cash. The statement of cash flows provides information about the changes in cash and cash equivalents of an entity for a reporting period, showing separately changes from operating activities, investing activities and financing activities.

This information, when combined with information in the rest of the financial statements, provides information to users to enable them to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows to adapt to changing circumstances and opportunities.

Section 7 is based on the equivalent IFRS standard, IAS 7. However, a number of the explanatory paragraphs within IAS 7 have not been incorporated into Section 7 of FRS 102.

2 Comparison between Section 7 and IFRS

Section 7 of FRS 102 is comparable to IAS 7, but there are some notable differences that are discussed in 2.1 to 2.6 below. Unlike Section 7 of FRS 102, IAS 7 includes additional explanatory paragraphs that provide more details. However, by applying Section 2 *Concepts and Pervasive Principles* - FRS 102 financial statement preparers will most likely reach the same conclusions under FRS 102.

2.1 Entities exempt from preparing a statement of cash flows

There are no exemptions from preparing a statement of cash flows in IAS 7.

In contrast, FRS 102 allows the following entities an exemption from preparing a statement of cash flows:

- Qualifying entities (see Chapter 3).
- Mutual life assurance companies.
- Retirement benefit plans.

And

- Investment funds meeting certain conditions. [FRS 102.1.12(b), FRS 102.7.1A].

Additionally, a financial institution that undertakes the business of effecting or carrying out insurance contracts must include the cash flows of their long-term business only to the extent of cash transferred and available to meet the obligations of the company or group as a whole. [FRS 102.7.10E].

A small entity is not required to comply with Section 7, even if it does not apply Section 1A *Small Entities*. [FRS 102.7.1B]. However, a small entity may be required to prepare a statement of cash flows by an applicable Statement of Recommended Practice (SORP). [FRS 102.3.1B].

2.2 Presentation using the indirect method

IAS 7 allows an alternative presentation for the indirect method whereby the net cash flow from operating activities may be presented by showing the revenues and expenses disclosed in the statement of comprehensive income and the changes during the period in inventories and operating receivables and payables. [IAS 7.20].

This alternative presentation option of the indirect method is not available under Section 7.

IAS 7 is also stricter about which measure of profit figure is allowed to be used as the starting point for reconciliation when using the indirect method. Profit before tax and profit after tax can both be used as the starting point for the reconciliation. In contrast, FRS 102 allows the use of any profit measure reported on the income statement, as covered in 3.3.1.A below.

2.3 Cash flows of discontinued operations

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires an entity to disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures can be presented either on the face of the statement of cash flows or in the notes. Disclosure is not required for disposal groups that are newly acquired subsidiaries which are classified as held for sale on acquisition in accordance with IFRS 5. [IFRS 5.33(c)].

FRS 102 does not contain any requirements to make disclosures in respect of cash flows from discontinued operations. However, aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses are shown separately within investing activities. [FRS 102.7.10].

2.4 Cash flows of supplier finance arrangements

IFRS and FRS 102 reporters are required to disclose information about their supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities, cash flows and on the entity's exposure to liquidity risk. [IAS 7.44F, FRS 102.7.20C].

Although the disclosure requirements for supplier finance arrangements under IAS 7 are similar to those under Section 7 of FRS 102, they are not identical. While IAS 7 mandates the disclosure of the carrying amounts and associated line items of financial liabilities for which suppliers have already received payment from finance providers, FRS 102 does not specifically require this disclosure.

There are disclosure exemptions for qualifying entities under FRS 102, provided equivalent disclosures have been included in the consolidated financial statements in which the qualifying entity is included. *[FRS 102.1.12(b)].*

2.5 Contingent consideration paid on business combinations

After initial recognition and measurement, IFRS requires that any subsequent changes in the measurement of contingent consideration in a business combination must be recognised in profit or loss.

[IFRS 3.58]. This means that any excess cash flow above the value of the contingent consideration recognised at the acquisition date is classified as an operating activity, as IAS 7 stipulates that only expenditures resulting in a recognised asset are eligible for classification as investing activities. *[IAS 7.16]*. However, under Section 7, these excess cash flows are classified as investing activities because Section 19 requires that, apart from any element of discounting to reflect the time value of money, any changes to the estimate of the contingent consideration are treated as adjustments to the cost of the business combination.

2.6 Net debt disclosure

FRS 102 requires the disclosure of a reconciliation of changes in net debt as part of the financial statements. This reconciliation involves detailing the movements in the components of net debt, such as borrowings, cash and cash equivalents, over a reporting period.

In contrast, IFRS does not explicitly require a net debt reconciliation. It makes no specific reference to 'net debt' or the need for a reconciliation of changes in net debt. However, it requires disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes, with changes presented by the categories specified in IAS 7.

3 The requirements of Section 7 for a statement of cash flows

Section 7 specifies how entities report information about the historical changes in cash and cash equivalents and has a relatively flexible approach, which allows them to be applied to all entities including financial institutions. This flexibility can be seen, for example, in the way entities can determine their own policy for the classification of interest and dividend cash flows, provided that they are separately disclosed, and this is applied consistently from period to period. Additional disclosure is encouraged where this provides information on an entity's specific circumstances.

3.1 Scope

The application of Section 7 is not mandatory for entities that are 'qualifying entities' (see Chapter 3 at 3.1 and Chapter 3 at 3.3.1). In substance, this means that most subsidiaries, regardless of the percentage of voting rights controlled within a group, and parents that also prepare publicly available consolidated financial statements, will not need to prepare a statement of cash flows in their individual financial statements. However, a qualifying entity that prepares consolidated financial statements is required to prepare a statement of cash flows in those consolidated financial statements. The following entities are also not required to produce a statement of cash flows:

- Mutual life assurance companies.
- Retirement benefit plans.
- Or
- Investment funds that meet all of the following conditions:
 - Substantially all of the entity's investments are highly liquid
 - Substantially all of the entity's investments are carried at market value.
- And
- The entity provides a statement of changes in net assets. [FRS 102.7.1A].

A financial institution that undertakes the business of effecting or carrying out insurance contracts (other than mutual life assurance companies scoped out as above) must include the cash flows of their long-term business only to the extent of cash transferred and available to meet obligations of the company or group as a whole. [FRS 102.7.10E].

A small entity is not required to prepare a statement of cash flows. [FRS 102.7.1B, FRS 102.1A.7]. This exemption applies even if the small entity does not use the small entities accounting regime in Section 1A. However, a small entity may be required to prepare a statement of cash flows by an applicable SORP.

3.2 Cash and cash equivalents

The purpose of the statement of cash flows is to provide information about changes in cash and cash equivalent. Understanding the definitions of cash and cash equivalents are therefore essential to its presentation.

Amounts that fail to meet the definitions of cash and cash equivalents are not to be included as part of cash and cash equivalents for the purposes of preparing the statement of cash flows. In the statement of financial position, such amounts must be presented separately from cash and cash equivalents.

Cash flows relating to restricted amounts that fail to meet the definition of cash and cash equivalents would generally meet the definition of investing activities, as they relate to the acquisition or disposal of investments (see 3.2.1.A below). Cash held in a foreign currency, or investments acquired in a currency other than the functional currency of the entity ('foreign currency') are not excluded from qualifying as cash and cash equivalents merely because they are denominated in a foreign currency, provided they meet the other criteria discussed below.

3.2.1 Cash

FRS 102 defines cash as "cash on hand and demand deposits" and includes no other requirements with respect to determining whether an item qualifies as cash. [FRS 102 Appendix I].

In defining 'cash', FRS 102 does not explain what is meant by 'demand deposits', perhaps because the term is commonly understood as amounts that can be withdrawn on demand, without prior notice being required or a penalty being charged (for example, by an additional fee or forfeiture of interest). In contrast to 'demand deposits', term deposits are discussed at 3.2.2.C below.

In practice, cash may be held by an entity for a specific purpose or may be subject to restrictions on its use, imposed either by the bank, by the entity or by a third party.

The nature of any restriction on use of cash (and cash equivalents - see 3.2.1.A below) must be carefully assessed to determine if the balance still meets the definition of cash in the standard.

3.2.1.A Restrictions on the use of cash

As discussed at 4.1.2. below, an entity must disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the entity. [FRS 102.7.21]. The nature of the restriction must be assessed to determine if the balance is ineligible for inclusion in cash equivalents because the restriction results in the investment ceasing to be highly liquid or readily convertible. For example, when an entity covenants to maintain a minimum level of cash or deposits as security for certain short-term obligations, and no amounts are specifically designated for that purpose, such balances could still be regarded as cash equivalents, albeit subject to restrictions, provided they meet the criteria outlined in paragraph 2 of Section 7 (see 3.2.2 below).

However, an entity may be required formally to set aside cash, for example by way of a deposit into an escrow account, as part of a specific project or transaction, such as the acquisition or construction of a property. In such circumstances, it is necessary to consider the terms and conditions relating to the account and the conditions relating to both the entity and counterparty's access to the funds within it to determine whether it is appropriate for the deposit to be classified as cash equivalents.

Whilst decisions of the IFRS IC do not apply directly to entities reporting under FRS 102, due to the similarities between Section 7 and IAS 7, entities considering a similar fact pattern under FRS 102 could leverage on the analysis and interpretation of IFRS IC on demand deposits with restrictions on use arising from contracts with third parties. This is detailed below.

In March 2022, the IFRS IC issued an agenda decision⁸⁴ following a request about whether an entity includes a demand deposit as a component of cash and cash equivalents in its statements of cash flows and financial position when the demand deposit is subject to contractual restrictions on use agreed with a third party.

In the fact pattern described in the request, the entity:

- Holds a demand deposit whose terms and conditions do not prevent the entity from accessing the amounts held in it (that is, were the entity to request any amount from the deposit, it would receive that amount on demand).
- Has a contractual obligation with a third party to keep a specified amount of cash in that separate demand deposit and to use the cash only for specified purposes. If the entity were to use the amounts held in the demand deposit for purposes other than those agreed with the third party, the entity would be in breach of its contractual obligation.

The IFRS IC concluded that restrictions on the use of a demand deposit arising from a contract with a third party do not result in the deposit no longer being cash unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7.

In the fact pattern described in the request, the contractual restrictions on use of the amounts held in the demand deposit do not change the nature of the deposit - the entity can access those amounts on demand.

The IFRS IC therefore concluded that the entity includes the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.

3.2.1.B Cryptocurrencies vs. Central Bank Digital Currencies (CBDC)

Section 7 has no specific guidance on Cryptocurrencies and Central Bank Digital Currencies (CBDC) however there has been some guidance from the IFRS IC which could be applied by FRS 102 reporters since there are no significant differences between the principles of Section 7 and IAS 7.

In a June 2019 agenda decision², the IFRS IC defined a cryptocurrency as a crypto-asset with all of the following characteristics:

- A digital or virtual currency recorded on a distributed ledger that uses cryptography for security.
 - Not issued by a jurisdictional authority or other party.
- And
- Does not give rise to a contract between the holder and another party.

⁸⁴ [IFRIC Update](#), March 2022, available on the IFRS Foundation's website.

In the agenda decision the IFRS IC observed that cryptocurrencies did not have at that time the characteristics of cash. In particular, the IFRS IC noted that, although some cryptocurrencies could be used in exchange for particular goods or services, it was not aware of any cryptocurrency that was used as a medium of exchange or as the monetary unit in pricing goods or services to such an extent that it would have been the basis on which all transactions were measured and recognised in financial statements.⁸⁵

Until now, the volume of transactions in which cryptocurrencies are used as a medium of exchange has remained quite low and some crypto assets are not used as a medium of exchange at all at this stage. There are some jurisdictions where payment in bitcoin, for example, is accepted, but currently, the acceptance of cryptocurrencies by a merchant is not mandated in most jurisdictions.

How we see it

We are not aware of any cryptocurrencies that would currently be considered cash.

In future periods, a holder would need to consider whether those cryptocurrencies represent a medium of exchange and unit of account to such extent that it could be the basis on which the holder recognises and measures all transactions in its financial statements (i.e., it could act as the functional currency of an entity).

Cryptocurrencies also currently do not meet the definition of cash equivalents because they are generally not convertible to known amounts of cash, nor are they subject to an insignificant risk of change in value or have maturities.

3.2.1.C Client money

Some financial institutions and other entities hold money on behalf of clients. The terms on which such money is held can vary widely. There are numerous types of arrangements that result in an entity depositing their money in a client account held by another entity. It is impossible to generalise as to the appropriate treatment in either of the parties' financial statement as this will be dependent on a careful assessment of the terms and conditions of each specific arrangement.

From the perspective of the depositary entity (i.e., the entity that holds the money on behalf of its client) it is important to identify precisely how the funds are held. Are they required to be segregated in bank accounts separate from that of the depositary entity itself or are they allowed to be commingled with those of the depositary entity? Other key considerations include:

- Which party is at risk from the failure of assets, such as bank accounts, in which the client money is held?
 - The status of the funds in the event of the insolvency of either the reporting entity or its client.
 - Whether the reporting entity can use the cash for its own purposes as opposed to administering the cash on behalf of the client in its capacity as an agent.
- And
- Which party has the benefit of income from the assets.

If the depositary entity assesses that the funds will be included as an asset on its statement of financial position, it would then need to assess what kind of financial asset this represents; cash or cash equivalents, by applying the definitions, (see 3.2 above). A corresponding liability would also be recognised. Any restrictions on the use of the cash or cash equivalents must be considered and disclosed.

From the perspective of the entity depositing its money in a client account held by another entity, it would be necessary to consider whether the funds still meet the definition of cash (see 3.2.1 above). This would only be the case if the funds are available to withdraw on demand, and without penalty, directly by the entity. If the funds held are subject to an advance notice period before they can be withdrawn or used, or there are other restrictions on their withdrawal, it is unlikely that they will meet the definition of cash. Depending on the specific facts and circumstances, the funds may meet the definition of a 'cash equivalent' however, this would only be the case if the definition of cash equivalents is met. If the definitions of cash and cash equivalents are not met, the funds will be presented as a receivable in the financial statements of the entity depositing its money in a client account.

⁸⁵ [IFRIC Update](#), June 2019, available on the IFRS Foundation's website.

3.2.2 Cash equivalents

Extract from Section 7

7.2 Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Bank overdrafts are normally considered financing activities similar to borrowings. However, if they are repayable on demand and form an integral part of an entity's cash management, bank overdrafts are a component of cash and cash equivalents. *[FRS 102.7.2].*

How we see it

FRS 102 does not offer any additional guidance on defining cash and cash equivalents. Given the alignment between Section 7 of FRS 102 and IAS 7, it would not be unreasonable for entities preparing financial statements under FRS 102 to refer to IAS 7 which explains that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. See the EY publication, International GAAP® for further details.

Bank overdrafts are normally considered financing activities unless they are repayable on demand and form an integral part of an entity's cash management, in which case they are a component of cash and cash equivalents. *[FRS 102.7.2].*

In practice, however, determining the components of cash equivalents can be difficult. This is discussed further at 3.2.2 A to 3.2.2.D below.

An entity must disclose the components of cash and cash equivalents and present a reconciliation of the amounts in the statement of cash flows to the equivalent amounts in the balance sheet. However, an entity is not required to present this reconciliation if the amount of cash and cash equivalents presented in the statement of cash flows is identical to the amount similarly described in the statement of financial position. *[FRS 102.7.20].*

This reconciliation is needed because the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (the Regulations) require the separate presentation of cash at bank and in hand on the face of the balance sheet. Banking Entities that apply Schedule 2 formats must include as cash only balances at central banks and loans and advances to banks repayable on demand within cash on the balance sheet. *[FRS 102.7.20A].*

FRS 102 states that a complete set of financial statements must include in the notes a summary of significant accounting policies, which would include a policy on how the entity determines cash equivalents. *[FRS 102.3.17(e)].* These cash equivalents would need to meet the four conditions shown above to qualify as a cash equivalent, namely that they are short term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

The effect of any changes in the policy for determining components of cash and cash equivalents, for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio, must be reported under Section 10 *Accounting Policies, Estimates and Errors*. *[FRS 102.10.11(d)].* This would require comparatives to be restated, and additional disclosures given, including the reasons for the change in policy.

If, however, an entity changes the purpose for which it holds certain investments, for example a deposit which was previously held for the short term and is now held for the longer term to generate an investment return, this would be considered a change in facts and circumstances, which would be accounted for prospectively. In these circumstances, the reclassification out of cash and cash equivalents would appear as a reconciling item in the statement of cash flows, rather than as an investing cash outflow.

3.2.2.A Short-term investments

As discussed at 3.2.2 above, for an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Normally only an investment with a short maturity of, say, three months or less from the date of acquisition qualifies as a cash equivalent. *[FRS 102.7.2].* Whilst Section 7 does not address the matter, it would seem logical that equity instruments will not normally meet the definition of cash equivalents as they have no maturity date and are usually exposed to a not insignificant risk of changes in value. One exception to this is where an equity instrument is a cash equivalent in substance, such as redeemable preference shares acquired within a short period to their maturity date.

When the standard refers to a 'known amount of cash' it means that the amount must be known or determinable at the date on which the investment is acquired. Accordingly, traded commodities, such as gold bullion, would not normally be expected to be cash equivalents because the proceeds to be realised from such commodities is determined at the date of disposal rather than being known or determinable when the investment is made.

3.2.2.B Money market funds

Entities commonly invest in money market-type funds (MMF) such as an open-ended mutual fund that invests in money market instruments like certificates of deposit, commercial paper, treasury bills, bankers' acceptances and repurchase agreements. Although there are different types of money market funds, they generally aim to provide investors with a low-risk, low-return investment while preserving the value of the assets and maintaining a high level of liquidity. The question then arises as to whether investments in such funds can be classified as cash equivalents. As discussed below, entities may consider the underlying investments of the fund when assessing the significance of the risk of changes in value, however when determining whether classification as a cash equivalent is appropriate, the unit of account is the investment in the money market fund itself.

To meet the definition of a cash equivalent, an investment must be short term; highly liquid; readily convertible to a known amount of cash; and subject to insignificant risk of changes in value. Section 7 considers a maturity date of three months or less from the date of acquisition to be short-term in the context of maturity, however money market funds generally do not have a legal maturity date. However, if the investments are puttable and can be sold back to the fund at any time, they may meet the short-term criterion.

Typically, investments in money market funds are redeemed directly with the fund, therefore in assessing liquidity of the investment, focus must be on the liquidity of the fund itself. In making this assessment, entities must consider the nature of any redemption restrictions in place as these may prevent the redemption of the investment in the short term. Alternatively, if a money market fund investment is quoted in an active market, it might be regarded as highly liquid on that basis.

The short-term and highly liquid investment must also be readily convertible into known amounts of cash which are subject to an insignificant risk of changes in value. [FRS 102.7.2].

As discussed in 3.2.2A above, this means that the amount of cash that will be received must be known at the time of the initial investment. Accordingly, investments in shares or units of money market funds cannot be considered as cash equivalents simply because they are convertible at any time at the then market price in an active market. In addition, an entity would have to satisfy itself that any investment was subject to an insignificant risk of change in value for it to be classified as a cash equivalent.

How we see it

In our view, in order for an entity to satisfy itself that an investment in a money market fund is subject to an insignificant risk of change in value, the entity must conclude that the range of possible returns are very small. This evaluation is first made at the time of acquiring the investment and reassessment is required if the facts and circumstances change.

The evaluation will involve consideration of factors such as:

- The maturity of the underlying investments of the fund.
- The credit rating of the fund.
- The nature of the investments held by the fund (i.e., not subject to volatility).
- The extent of diversification in the portfolio (which is expected to be very high).

And

- The investment policy of the fund; and any mechanisms by the fund to guarantee returns (for example by reference to short-term money market interest rates).

Substantial judgement may be required in assessing whether an investment in money market funds can be classified as a cash equivalent. As discussed in 4.1.1 below, entities are required to disclose the policies adopted in determining the composition of cash equivalents and, where relevant, this must include the policy applied and judgements made in classifying investments in money market fund.

3.2.2.C Investments with maturities greater than three months

The longer the term of an investment, the greater the risk that a change in market conditions (such as interest rates) can significantly affect its value. For this reason, FRS 102 excludes most equity investments from cash equivalents and restricts the inclusion of other investments to those with a short maturity (which the standard illustrates as three months or less from the date of their acquisition by the entity).

[FRS 102.7.2].

An investment with a term on acquisition of, say, nine months is not reclassified as a cash equivalent from the date on which there is less than three months remaining to its maturity. This is because the classification as cash equivalent is based on the maturity and the nature of the instrument at acquisition. The fact that the instrument is now approaching its maturity does not change its nature nor the purpose for which it was acquired.

In the final analysis, cash equivalents are short term, highly liquid investments and amounts can only be included in cash equivalents if they can be regarded as being nearly as accessible as cash and essentially as free from exposure to changes in value as cash.

For example, an entity might justify including in cash equivalents a fixed deposit with an original term longer than three months if it effectively functions like a demand deposit. Typically, a fixed deposit will carry a penalty charge for withdrawal prior to maturity. A penalty will usually indicate that the investment is held for investment purposes and for the longer term rather than being a short-term investment. However, some fixed deposits still offer interest at a prevailing demand deposit rate in the event of early withdrawal, with any penalty limited to the entity being required to forego the incremental higher interest that it would have received if the deposit were held to maturity. In this case, it may be arguable that there is effectively no significant penalty for early withdrawal, as the entity receives at least the same return that it otherwise would have in a demand deposit arrangement.

How we see it

In our view, investments in deposit accounts that upon withdrawal are subject to penalties of such significance, that the funds obtained are appreciably different than the funds that would have been obtained had a shorter-term investment been initially purchased, are not consistent with the assertion that the investment is a short-term investment.

Significance is viewed from the perspective of the entity, taking into consideration the environment in which it operates. If the investor would be indifferent to the penalty because the funds obtained are relatively consistent with the funds that would have been obtained had a shorter-term investment been initially purchased, the terms of the instrument may be consistent with the assertion that the investment will be held for only for a short-term.

3.2.2.D Bank overdrafts

Although bank borrowings are generally considered to be financing activities, there are circumstances in which bank overdrafts repayable on demand are included as a component of cash and cash equivalents. This is only in cases where bank overdrafts, in addition to being repayable on demand, forms an integral part of an entity's cash management. [FRS 102.7.2].

Including a bank overdraft as a component of cash and cash equivalents does not automatically mean the bank overdraft will be included in the cash and cash equivalents as presented on the face of statement of financial position unless the conditions in FRS 102 off set requirements are met. [FRS 102.11.38A]. See Chapter 15 at 3.3 for further discussion.

3.2.2.E Credit card receivables at the point of sale

In some industries, entities are paid in exchange for their goods or services at the point of sale through credit card payment systems. Since entities have no practical ability to access cash from the expected payments until the settlement date, they cannot recognize such payments as part of their cash balances before that date.

A question arises however as to whether credit card receivables at the point of sale would be eligible for classification as cash equivalents.

Section 7 defines cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash, and which are subject to an insignificant risk of changes in value. [FRS 102.7.2].

How we see it

Entities must consider all aspects of the definition of cash equivalents and exercise judgement to consider how a credit card receivable arising at the point of sale are classified. This analysis is done with reference to the contractual terms of each credit card payment system and the applicable laws and regulations in the relevant jurisdiction.

Factors to consider would include:

- Who bears the risk of payment if the ultimate customer defaults or the transaction is fraudulent.
 - The length of time that will elapse between the transaction and the receipt of the cash from the counterparty. For example, if the cash is received shortly (e.g., 5 to 10 days) after the transaction is initiated then there is less risk of a change in value.
 - How reputable the counterparty is.
 - How the counterparty is regulated.
- And
- The credit risk of the counterparty.

For example, there may be provisions in the contract between the entity and the credit card system provider such that the entity is not guaranteed to be paid by the credit card payment system provider, including in case of customer credit default or fraudulent use of the card. In this situation, this would be a strong indicator that the credit card receivables would not meet the definition of cash equivalent. These transactions would be accounted for as a sale on credit and the amount outstanding should be classified as a receivable until it has been settled.

Because each arrangement with a credit card system provider may have different contractual characteristics, management may come to different conclusions depending on each arrangement. If material, an entity must disclose and explain the judgement it has made in the process of applying its accounting policy and disclose the amount of the cash equivalents to which this judgement has been applied, in accordance with paragraphs 20 and 21 of Section 7. Where relevant, this must include the policy applied and judgements made in classifying credit card receivables.

3.2.3 Reassessment of cash and cash equivalents after initial recognition

There is no specific requirement in Section 7 for the re-assessment of the criteria for classification as cash or cash equivalents after initial recognition. However, it is implicit in the definition that the amounts must still meet those definitions at the end of each reporting period to be presented as such. Changes that may affect the criteria for classification could arise from contractual or non-contractual changes. For contractual changes, it will usually be clear when these changes are made and the nature of the changes. Such changes could affect the nature of the asset and require the new asset to be tested against the definition of cash and cash equivalents.

Other changes in facts and circumstances could also require careful consideration and the application of judgement. For cash equivalents, reassessment may be particularly relevant when looking at the requirements that cash equivalents are highly liquid and subject to an insignificant risk of changes in value.

For example, since initial recognition of an investment as a cash equivalent, there may have been adverse changes to the credit status of the counterparty to the investment or a significant decline in the economic stability of the jurisdiction in which the funds are invested. At the end of the reporting period, the investment may no longer meet the definition of cash equivalents since it is no longer highly liquid and readily convertible into known amounts of cash and is now subject to more than an insignificant risk of changes in value.

3.3 Classification in the statement of cash flows

The statement of cash flows reports inflows and outflows of cash and cash equivalents during the period classified under:

- Operating activities (see 3.3.1 below)
 - Investing activities (see 3.3.2 below)
- And
- Financing activities (see 3.3.3 below) [FRS 102.7.3]

This classification is intended to allow users to assess the impact of these three types of activities on the financial position of the entity and the amount of its cash and cash equivalents. Although the presentation is not required to follow this layout, we would expect it to be followed in practice. Comparative figures are required for all items in the statement of cash flows and the related notes. [FRS 102.3.14].

Where it's not clear how to classify a specific cash flow between operating, investing and financing activities, an entity will apply judgement to determine the appropriate presentation of material items based on the principles of Section 7. Additional disclosures may be needed to explain the judgements applied. [FRS 102.8.6].

3.3.1 Reporting cash flows from operating activities

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. [FRS 102.7.4, FRS 102 Appendix I]. This means that operating is the 'default' category, with all cash flows that do not fall within either the investing or financing classifications being automatically deemed to be operating.

Cash flows from operating activities generally result from transactions and other events that enter into the determination of profit or loss. Examples include: [FRS 102.7.4].

- Cash receipts from the sale of goods and the rendering of services.
- Cash receipts from royalties, fees, commissions and other revenue.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of employees.
- Cash payments or refunds of income tax, unless they can be specifically identified with financing and investing activities.
- Cash receipts and payments from investments, loans and other contracts held for dealing or trading purposes, which are similar to inventory acquired specifically for resale.
- Cash advances and loans made by financial institutions.

And

- Cash payments for short-term leases, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability as required by Section 20 *Leases*.

An example of an item that enters into the determination of profit or loss that is not usually an operating cash flow is the proceeds from the sale of property, plant and equipment, which are usually included in cash flows from investing activities. [FRS 102.7.4].

Cash flows from operating activities may be presented using either:

- The indirect method
- Or
- The direct method. [FRS 102.7.7].

FRS 102 does not express a preference for the method to be used. The use of the direct or indirect method is an accounting policy choice and must be applied consistently from period to period. Any change in method must be reported following the requirements of Section 10. This would require comparatives to be restated, and additional disclosures given, including the reasons for the change in policy. [FRS 102.10.12].

3.3.1.A Indirect method

Under the indirect method, an entity presents a reconciliation determining the net cash flow from operating activities by adjusting a measure of profit or loss disclosed in the statement of comprehensive income (or separate income statement if presented) for the effects of:

- Changes during the period in inventories and operating receivables and payables.
- Non-cash items such as depreciation, provisions, deferred tax, accrued income/(expenses) not yet received/(paid) in cash, unrealised foreign currency gains and losses, undistributed profits of associates, and non-controlling interests.

And

- All other items for which the cash effects relate to investing or financing activities. [FRS 102.7.8].

Under the indirect method, paragraph 8 of Section 7 requires the reconciliation to start with “any measure of profit or loss disclosed in the statement of comprehensive income”. This means that entities are permitted to use any profit figure (including operating profit) as a starting point for the reconciliation, if that profit figure appears as a subtotal in their statement of comprehensive income. The reconciling items required will vary depending on which profit figure is used. The reconciliation of net cash flows from operating activities may be presented either on the face of the statement of cash flows or in a note.⁸⁶

The reconciliation of profit or loss to cash flow from operating activities will include the increase or decrease in receivables or payables, but only in respect of those elements thereof that relate to operating activities. For example, amounts owed in respect of the acquisition of property, plant and equipment (other than assets held for rental and subsequent sale), intangible assets, or non-operational investments will be excluded from the movement in payables included in this reconciliation.

Furthermore, when a group has acquired a subsidiary during the year, the change in working capital items will have to be split between the increase due to the acquisition (to the extent that the purchase consideration was settled in cash, this will be shown under investing activities) and the element related to post-acquisition operating activities which will be shown in the reconciliation.

⁸⁶ SEN 1, FRC, December 2013, footnote 4.

Illustration 3-1: The following is an illustration of a statement of cash flows and related notes prepared using the indirect method.
Group statement of cash flows

	20X6	20X5
	£000	£000
Net cash (outflow)/inflow from operating activities	(859)	3,964
<i>Investing activities</i>		
Dividends from joint venture	700	545
Dividends from associates	135	105
Interest received	993	345
Dividends received	200	160
Payments to acquire intangible fixed assets	(575)	(1,010)
Payments to acquire tangible fixed assets	(11,423)	(3,110)
Receipts from sales of tangible fixed assets	8,625	2,765
Payments to acquire investments	(465)	(230)
Receipts from sales of investments	125	-
Proceeds from sale of subsidiary undertaking (net of cash & cash equivalents disposed of)	2,172	-
Purchase of subsidiary undertaking (net of cash & cash equivalents acquired)	(270)	-
Net cash flow from investing activities	217	(430)
<i>Financing activities</i>		
Dividends paid to non-controlling interests	(30)	(30)
Dividends paid to preference shareholders	(175)	(175)
Interest paid	(973)	(1,075)
Interest element of lease rental payments	(40)	(50)
Issue costs on new long-term loans	(50)	(56)
Issue of ordinary share capital	175	-
Share issue costs	(100)	-
Purchase of own shares	(1,700)	-
Share purchase costs	(100)	-
New long-term loans	4,660	4,500
Repayment of long-term loans	(500)	-
Repayments of capital element of leases	(370)	(243)
Equity dividends paid	(1,431)	(1,170)
Net cash flow from financing activities	(634)	1,701
(Decrease)/Increase in cash and cash equivalents	(1,276)	5,235
Effect of exchange rates on cash and cash equivalents	(120)	(78)
Cash and cash equivalents at 1 January	7,560	2,403
Cash and cash equivalents at 31 December	6,164	7,560

Notes to the statement of cash flows**Reconciliation of profit to net cash (outflow)/inflow from operating activities**

	20X6	20X5
	£000	£000
Group profit for the year before taxation	8,694	7,547
Adjustments to reconcile profit for the year to net cash flow from operating activities		
Loss on revaluation of investment properties	350	474
Depreciation and impairment of tangible fixed assets	5,590	2,610
Amortisation of development expenditure	125	40
Amortisation of patents	50	10
Amortisation of goodwill	160	25
Share-based payment expense	412	492
Difference between pension charge and cash contributions	(46)	(196)
Increase in provision for maintenance warranties	200	50
Increase in provision for National Insurance contributions on share options	4	4
Provision for maintenance warranties utilised	(219)	(25)
Deferred government grants released	(1,012)	(530)
Share of income from associates and joint ventures	(2,910)	(1,262)
(Profit)/loss on disposal of tangible fixed assets	(1,250)	850
Loss on disposal of fixed asset investments	350	-
Loss on sale of discontinued operations	2,037	-
Net finance costs	167	820
Working capital movements		
Increase in debtors	(4,475)	(2,694)
Increase in stocks	(4,332)	(2,529)
Decrease in creditors	(1,917)	(389)
Taxation		
Corporation tax paid	(2,379)	(1,218)
Overseas tax paid	(458)	(115)
	<u>(9,553)</u>	<u>(3,583)</u>
Net cash (outflow)/inflow from operating activities	<u>(859)</u>	<u>3,964</u>

Cash and cash equivalents

Cash and cash equivalents comprise the following:

	At	Group At
	31 December	31 December
	20X6	20X5
	£000	£000
Cash at bank and in hand	5,441	9,291
Short-term deposits	1,483	2,039
	6,924	11,330
Bank overdrafts	(760)	(3,770)
Cash and cash equivalents	6,164	7,560

3.3.1.B Direct method

The direct method arrives at the same value for net cash flow from operating activities but does so by disclosing major classes of gross cash receipts and gross cash payments. Such information may be obtained either:

- From the accounting records of the entity.
- Or
- By adjusting sales, cost of sales (interest and similar income and interest expenses and similar charges for a financial institution) and other items in the statement of comprehensive income (or income statement if presented) for changes during the period in inventories and operating receivables and payables, other items for which the cash effects are investing or financing cash flows and other non-cash items. [FRS 102.7.9].

A statement of cash flows prepared under the direct method must include the same disclosures of gross cash receipts and gross cash payments irrespective of which approach has been used to determine their value. There is no requirement for entities to present a reconciliation showing the adjustments made between, for example, revenue in the statement of comprehensive income and cash receipts from customers.

3.3.2 Reporting cash flows from investing activities

Unless a net presentation is permitted under FRS 102 (see 3.5.1 below), an entity must present separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities. [FRS 102.7.10].

Investing activities are defined as the acquisition and disposal of long-term assets and other investments not included in cash equivalents. [FRS 102.7.5]. This separate category of cash flows allows users of the financial statements to understand the extent to which expenditures have been made for resources intended to generate future income and cash flows. Cash flows arising from investing activities include:

- Payments to acquire, and receipts from the sale of, property, plant and equipment, intangibles and other long-term assets (including payments relating to capitalised development costs and self-constructed property, plant and equipment).
- Payments to acquire, and receipts from the sale of, equity or debt instruments of other entities and interests in joint ventures, including the net cash flows arising from obtaining or losing control of subsidiaries or other businesses (other than payments and receipts for those instruments considered to be cash equivalents or those held for dealing or trading purposes).
- Advances and loans made to, and repaid by, other parties (other than advances and loans made by a financial institution).
- And
- Payments for, and receipts from, futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading purposes, or the cash flows are classified as financing activities.

When a contract is accounted for as a hedge, an entity must classify the cash flows of the contract in the same manner as the item being hedged. [FRS 102.7.5].

Major classes of gross receipts and gross payments arising from investing activities must be reported separately, except for those items that are permitted to be reported on a net basis, as discussed at 3.5.1 below. [FRS 102.7.10].

3.3.3 Reporting cash flows from financing activities

Financing activities are defined as those activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. [FRS 102.7.6].

Cash flows arising from financing activities include:

- Proceeds from issuing shares or other equity instruments.
 - Payments to owners to acquire or redeem the entity's shares.
 - Proceeds from issuing, and outflows to repay, debentures, loans, notes, bonds, mortgages and other short or long-term borrowings.
- And
- Payments by a lessee for the principal portion of the lease liability. [FRS 102.7.6].

Major classes of gross receipts and gross payments arising from financing activities must be reported separately, except for those items that are permitted to be reported on a net basis, as discussed at 3.5.1 below. [FRS 102.7.10].

3.4 Allocating items to operating, investing and financing activities

Sometimes it is not clear how to classify cash flows amongst operating, investing and financing activities. Section 7 provides additional guidance on the classification of certain transactions, including interest, dividends and income taxes, while other questions are not addressed explicitly in the section. These, as well as some common areas where judgement may be required to classify cash flows, are discussed below.

Where the appropriate classification is not clear from Section 7 and an entity has therefore applied judgement to determine the appropriate presentation of material items based on the principles of Section 7, additional disclosure may be needed to explain these judgements. Section 8 - Notes to the Financial Statements requires disclosure of the judgements that management has made that have the most significant effect on the amounts recognised in the financial statements, [FRS 102.8.6], as well as information that is relevant to an understanding of any of the entity's financial statements. [FRS 102.8.2(c)]. (See Chapter 6 at 7.3).

3.4.1 Interest and dividends

Extract from Section 7

- 7.14** An entity shall present separately cash flows from interest and dividends received and paid. The entity shall classify these cash flows consistently from period to period as operating, investing or financing activities. [FRS 102.7.14].

Interest paid can either be classified as an operating cash flow (because it is included in profit and loss) or as a financing cash flow because it is a cost of obtaining financial resources.

Interest and dividends received can either be classified as operating cash flows, as they are included in profit and loss, or they may be classified as investing cash flows because they represent returns on investments. Interest paid includes cash payments made by a lessee for the interest portion of a lease liability measured in accordance with Section 20. [FRS 102.7.15].

Dividends paid can either be classified as a financing cash flow (because they are a cost of obtaining financial resources) or as a component of cash flows from operating activities because they are paid out of operating cash flows. [FRS 102.7.16].

The flexibility in the above paragraphs of Section 7 means that all of these treatments are equally acceptable. Nevertheless, it could be argued that entities which do not include interest or dividends received within revenue must not include interest or dividends in operating cash flows because cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. [FRS 102.7.4]. On this basis, interest paid would be a financing cash flow and interest and dividends received

classified as investing cash flows. [FRS 102.7.15]. Such entities would also treat dividends paid as a financing cash flow, because they are a cost of obtaining financial resources. [FRS 102.7.16].

3.4.2 Taxes on income

Cash flows arising from taxes on income must be separately disclosed within operating cash flows unless they can be specifically identified with investing or financing activities. Where tax cash flows are allocated over more than one class of activity, FRS 102 requires that the total amount of taxes paid be disclosed. [FRS 102.7.17]. It is possible to match elements of tax expense to transactions for which cash flows are classified under investing or financing activities. However, taxes paid are usually classified as cash flows from operating activities because it is often impracticable to match tax cash flows with specific elements of tax expense and those tax cash flows may arise in a different period from the underlying transaction.

3.4.3 VAT and other non-income tax cash flows

Section 7 does not specifically address the treatment of cash flows relating to other taxes, such as value added tax (VAT) or other sales taxes and duty. FRS 102 reporters could leverage on an IFRS IC discussion which concluded that it was not appropriate to develop an interpretation and that, while different practices may emerge, they are not expected to be widespread.⁸⁷

How we see it

In our view, entities can choose to disclose sales taxes and other non-income tax receipts and payments separately in the statement of cash flows or as part of the related cash inflows and outflows. Even if presented separately, the tax cash flows are presented as operating, investing or financing in accordance with the classification of the underlying transactions that gives rise to the tax cash flows. [FRS 102.7.3].

Given the availability of alternative treatments, where material, entities must disclose whether cash flows are presented inclusive or exclusive of related VAT.

3.4.4 Cash contributions to a long-term employee benefit fund

As discussed in 3.3.1 above, the definition of operating activities in Section 7 includes as one of its examples “cash payments to and on behalf of employees”. [FRS 102.7.4(d)]. Such cash outflows would typically involve wages and salaries paid to employees, taxes paid on behalf of employees and any other employee benefit contributions made on behalf of employees. Where a company makes contributions to a long-term employee benefit fund on behalf of its employees, those cash outflows are part of the compensation for employment services and are classified as operating cash flows.

3.4.5 Cash flows from factoring of trade receivables

Section 7 does not address the classification of cash receipts arising from the factoring of trade receivables. In these circumstances, an entity uses a factoring structure to produce cash flows from trade receivables more quickly than would arise from normal collection from customers, generally by transferring rights over those receivables to a financial institution.

How we see it

In our view, the classification of the cash receipt from the financial institution depends on the accounting treatment of the trade receivables. Only to the extent that the factoring arrangement results in the derecognition of the original trade receivable would it be appropriate to regard the cash receipt in the same way as any other receipt from the sale of goods and rendering of services and classify it in operating activities.

In cases where the trade receivable is not derecognised and a liability is recorded, the nature of the arrangement is a borrowing secured against trade receivables and accordingly we believe that the cash receipt from factoring must be treated in the same way as any short-term borrowing and included in financing activities.

The later cash inflow from the customer for settlement of the trade receivable would be included in operating cash flows and the reduction in the liability to the financial institution would be a financing outflow and these two amounts would not be netted off in the statement of cash flows. However, it would

⁸⁷ [IFRIC Update](#), August 2005, available on the IFRS Foundation's website.

be acceptable for the entity to disclose the net borrowing receipts from, or repayments to, the financial institution, if it was determined that these relate to advances made for and the repayment of short-term borrowings such as those which have a maturity period of three months or less. [FRS 102.7.10C(c)].

In some cases, the factoring agreement requires customers to remit cash directly to the financial institution, but the arrangement does not result in the derecognition of the original trade receivables. As, discussed above, the initial cash receipt from factoring is included in financing activities. [FRS 102.7.6]. However, there is currently diversity as to whether, and how, the cash received by the financial institution from customers are presented in the entity's statement of cash flows.

When the transfer does not give rise to derecognition of the trade receivable by the reporting entity, the reporting entity may determine that the factoring entity is acting as its agent and is therefore collecting the cash on its behalf before drawing down amounts to settle the liability it is owed by the reporting entity. In this case the entity would report an operating cash inflow from the customer and a financing cash outflow to the financial institution when the financial institution collects the cash from the customers. See 3.5.3 below for further discussion of the presentation of cash paid or received on an entity's behalf. Alternatively, if the reporting entity determines that the factoring agent is not acting as its agent the entity will reflect the later settlement of the debt by the customer as a non-cash transaction with no cash flows reported at the time of the ultimate derecognition of the trade receivable and the related factoring liability

3.4.6 Cash flows from supply-chain financing arrangements

Supplier finance arrangements are characterised by one or more finance providers offering to pay amounts an entity owes its suppliers and the entity agreeing to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, suppliers are paid. These arrangements provide the entity with extended payment terms, or the entity's suppliers with early payment terms, compared to the related invoice payment due date. Supplier finance arrangements are often referred to as supply chain finance, payables finance or reverse factoring arrangements. Arrangements that are solely credit enhancements for the entity (e.g., financial guarantee contracts) or instruments used to settle directly with a supplier the amounts owed (e.g., credit cards) are not supplier finance arrangements. [FRS 102.7.20B].

There is no specific requirement in Section 7 on how cash flows from supply-chain financing arrangements should be classified, although Section 7 does require certain disclosures to be made in relation to an entity's supply-chain financing which are detailed in 4.2 below.

FRS 102 reporters can leverage on the IFRS IC discussion on reverse factoring arrangements for guidance on how to classify the cash flows from such arrangements. The IFRS IC published an agenda decision⁸⁸ in December 2020, outlining how IFRS accounting standards are applied to the different aspects of accounting for such arrangements. The agenda decision considers the presentation in the statement of financial position, the derecognition of a financial liability, the presentation in the statement of cash flows and disclosure in the notes to the financial statements.

In respect of the presentation in the statement of cash flows, an entity that has entered into a supply chain financing arrangement would need to determine whether to classify cash flows under the arrangement as cash flows from operating activities or cash flows from financing activities.

This in turn poses the following challenges:

- Does the presentation of the liability to the financial institution in the statement of financial position impact the presentation of cash flows? For example, if the liability is presented outside of trade and other payables, must the ultimate payment to the financial institution be presented as a financing outflow? Or can it instead be presented as an operating cash flow based on the nature of the activities that initially led to the recognition of the trade payable that was settled through the supply-chain financing?
- Will the remittance of cash directly to the supplier by the financial institution be reflected at all in the statement of cash flow or is it a non-cash transaction?

With respect to the first question above, the IFRS IC agenda decision notes that "an entity's assessment of the nature of the liabilities that are part of the arrangement may help in determining whether the related cash flows arise from operating or financing activities. For example, if the entity considers the related liability to be a trade or other payable that is part of the working capital used in the entity's principal revenue-producing activities, the entity presents cash outflows to settle the liability as arising from operating activities in its statement of cash flows. In contrast, if the entity considers that the related liability is not a trade or other payable because the liability represents borrowings of the entity, the entity

88 [IFRIC Update](#), December 2020, available on the IFRS Foundation's website.

presents cash outflows to settle the liability as arising from financing activities in its statement of cash flows”.

How we see it

In our view, the agenda decision does not preclude an entity from presenting the repayment of the liability owed to the factor as an operating cashflow based on the nature of the transaction that led to the initial recognition of the liability to the entity's supplier, notwithstanding a presentation in the statement of financial position of the liability to the financial institution outside of trade and other payables. This is because there is no automatic link between the statement of financial position and the statement of cash flows.⁸⁹ In both cases, such presentations must be applied consistently and disclosed and explained in the notes.

As regards the identification of cash flows and the second question above, the agenda decision notes that investing and financing transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows in accordance with paragraph 43 of IAS 7. FRS 102 has a similar requirement in paragraph 7.18. Consequently, if a cash inflow and cash outflow occur for an entity when an invoice is factored as part of a reverse factoring arrangement, the entity presents those cash flows in its statement of cash flows. If no cash inflow or cash outflow occurs for an entity in a financing transaction, the entity discloses the transaction elsewhere in the financial statements in a way that provides all the relevant information about the financing activity. [FRS 102.7.18].

How we see it

In our view, the IFRS IC agenda decision does not go beyond confirming the requirements of IAS 7 (and hence Section 7 of FRS 102) when it states that if no cash flows are involved, then no cash flows are presented in the statement of cash flows. In practice, a careful analysis of the relationship between the entity and the financial institution is needed to determine whether the financial institution is acting as an agent on behalf of the entity and receiving and incurring cash flows on its behalf. This will inform the appropriate presentation in the statement of cash flows. We discuss this issue further in 3.5.3 below.

In its agenda decision, the IFRS IC rightly observed that, assessing how to present liabilities and cash flows related to reverse factoring arrangements may involve judgement and emphasised the requirement in IAS 1 to disclose judgements that management has made in this respect if they are among the judgements made that have the most significant effect on the amounts recognised in the financial statements, as well as any information that is relevant to an understanding of any of the entity's financial statements. Similar requirements apply in FRS 102 financial statements by virtue of the disclosure requirements in paragraph 6 of Section 8.

The agenda decision suggests that the issue is only about whether to classify the associated cash flows as operating or financing activities. However, we note that if the cost of the goods or services is capitalised into a longer-term asset such as property, plant and equipment, or possibly an intangible asset, the classification decision would be between investing and financing activities. This may be particularly relevant in asset intensive industries such as telecommunications or the extractive industries.

3.4.7 Cash received as compensation for an insured loss

As discussed in 3.3.2 above, cash flows arising from investing activities include receipts from the sale of property, plant and equipment and other long-term assets. [FRS 102.7.5(b)]. This classification would also be appropriate if the receipt of cash came from insurance proceeds received to cover for the loss or damage of such assets. It would not be appropriate to present the cash inflow as an operating cash flow as the insurance proceeds are not derived from the principal revenue-generating activities of the business. [FRS 102.7.4]. However, the nature of the claim giving rise to the cash inflow must be carefully considered. If the claim relates only partially to the loss of damage of a long-term asset, it may be necessary for the cash inflows to be allocated between cash flows from operating activities (e.g., for the compensation for business interruption) and cash flows from investing activities.

⁸⁹ [IASB Staff Paper](#), Project: Supply Chain Financing Arrangements-Reverse Factoring, Paper topic: Comment letters on tentative agenda decision, IFRS IC Meeting, December 2020, paragraph 50. Available on the IFRS Foundation's website.

3.4.8 Cash flows for service concession arrangements

3.4.8.A Accounting by grantors

Section 34 *Specialised Activities* requires a grantor to account for its interest in a service concession contract using a lease liability model. [FRS 102.34.12E].

Therefore, any cash flows paid or received by the grantor relating to the service concession contract must be presented in the statement of cash flows in line with the requirements for lessees as explained in 3.8.1 below.

3.4.8.B Accounting by operators

A service concession arrangement per Section 34 features two possible accounting models from the perspective of the operator, the intangible asset model or the financial asset model (see Chapter 36 at 4). Under both models, the service element relating to the construction of the infrastructure asset is accounted for in accordance with Section 23 *Revenue from Contracts with Customers* and the revenue recognised gives rise to an intangible or a financial asset. It is unclear whether cash flows incurred in the construction or upgrade phase must always be regarded as operating cash flows because they relate to the provision of construction services; or whether they are more accurately classified as investing activities, as they reflect cash outflows that result in the construction of a long-term asset.

In the case of an arrangement under the intangible asset model, the cash flows incurred during construction or upgrading could be classified in investing activities as they relate to the acquisition of an intangible asset that will generate future income and cash flows. Once the operating phase is reached, the cash inflows received would be most appropriately classified in operating activities as most operating and maintenance costs are likely to be executory and will be accounted for as incurred.

On the other hand, when the financial asset model applies, cash outflows during the construction phase may be considered to represent the provision of financing to the grantor and as such an investing outflow. The repayment by the grantor during the operating phase would be considered an investing cash flow (or potentially split between investing and operating cash flows for the capital and interest components respectively, depending on the policy of the entity).

Since there is no specific guidance relating to the classification of cash flows for service concession arrangements, current practice is mixed.

3.4.9 Treasury shares

Treasury shares are the equity instruments of an entity that have been issued and subsequently reacquired by the entity. An entity deducts from equity the fair value of the consideration given for the treasury shares. [FRS 102.22.16].

Cash payments to redeem an entity's shares are required to be classified as financing activities [FRS 102.7.6(b)]. Therefore, it follows that payments to acquire treasury shares must be classified within financing activities. Even where such treasury shares are acquired by the entity as part of an equity-settled share-based payment transaction, the cash outflow is classified under financing activities.

Whilst cash payments to and on behalf of employees are classified under operating activities, [FRS 102.7.4(d)], the acquisition of treasury shares does not settle a transaction between the entity and its employees. An equity-settled share-based payment transaction is completed when the entity transfers its equity instruments to employees in consideration for the services received.

When a subsidiary makes a recharge payment to its parent or a trust holding treasury shares as part of an equity-settled share-based payment arrangement for the subsidiary's employees, the payment is recorded as a deduction from equity in the subsidiary's separate financial statements. This is because the payment does not settle the transaction with the employees but rather returns the capital contribution recorded as a credit to equity required by Section 26, up to the amount of that contribution. Any amount beyond this is considered a distribution (see Chapter 28 at 13.2.7). The capital contribution repayment element must be classified as a financing activity, while the distribution thereafter can be classified as either operating or financing, depending on the entity's policy on dividends as discussed in 3.4.1 above.

3.4.10 Cash flows related to the costs of a share issue

Costs directly related to the issue of shares are required to be deducted from equity. [FRS 102.22.8]. As the costs reduce the amount of the proceeds received from the share issue, they are classified as a financing cash flow. [FRS 102.7.6(a)]. However, where a proposed share issue is cancelled, there would be no proceeds

from the issue to record, and the related expenses would be included in profit and loss rather than equity. As such, the definition of a financing cash flow would not be met, and the transaction costs would be classified in operating cash flows as they do not also meet the definition of an investing activity.

3.4.11 Cash flows paid or received under derivative contracts

Payments and receipts relating to derivative contracts can be classified within operating, investing or financing in different circumstances. Where the contract is held for dealing or trading purposes, the cash flows are classified under operating activities. [FRS 102.7.4(f)]. Section 7 requires payments for, and receipts from, futures contracts, forward contracts, option contracts and swap contracts are classified as cash flows from investing activities, except when the contracts are held for dealing or trading purposes, or the cash flows are classified as financing activities. [FRS 102.7.5(g)].

Section 7 adds that when a contract is accounted for as a hedge (see Section 12 *Other Financial Instruments Issues*), an entity must classify the cash flows of the contract in the same manner as the cash flows of the item being hedged. [FRS 102.7.5]. An example is an interest rate swap. An entity wishing to convert an existing fixed rate borrowing into a floating rate equivalent could enter into an interest rate swap under which it receives interest at fixed rates and pays at floating rates. All the cash flows under the swap are reported under the same cash flow heading as interest paid (i.e., as financing activities or operating activities, in accordance with the entity's determined policy, as discussed in 3.4.1 above), because they are equivalent to interest or are hedges of interest payments.

3.4.12 Debt instruments issued at a discount or premium

When a company issues a zero-coupon bond at nominal value, with a premium payable on redemption, the cash outflows that represent the repayment of the principal amount of a loan or other debt instrument are classified as financing activities. [FRS 102.7.6(d)]. As discussed in 3.4.1 above, interest paid may be classified under either operating or financing activities. Therefore, where an entity adopts a policy of classifying interest under operating activities, it may be necessary to consider carefully the nature of any payment to the lender to ensure the appropriate classification between operating and financing. This will be particularly relevant where the pattern of payments differs from the recognition of the interest expense in profit or loss.

For example, a company that issues a zero-coupon bond at nominal value, with a premium payable on redemption, will not make any interest payments over the life of the bond. However, in accounting for the financial liability at amortised cost under Section 11, the entity will recognise interest at the effective interest rate (EIR), calculated to reflect the premium payable on redemption, as explained in Chapter 13. This raises the question of how to present the cash paid on redemption. Is it appropriate to present the entire cash outflow within financing activities as the redemption of a debt instrument?

How we see it

In our view, when an entity adopts a policy of classifying interest under operating activities and the cash paid on redemption is presented in the statement of cash flows, a split must be made to show the amount that relates to the interest cost (within operating activities) and the amount that relates to the repayment of the principal (within financing activities). The same principles would be applied where a debt is issued at a discount or in any other situation where the pattern of cash flows relating to interest on a financial liability are not reflected in the pattern of recognition of the interest cost.

3.4.13 Early settlement of a debt instrument

A similar issue to that discussed in 3.4.12 above is how to present the cash payments on early settlement of a loan or other borrowing. As already noted in 3.3.3 above, cash flows arising from financing activities include outflows to repay borrowings. However, in some situations an element of the cash paid on early settlement could be viewed as compensation to the lender for lost interest.

Lenders will often include a prepayment penalty provision in loan agreements that can be based on a number of factors, including an approximation of the interest that will not be paid as a result of early settlement. This would support a split presentation of the cash outflow between repayment of borrowings and cash outflow for interest. Alternatively, the nature of the entire cash outflow may also be viewed as relating to a financing activity, being the extinguishment of a liability, which is then presented as one amount in the financing activities section of the statement.

3.4.14 Receipt of a government grant

The accounting requirements for government grants as set out in Section 24 *Government Grants* are covered in Chapter 26.

Neither Section 24 nor Section 7 provides guidance on where in the statement of cash flows to present the cash inflows from the receipt of government grants. Grants could be argued as being a source of financing to an entity, and consequently cash received would be part of the entity's financing activities. However, it could also be argued that a grant does not represent a borrowing activity because there is no expectation that the resource will be returned to the provider of finance.

Alternatively, cash flows received from government grants (or only those from grants related to income) could be presented as operating cash flows by default since they do not seem to meet the definition of financing activities and cash flows received from government grants related to assets could be presented as investing cash flows as they relate to an investing activity.

How we see it

Selecting the most appropriate presentation will be a matter of judgement. Once adopted, the presentation principles must be applied consistently and clear disclosure of the principles and the impact thereof on the statement of cash flows must be provided in accordance with Section 3 *Financial Statement Presentation*.

3.5 Other cash flow presentation matters

3.5.1 Reporting cash flows on a net basis

In general, major classes of gross receipts and gross payments must be reported separately, except to the extent that net presentation is specifically permitted. [FRS 102.7.10]. Operating, investing or financing cash flows may be reported on a net basis if they arise from:

- Cash flows that reflect the activities of customers rather than those of the entity and are thereby made on behalf of customers.
- Or
- Cash flows that relate to items in which the turnover is quick, the amounts are large, and the maturities are short. [FRS 102.7.10A].

Examples of cash receipts and payments that reflect the activities of customers rather than those of the entity include:

- The acceptance and repayment of demand deposits by a bank.
- Funds held for customers by an investment entity.
- And
- Rents collected on behalf of, and paid over to, the owners of properties. [FRS 102.7.10B].

Examples of cash receipts and payments in which turnover is quick, the amounts are large and the maturities are short include advances made for and the repayment of:

- Principal amounts relating to credit card customers.
- The purchase and sale of investments.
- And
- Other short-term borrowings, such as those with a maturity on draw down of three months or less. [FRS 102.7.10C].

Financial institutions may report certain cash flows on a net basis. [FRS 102.7.10D]. These cash flows are:

- Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date.
- The placement of deposits with and withdrawal of deposits from other financial institutions.
- And
- Cash advances and loans made to customers and the repayment of those advances and loans. [FRS 102.34.33].

3.5.2 Material cash flows

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the users of general-purpose financial statements make on the basis of those financial statements, which provides financial information about a specific reporting entity. [FRS 102 Appendix I].

FRS 102 requires additional line items, headings and sub-totals to be presented on the face of the statement of financial position or of the statement(s) presenting profit or loss and other comprehensive income when this is relevant to an understanding of the entity's financial performance and position. [FRS 102.5.9, FRS 102.4.3]. Although Section 7 does not include equivalent requirements in respect of the presentation in the statement of cash flows, the more general requirements in Section 3 on materiality and aggregation do apply. [FRS 102.3.15, FRS 102.3.16]. Each material class of similar cash flows must be presented separately, as must items of a dissimilar nature or function unless they are immaterial. [FRS 102.3.15].

If a line item is not individually material, it is aggregated with other items either in the statement of cash flows or in the notes. An item that may not warrant separate presentation in those statements may warrant separate presentation in the notes. [FRS 102.3.16].

How we see it

In our view, where specific events and transactions significantly affect the amount of cash flows reported in the statement of cash flows, they must be disclosed and explained in the notes in accordance with Section 8 *Notes to the Financial Statements*, regardless of whether they are presented as separate line items on the face of the statement of cash flows.

Examples of such events and transactions are the receipt of significant government grants, a change in the pattern of payments to suppliers or from customers or in the contractual terms of payments, the introduction of trade receivables factoring arrangements, supply chain financing or extension of existing arrangements.

3.5.3 Non-cash transactions and presentation of cash paid or received on an entity's behalf

FRS 102 requires that transactions that do not require the use of cash or cash equivalents are excluded from an entity's statement of cash flows. Disclosure is required elsewhere in the financial statements in order to provide all relevant information about these investing and financing activities. [FRS 102.7.18]. Non-cash transactions only ever appear in a statement of cash flows as adjustments to profit or loss for the period when using the indirect method of presenting cash flows from operating activities as discussed in 3.3.1.A above. Examples of such non-cash transactions provided in the standard are the acquisition of assets either by assuming directly related liabilities or by means of a lease; the acquisition of an entity by means of an equity issue; and the conversion of debt to equity. [FRS 102.7.19].

Asset exchange transactions and the issue of bonus shares out of retained earnings are other examples of investing and financing transactions that do not involve cash or cash equivalents but require disclosure.

However, there is no broader guidance in Section 7, or elsewhere in FRS 102, to help determine whether cash flows must be included in the statement of cash flows because the entity has directed another party to pay and/or receive cash on its behalf and so, in substance, the cash flows are the entity's cash flows. This is a matter of judgement based on facts and circumstances. However, disclosure is required elsewhere in the financial statements in order to provide all relevant information about these investing and financing activities. [FRS 102.7.18].

There may be transactions that, in substance, involve cash flows of the entity, without the cash resources of the entity actually changing. For example, where an entity purchases an item of property and finances the purchase by borrowing the funds from a financial institution, it may arrange for the money to be paid directly by the financial institution to the seller rather than receive the cash inflow from the loan into its bank account and make a subsequent cash payment to the seller. The relationship between the entity and the financial institution may be determined to be fiduciary in nature with the financial institution acting as an agent of the entity and receiving and incurring cash flows on its behalf.

In all situations, the nature of the relationship with the third party will need careful examination, including assessment of the terms and conditions of each specific arrangement. Factors to consider as part of the consideration could include:

- Who is directing the payment or receipt? If the reporting entity is directing the movement of the cash, it is more likely that the third party will be acting as its agent and therefore the cash flows will be cash flows of the entity.
- Who controls the timing and amount of the payment or receipt? If the reporting entity has control over the timing and the amount this may suggest the third party is acting as its agent and that the payment or receipt is, in substance, the entity's cash flow.

- Why has the arrangement with the third party been established and who benefits from the arrangement? If the arrangement has been established for the convenience of the reporting entity (for example because they do not have a bank account in a certain jurisdiction) this may provide evidence that the cash flow is, in substance, the entity's cash flow.

How we see it

Where it is determined that cash flows made or received by a third party are, in substance, cash flows of the entity, these cash flows must be reported in the statement of cash flows of the entity.

Appropriate disclosures will be important, in particular, disclosure of the facts considered, and the judgements management has made in applying Section 7 in accordance with paragraph 6 of Section 8.

3.6 Foreign currency cash flows

Foreign currency cash flows can arise either when an entity enters into transactions where the cash payments or receipts are denominated in a foreign currency or when the consolidated financial statements of a group include the cash flows of a subsidiary whose functional currency is different from the presentation currency of the group (e.g., a foreign subsidiary).

The requirements for entities falling within the scope of Section 31 *Hyperinflation* are discussed in Chapter 33.

3.6.1 Foreign currency denominated transactions

Cash flows arising from transactions in a foreign currency must be reported in the entity's functional currency in the statement of cash flows by applying the exchange rate between the functional currency and the foreign currency at the date of the cash flow or an exchange rate that approximates the actual rate (for example, a weighted average exchange rate for the period). [FRS 102.7.11]. Similarly, the cash flows of a foreign subsidiary must be translated using the exchange rate between the group's presentation currency and the foreign currency of the subsidiary at the date of the cash flow or at an exchange rate that approximates the actual rate. [FRS 102.7.12].

3.6.2 Operating cash flows presented using the indirect method

For operating cash flows presented using the indirect method, the entity presents the net cash flows from operating activities by working back from amounts reported in the income statement (see 3.3.1.A above). The most common approach adjusts reported profit or loss for the effects of:

- Changes in inventories and operating receivables and payables during the period.
- Non-cash items such as depreciation, provisions, deferred taxes, accrued income (expenses) not yet received (paid) in cash, unrealised foreign currency gains and losses, and undistributed profits of associates and non-controlling interests.

And

- All other items for which the cash effects are investing or financing cash flows. [FRS 102.7.8].

The exchange differences reported in profit or loss may include realised and unrealised gains and losses arising from operating activities and investing and financing activities. Entities must therefore determine what adjustments to make to profit or loss to ensure that foreign currency items are only included in the operating cash flow reconciliation to the extent that cash flows have occurred and that they relate to operating activities. This is discussed 3.6.2.A and 3.6.2.B below.

3.6.2.A Realised and unrealised gains and losses relating to operating activities

For realised gains or losses that relate to operating items such as sales or purchases of inventory by an entity, no adjustment is needed to get from profit or loss to operating cash flows if the starting point for the reconciliation is profit before tax or profit after tax. This is because it will include both the amount recorded at the date of sale and the amount of the exchange difference on settlement, the combination of which gives the amount of the actual cash flow.

For unrealised gains or losses that relate to operating items, no adjustment will be needed as the unrealised exchange gain or loss is generally already reflected in the movement in the related payable or receivable included in the reconciliation to operating cash flows. Alternatively, some entities may choose to reflect these gains and losses as a reconciling item and then also include an equivalent adjustment in the movement in the related receivable or payable, however this method is rarely seen in practice.

3.6.2.B Realised and unrealised gains and losses relating to non-operating activities

For realised gains or losses arising on a settled transaction relating to investing or financing activities, an adjustment is needed to reconcile reported profit or loss to the net cash flow from operating activities.

For example, the foreign currency purchase of property, plant and equipment would be recorded at the rate prevailing on the date of the purchase and, if not paid for immediately, a creditor would be recorded for the same amount. Any exchange difference arising on final settlement of the creditor would be taken to profit or loss as an exchange gain or loss.

If left unadjusted, operating cash flows determined using the indirect approach would include this amount of exchange gain or loss. In addition, the investing cash flow for the asset purchase would be unadjusted and recorded at the purchase date exchange rate, rather than at the exchange rate prevailing at the date of settlement of the creditor. Therefore, this difference needs to be considered in calculating the cash flow to be shown under the relevant classification, in this case investing cash flows, so that the cash flow for the purchase of the asset reflects the exchange rate at the date of settlement of the related creditor. The difference also needs to be adjusted by subtracting or adding back the exchange gain or loss in the reconciliation of operating cash flows.

For unrealised gains or losses relating to investing or financing activities, an adjustment must be made to reconcile reported profit or loss to the net cash flow from operating activities. This is because the unrealised exchange differences will be reflected in the income statement as an exchange gain or loss. If left unadjusted, the reconciliation of operating cash flows prepared using the indirect approach would total to a figure for operating cash flows which would incorrectly include this amount of non-operating, unrealised exchange gain or loss.

3.6.3 Cash and cash equivalent balances denominated in foreign currencies

Unrealised gains and losses arising from exchange rate movements on foreign currency cash and cash equivalents are not cash flows. However, it is necessary to include these exchange differences in the statement of cash flows in order to reconcile the movement in cash and cash equivalents at the beginning and end of the reporting period. The effect of exchange rate movements on cash and cash equivalents is presented as a single amount at the foot of the statement of cash flows, separately from operating, investing and financing cash flows and includes the differences, if any, had those cash flows been reported at end of period exchange rates. [FRS 102.7.13]. This is illustrated in Illustration 3-1 in 3.3.1.A above.

This reconciling item reflects:

- The difference between the opening and closing exchange rate used multiplied by the foreign currency cash balances held at the beginning of the year.
- And
- The difference between the exchange rates used to translate foreign currency cash flows (e.g., an average rate) and the closing exchange rate multiplied by the net cash flow activity for the period measured in the foreign currency.

3.6.4 Consolidated financial statements including foreign subsidiaries

The general principles of preparing a consolidated statement of cash flows is discussed at 3.9.1 below. When the group contains a foreign subsidiary, the cash flows of that subsidiary must be translated into the presentation currency of the group using the exchange rates prevailing at the dates of the cash flows. [FRS 102.7.12]. This is similar to the treatment of foreign currency transactions discussed at 3.6.1 above. A rate that approximates the actual rate on the date of the cash flow (such as a weighted average for a period) can be used. [FRS 102.7.12]. However, this does not apply to the cash flows of a foreign subsidiary whose functional currency is the currency of a hyperinflationary economy as all amounts, including cash flows, are translated at the closing rate at the date of the most recent statement of financial position. See Chapter 33 for more discussion on translating amounts in a functional currency that is the currency of a hyperinflationary economy.

3.6.4.A The indirect method and foreign subsidiaries

Entities must exercise care when applying the indirect method at the 'more consolidated level' as described in 3.9.1 below when there are foreign subsidiaries. If the translated financial statements are used, exchange differences will be included in the movements between the opening and closing group balance sheets. For example, if inventories held by a US subsidiary of a UK parent increase from \$240 to \$270 during the year and the opening exchange rate of £1=\$1.60 becomes £1=\$1.80 by the year-end,

inventories will be reported as an unchanged amount of £150 in both balance sheets. This could result in the reconciliation showing no movement between opening and closing inventories which would be incorrect. In these circumstances it would be advisable for an entity to take the functional currency financial statements of the foreign subsidiary as the starting point or otherwise ensure the exchange differences have been correctly reflected.

3.6.4.B Exchange differences on retranslation of foreign subsidiaries reported in other comprehensive income.

All exchange differences arising on translation of foreign operations will have been recognised in other comprehensive income (see Chapter 32). Such exchange differences are not cash flows and will therefore not be reported as such in the consolidated statement of cash flows. However, any exchange differences relating to the translation of cash and cash equivalents held in foreign currencies by the foreign subsidiaries will be included in the reconciliation of cash and cash equivalents at the beginning and end of the period, as reported at the foot of the statements of cash flows. See 3.6.3 above.

3.7 Transactions on deferred terms

Some investing and financing activities do not have a direct impact on current cash flows even though they affect the entity's capital and asset. As discussed at 3.5.3 above, only transactions that require the use of cash or cash equivalents will be included in a statement of cash flows. Transactions on deferred payment terms are non-cash transactions until payments are made or received. Specific examples are discussed below.

3.7.1 Asset purchased on deferred terms from the supplier

When an asset is purchased on deferred terms granted by the supplier directly, it may not be clear whether the associated cash flows are to be classified within investing activities or within financing activities. Classification of the payment comes down to a judgement as to whether its nature relates to the acquisition of an asset or the repayment of a liability.

How we see it

The settlement of a short-term payable for the purchase of an asset is an investing cash flow. Where the period between acquisition and payment is significant, judgement must be applied to determine whether the definition of a financing cash flow has now been met.

The liability recorded for the deferred consideration would be classified and subsequently measured in accordance with Section 11 *Basic Financial Instruments* (see Chapter 13). When the liability is paid, the cash out flow may need to be split to separate the cash flows relating to payment of interest and payment of principal, depending on the policy of the entity - see 3.4.1 above.

Where an asset is acquired on deferred terms it would, where significant, require disclosure as a non-cash transaction elsewhere in the financial statements in a way that provides all the relevant information about those investing and financing activities. [FRS 102.7.18].

Where an entity acquires a right-of-use asset under a lease, per Section 20 the transaction is presumed to be a non-cash transaction. [FRS 102.7.19(a)]. The cash flow presentation of leasing transactions is discussed in 3.8 below.

3.7.2 Asset disposals on deferred terms

When an asset is sold but no payment is received in the period of the sale, there will be no amounts reported in the statement of cash flows. Where the arrangement is determined to be the provision of finance by the vendor, for example the derecognition of property, plant and equipment by the lessor under a finance lease, subsequent cash receipts to reduce the receivable from the purchaser would be investing cash flows, but appropriately described, for example as the receipt of deferred consideration rather than the proceeds on sale of property, plant and equipment. [FRS 102.7.5(a)].

3.7.3 Revenue contracts with deferred payment terms

If payment is deferred beyond normal business terms or is financed (by the entity) at a rate of interest that is not a market rate, the arrangement constitutes a financing transaction. The promised amount of

consideration must be adjusted for the effects of the time value of money and the interest revenue recognised in accordance with Section 11 or Section 12. [FRS 102.23.58].

The revenue component will be classified as cash flows from operating activities and the financing component classified consistently with the entity's choice to present cash flows from interest received (see 3.4.1 above). If the customer pays in advance, the sum of the cash amount and the accrued interest represent revenue, and thus there is only one cash flow component (being the advance payment) which must be classified as cash inflow from operating activities. [FRS 102.7.4(a)].

3.7.4 Variable and contingent consideration for asset acquisitions outside of a business combination

Contingent consideration paid on a business combination is discussed in 3.10.2 below. The purchase price of intangible assets or tangible assets acquired outside of a business combination also sometimes includes variable or contingent consideration, for example to resolve an uncertainty or a difference in views about the initial value of the asset transferred.

Accounting for the contingent consideration element of such asset purchases is discussed in Chapter 20 for property, plant and equipment, and Chapter 21 for intangible assets. As explained in those chapters, such transactions can be very complex and payment can be dependent on a number of factors, with no specific guidance provided in Section 18 *Intangible Assets* or Section 17 *Property, Plant and Equipment*. Therefore, an entity must develop and consistently apply an accounting policy for the initial and subsequent measurement of such assets that results in information that is relevant and reliable in its circumstances.

Once such an accounting policy is developed, the presentation in the statement of cash flows must be informed by the accounting treatment adopted in the statement of financial position.

How we see it

In our view, cash payments up to the amount capitalised in relation to the acquired assets would be classified in investing activities. Since variable and contingent consideration generally arises for reasons other than the provision of finance to the acquirer, any resulting payments would generally not seem to be eligible for classification as financing cash flows. As a result, any variable and contingent consideration in excess of the amount that has been capitalised as part of the cost of the asset (whether on initial recognition or to reflect changes in variable and contingent consideration that have been capitalised in line with the entity's accounting policy for such payments), would need to be presented as operating cash flows by default. However, if the accounting variability of the contingent consideration is driven from factors such as currency or time value of money that are within the scope of other standards (e.g., Section 30 *Foreign Currency Translation*, Section 12 or IFRS 9), the cash flow presentation must be consistent with the requirements of such sections.

3.8 Cash flows from leasing transactions

3.8.1 Accounting as lessee

When an entity acquires a right-of-use asset under a lease, the acquisition of the asset is clearly a non-cash transaction. [FRS 102.7.19(a)]. The requirements of lease accounting and disclosure requirements are covered in Section 20 and are discussed in Chapter 23. In relation to the cash flow presentation, a lessee classifies:

- Cash payments for the principal portion of the lease liability within financing activities. [FRS 102.7.6(e)].
- Cash payments for the interest portion of the lease liability as either operating or financing activities depending on the accounting policy of the entity. [FRS 102.7.15].

And

- Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities. [FRS 102.7.4(h)].

FRS 102 also requires disclosure of the total cash outflow for leases. [FRS 102.20.80(f)]. This will include lease payments for short-term leases and leases of low-value assets and variable lease payments (see Chapter 23).

A lessee must also include lease liabilities (and the related cash and non-cash movements) in the disclosures of changes in net debt from the beginning to the end of the reporting period. [FRS 102.7.22]. See 4.3 below for more details.

3.8.2 Payments made by the lessee before commencement date

Where a lessee makes a lease payment to the lessor at or before the commencement date, this payment is included in the initial measurement of the right-of-use asset (see Chapter 23). The nature of the activity giving rise to this cash outflow must be considered to determine how it is presented in the statement of cash flows.

For example, if the payment represents all or substantially all of the total lease payments to be made over the lease term, the lessee classifies the cash outflow as an investing activity, being the acquisition of the right of use asset. [FRS 102.7.5(a)]. In contrast, if the payment is only the first of the periodic lease payments that the lessee will make and is financing in nature, being a payment for the reduction of the lease liability, the cash outflow would then be classified as a financing activity. [FRS 102.7.6(e)].

3.8.3 Lease incentives

Lease incentives are defined as “Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee” and are discussed in Chapter 23.

[FRS 102 Appendix I].

Neither Section 7 nor Section 20 provides specific guidance on the presentation of the cash inflows from lease incentives. However, the definition of ‘lease payments’ in the standard is clear that any lease incentives are deducted from the value of any payments to be made by the lessee to the lessor relating to the right to use the underlying asset. [FRS 102 Appendix I].

How we see it

Considering the definition of lease payments in the context of FRS 102, in our view the appropriate presentation of cash flows from lease incentives would be to present the corresponding cashflows as part of financing activities in the statement of cash flows, regardless of whether they are received after the commencement date of the lease and are deducted from the lease liability or before the lease commencement date.

Where lease incentives are received in the same period that lease payments are made, these cash inflows and outflows must, where material, be separately presented and not netted. See 3.5.1 to 3.5.2 above.

3.8.4. Sale and leaseback transactions

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Sale and leaseback transactions are discussed in Chapter 23.

In terms of presentation in the statement of cash flows, Section 7 only refers to leases, requiring the cash payments for the principal portion of the lease liability to be presented in financing activities and cash payments for the interest portion to be presented either as financing or operating activities depending on the entity’s accounting policy (see 3.4.1 above). Neither FRS 102 nor Section 7 include guidance with respect to cash flow presentation in the case of a sale and leaseback transaction.

Presentation of the cash flows relating to the sale and leaseback transaction for a seller-lessee will depend on how the transaction is accounted for under Section 23 *Revenue from Contracts with Customers*.

[FRS 102.20.123]. Specifically, whether the transfer of the asset is accounted for as a sale of the asset in accordance with the requirements of Section 23 of FRS 102.

If the transaction does not satisfy the requirements of Section 23 to be accounted for as a sale, the cash received is classified in the statement of cash flows as a cash inflow from financing activities because the substance of the transaction is that the lessee has raised finance, with the asset provided as security. Repayments of the principal are classified as financing cash flows, whereas interest must be presented in a manner consistent with the entity’s accounting policy (see 3.3.3 and 3.4.1 above).

If the transaction does satisfy the requirements of Section 23 to be accounted for as a sale, the analysis can be more complex, as the cash received may comprise an amount reflecting the fair value of the underlying asset plus the amount of any additional financing provided by the buyer-lessor to the seller-lessee. This will be reflected in the statements of cash flows by splitting the proceeds between investing cash flows and financing cash flows. However, there are different approaches as to how this split could be determined. From an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback - it has retained its right to use the asset for the duration of the leaseback. Therefore, the amount that would be shown as an investing cash inflow must reflect this.

How we see it

In our view there are two acceptable approaches for determining the split between investing cash flows and financing cash flows.

One approach is to present the investing cash inflow as the amount of the sale proceeds that reflects the proportion of the fair value of the underlying asset that is not retained by the seller-lessee. Any excess would be presented as part of cash flows from financing activities. This presentation in the statement of cash flows would be consistent with the requirement in Section 20 to recognise only the amount of any gain or loss on the sale and leaseback relating to the rights that have been transferred to the buyer-lessor and also to measure the right-of-use asset as a proportion of the previous carrying amount of the underlying asset.

Alternatively, the seller-lessee may present any excess of the sale proceeds over the fair value of the asset as financing cash inflows and the remaining proceeds as investing cash inflows.

3.8.5 Accounting as lessor

For lessors, Section 20 is silent on the presentation of cash flows arising from their leasing activities. In practice, the presentation of cash flows for lessors must be established and well understood. In summary, the cash inflows from operating leases will form part of the cash flows from operating activities.

[FRS 102.7.4]. The cash inflows from finance leases will follow the treatment set out at 3.7.2 above in relation to assets disposed of on deferred terms.

3.9 Additional considerations for groups

Section 7 does not distinguish between single entities and groups, and there is no specific guidance as to how an entity must prepare a consolidated statement of cash flows. In the absence of specific requirements, cash inflows and outflows would be treated in the same way as income and expenses under Section 9 *Consolidated and Separate Financial Statements*. Applying these principles, the statement of cash flows presented in the consolidated financial statements must reflect only the flows of cash and cash equivalents into and out of the group, i.e., consolidated cash flows are presented as those of a single economic entity.

On the same basis, the cash flows of a consolidated subsidiary must be included in the consolidated statement of cash flows for the same period as its results are reported in the consolidated statement of comprehensive income, i.e., from the date the group gains control until the date it loses control.

[FRS 102.9.18].

Cash flows that are internal to the group (such as payments and receipts for intragroup sales, management charges, dividends, interest and financing arrangements) must be eliminated. [FRS 102.9.15]. However, transactions with non-controlling interests as well as with associates, joint ventures and unconsolidated subsidiaries would not be eliminated and are discussed in greater detail below.

3.9.1 Preparing a consolidated statement of cash flows

In principle, the group statement of cash flows will be compiled from those prepared by individual subsidiaries with intra-group cash flows being eliminated as part of the aggregation process. This would generally be the case for entities presenting operating cash flows under the direct method, where information on gross cash receipts and payments has been obtained from each group entity's accounting records.

In practice, however, it may be possible to prepare a statement of cash flows at a more consolidated level, by starting with the disclosures in the consolidated statement of comprehensive income and statement of financial position and then applying the adjustments reflected as part of the financial statement consolidation process, together with information provided on external cash flows by individual subsidiaries. Thus, an entity adopting the direct method could use this information to derive the value of the major classes of gross cash receipts and gross cash payments. [FRS 102.7.9]. An entity presenting operating cash flows under the indirect method would use this information to calculate the values for movements in inventories, operating receivables and payables and other non-cash items that appear in the reconciliation of consolidated profit or loss to the group's cash flow from operating activities. [FRS 102.7.8].

As noted in 3.6.4.A above, groups with foreign subsidiaries will need to take extra care when using this method to ensure exchange differences are treated appropriately.

Cash flows from investing and financing activities could similarly be derived from a reconciliation of the relevant headings in the consolidated statement of comprehensive income to statement of financial position movements. However, for this to be possible, subsidiaries would have to provide supplementary information (as part of internal group reporting) to prevent gross cash flows from being netted off and to ensure that the cash flows are shown under the correct classifications. In particular, detailed information about receivables and payables would be essential to ensure that the movements in operating, investing and financing receivables and payables are identified.

3.9.2 Transactions with non-controlling interests

Dividends paid to non-controlling interest holders in subsidiaries are included under cash flows from financing activities or operating activities, in accordance with the entity's determined policy for dividends paid (see 3.4.1 above).

Section 9 *Consolidated and Separate Financial Statements* requires entities to distinguish between transactions that give rise to a change in control and those that do not, because a transaction where there is no change in control is effectively one with the owners in their capacity as owners. [FRS 102.9.20A]. Changes in ownership interests in a subsidiary that do not result in a loss of control are therefore accounted for as equity transactions, and the resulting cash flows would be classified as financing in the same way as any other cash flows that result in changes in the size and composition of equity. [FRS 102.7.6].

3.10 Acquisitions and disposals

The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses are shown separately within investing activities. [FRS 102.7.10].

Such amounts must be shown net of cash acquired on acquisition of the subsidiary or disposed of with the subsidiary. [FRS 102.7.5(c), FRS 102.7.5(d)]. FRS 102 does not explicitly require the disclosure of the cash or overdrafts acquired as part of an acquisition. However, if the cash or overdraft acquired was material it may be regarded as a major class of gross cash receipts or payments and separate presentation would be required.⁹⁰

3.10.1 Deferred and other non-cash consideration

Not all acquisitions or disposals of businesses are satisfied in full by the exchange of cash. Any non-cash consideration, such as shares issued by either party or amounts to be paid or received by the entity later date, is not included in the amount presented under investing activities. [FRS 102.7.19(b)]. Instead, the non-cash element of the acquisition or disposal is disclosed. [FRS 102.7.18]. As explained in more detail in 3.7.2 above, the purchase of assets on deferred terms can be a complicated area because it may not be clear whether to classify the associated cash flows within investing activities or within financing activities, as the repayment of borrowings. Hence, judgement is required when determining the appropriate classification of the deferred payment in the statement of cash flows. These same principles apply on the acquisition of a business involving deferred consideration.

3.10.2 Contingent consideration paid on business combinations

FRS 102 requires recognition of any contingent consideration at the acquisition date subject to an adjustment (reflecting the time value of money, if material) and if the contingent consideration is 'probable and can be measured reliably'. [FRS 102.19.12]. If the potential adjustment is not recognised at the acquisition date, but subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the combination. [FRS 102.19.13]. Similarly, if the future events that, at the acquisition date, were expected to occur do not occur, or the estimate needs to be revised, the cost of the business combination is adjusted accordingly. [FRS 102.19.13A]. The unwinding of any discounting is recognised as a finance cost in profit or loss in the period it arises. [FRS 102.19.13B].

Because any changes to the estimate of the contingent consideration are treated as an adjustment to the cost of the business combination, it follows that, apart from any element of discounting to reflect the time value of money, the payment of the contingent consideration must be presented as an investing cash flow. The cash outflow relating to the finance cost arising from discounting would be classified as either operating or financing activities depending on the accounting policy adopted by the entity for the classification of interest paid. [FRS 102.7.15].

⁹⁰ SEN 1, FRC, December 2013, p.8.

The treatment under IAS 7 is different, because IFRS 3 - Business Combinations has different requirements for subsequent changes in measurement of contingent consideration. This means that any excess cash flow above the value of the contingent consideration recognised at the acquisition date is classified as an operating activity, as IAS 7 stipulates that only expenditures resulting in a recognised asset are eligible for classification as investing activities [IAS 7.16].

3.10.2.A Contingent consideration conditional on continuing employment

A transaction that remunerates employees or former owners of the acquiree for future services is excluded from the business combination accounting and accounted for separately. [FRS 102.19.11B]. Therefore, cash flows relating to payment of purchase consideration that is conditional on the continuing employment of the vendors in the business, or the existing employees of the business must be classified within operating activities and not within investing activities. This faithfully reflects the fact that these payments are not part of the consideration transferred on a business combination but are remuneration for post-combination services received. [FRS 102.7.4(d)].

3.10.2.B Contingent consideration received on disposals

When an entity disposes of a subsidiary, it presents the cash flows separately within investing activities. This will be the case even for the receipt of contingent consideration because the cash inflow is still an investing cash flow being the receipt from the sale of equity or debt instruments of another entity. (see 3.3.2 above). [FRS 102.7.5(d)].

3.10.3 Acquisition of a business that is not a subsidiary

A business combination may be enacted through the acquisition of a subsidiary (i.e., a business held in a separate legal entity) or through the acquisition of a group of assets and liabilities that constitute a business (sometimes referred to as 'a purchase of net assets and trade').

The cash flows arising from the acquisition and disposal of a group of assets and liabilities that constitute a business would be classified as investing activities. [FRS 102.7.5(c)]. In addition, the considerations set out in 3.10.1 to 3.10.2 above in respect of deferred and contingent consideration also be apply.

3.11 Cash flows of associates, joint arrangements and investment entities

3.11.1 Investments in associates and joint ventures

Cash flows in respect of an entity's acquisition and disposal of an investment in an associate or joint venture would also be classified as an investing activity. [FRS 102.7.5(c), FRS 102.7.5(d)]. Changes in cash and cash equivalents relating to associates or joint ventures accounted for under the equity or cost method will be reflected in the entity's statement of cash flows only to the extent of the cash flows between the group and the investee. Examples include cash dividends received and loans advanced or repaid.

Cash dividends received from equity accounted associates and joint ventures would be classified as operating or investing activities in accordance with the entity's determined policy for other dividends received (see 3.4.1 above). Loans advanced or repaid would be classified as investing activities. [FRS 102.7.5(e), FRS 102.7.5(f)]. Where the net cash inflow from operating activities is determined using the indirect method, the group's share of profits or losses from equity-accounted investments will appear as a non-cash reconciling item in the statement of cash flows (see 3.3.1.A above).

The considerations set out in 3.10.1 and 3.10.2 above in respect of deferred and contingent consideration on acquisition and disposal of a subsidiary must also be applied when determining the appropriate classifications of cash flows relating to the acquisition and disposal of associates and joint ventures.

3.11.2 Jointly controlled operations

Section 7 does not specifically deal with the treatment of the cash flows of joint operations. However, following the principles in Section 15 *Investments in Joint Ventures* all transactions must be reflected in the accounts of the joint operator's financial results to the extent of its interests in those transactions, the cash flows of the joint arrangement are already included in the operator's financial statements and no additional adjustments are required to reflect the activities of the joint operation. [FRS 102.15.5].

The treatment of cash flows for the acquisition and disposal of a joint operation is less clear as there is an argument for presentation either as a single net cash flow in investing activities (as is required for the cost

of a business combination, discussed in 3.10 above); or as separate cash flows, classified according to the nature of the underlying assets and liabilities acquired.

How we see it

In our view, an entity presents the cash flows for the acquisition and disposal of a joint operation consistently with the treatment of the joint operation as either a business or a group of assets and liabilities. Therefore, acquisitions and disposals of operations meeting the definition of a business in FRS 102 would give rise to a single investing cash flow, and acquisitions and disposals of operations not regarded as a business would give rise to cash flows presented according to the nature of the assets and liabilities acquired or disposed.

3.12 Cash flows in separate financial statements

3.12.1 Cash flows of subsidiaries, associates and joint ventures

The presentation of cash payments and receipts between a parent and its subsidiaries, associates and joint ventures in the statement of cash flows which forms part of the separate financial statements of the parent are presented in accordance with the general requirements in Section 7 for classification as operating, investing and financing cash flows, as explained in 3.3.1 to 3.3.3 above. For example, where a parent provides a loan to a subsidiary, an associate or a joint venture, it will be necessary to consider whether the cash outflow (and the subsequent cash inflow when the loan is repaid) meets the definition of operating activities or investing activities in respect of the separate financial statements of the parent. [FRS 102.7.4(f)], [FRS 102.7.5(e)]. Conversely, where a subsidiary, an associate or a joint venture provides a loan to the parent, this is much more clearly part of financing activities of the parent. [FRS 102.7.6(c)].

3.12.2 Group treasury arrangements

Some groups adopt treasury arrangements under which cash resources are held centrally, either by the parent company or by a designated subsidiary. Any excess cash is transferred to the central bank account which is in the name of the designated 'treasury entity'. In some cases, a subsidiary might not even have its own bank account, with all receipts and payments being made directly from the centrally controlled funds. Each individual group company will need to consider how to present the funds transferred to the treasury entity at the period end as cash, as cash equivalents or as a short-term intercompany receivable, by examining the specific facts and circumstances of each arrangement with reference to the definitions of cash and of cash equivalents as discussed in 3.2 above.

To meet the definition of cash, the individual company must be able to withdraw the funds from the treasury entity on demand without prior notice being required and without penalty. To meet the definition of cash equivalents, the funds must be a short-term highly liquid investment that is readily convertible into known amounts of cash and subject to insignificant risk of changes in value. [FRS 102.7.2].

A further question arises as to whether the subsidiary must prepare a statement of cash flows if there is no cash or cash equivalents balance held at each period end and in some cases, at any time during the year.

How we see it

In our view, the preparation of the statement of cash flows will be based upon the actual cash flows during the period regardless of cash and cash equivalents balance held directly by the entity. Where no cash flows through an entity, but rather all transactions flow through the group treasury function acting on behalf of the entity, the entity would still record receipts from debtors and payments to suppliers, albeit with an associated deposit to or withdrawal from a balance with another group company. Just as a bank processes payments and receipts as agent for the account holder, so the group treasury function is acting as agent for the entity, and these transactions will be reflected in a statement of cash flows.

For guidance to assist in the determination of whether another entity is acting on behalf of the reporting entity, as the entity's agent, see 3.5.3 above.

Where the subsidiary makes net deposits of funds to, or net withdrawals of funds from the designated group entity during the reporting period, a further question arises as to how to present these movements in the subsidiary's statement of cash flows. As explained above, these transactions normally give rise to intercompany balances. Therefore, the net deposits or net withdrawals must be shown as investing activities or financing activities, respectively. Further consideration may be made as to whether these cash flows meet the criteria for net presentation as discussed in 3.5.1 above.

3.12.3 Group cash pooling and cash sharing arrangements

Many groups use some form of cash pooling or cash sharing arrangement to manage the group's cash position on a consolidated basis, effectively concentrating the group's cash in one place. Such arrangements seek to maximise the return for the group as a whole on its cash, minimise the cost of funding and give visibility to the group of its combined cash and currency position.

The terms and conditions of such arrangements vary, and it is important to understand the specific nature of the pooling or sharing arrangement in place, in order to determine the appropriate accounting treatment. In 3.12.3.A to 3.12.3.C below we discuss three of the most common types of arrangements.

3.12.3.A Cash pooling

Groups often use what are commonly known as cash pooling arrangements. Typically, these will involve a number of subsidiaries within a group each having a legally separate bank account with the same bank, but these accounts are managed, with the agreement of the bank, on a consolidated basis. For example, interest will normally be determined on a notional basis using the net balance of all accounts; similarly, any overdraft limit will normally apply to the net balance. Typical characteristics of notional cash pooling and physical cash pooling are discussed below however arrangements vary. Therefore the terms and conditions of each arrangement must be reviewed carefully to ensure that the accounting treatment adopted is appropriate for that specific arrangement.

3.12.3.B Notional cash pooling

Notional cash pooling arrangements allow the group to net off the balances of different accounts across jurisdictions, without physically moving the cash to a header or master account, but with each individual entity continuing to have access to the cash it has deposited in its individual account, sometimes called a 'memo' or 'mirror' account. This is, in essence, an interest rate adjustment, and the ownership of the cash does not change.

In such cases, therefore, each entity will continue to report its cash as 'cash and cash equivalents'.

3.12.3.C Physical cash pooling

Typically, in these arrangements, which are also known as zero balancing, cash concentration or physical cash sweeping, the group physically sweeps excess cash out of the individual bank accounts to a 'header account' on a daily basis. In these arrangements, the ownership of the cash changes: the relationship moves from a deposit with a third-party bank to a loan to the group entity that is the holder of the 'header account'. As in the group treasury arrangements discussed above, the individual companies will need to consider how to present these balances at the period end as cash, as cash equivalents or as a short-term intercompany receivable.

4 Disclosures

Section 7 of FRS 102 contains some specific disclosure requirements to supplement the information that is presented in the statement of cash flows. In addition, disclosure may be needed to explain the judgements management has made during the preparation of the statement of cash flows, especially where the appropriate classification of an item is not clear from Section 7.

FRS 102 states that a complete set of financial statements must include in the notes a summary of significant accounting policies, which would include a policy on how an entity determines its cash equivalents and any significant judgement made in classifying cash flows in the statements of cash flows. [FRS 102.3.17(e), FRS 102.8.6].

4.1 Disclosure of components of cash and cash equivalents

Section 7 contains specific disclosures requirements relating to the composition of cash and cash equivalents. These cover:

- The components of cash and cash equivalents and a reconciliation to the amounts in the statement of financial position (see 4.1.1 below).
- The cash held by the entity but which is not available for use (see 4.1.2 below).

4.1.1 The components of cash and cash equivalents and a reconciliation to the amounts in the statement of financial position

Extract from Section 7

7.20 An entity shall present the components of cash and cash equivalents and shall present a reconciliation of the amounts presented in the statement of cash flows to the equivalent items presented in the statement of financial position. However, an entity is not required to present this reconciliation if the amount of cash and cash equivalents presented in the statement of cash flows is identical to the amount similarly described in the statement of financial position.

Cash and cash equivalents is one of the required line items that must be presented on the face of the statement of financial position for an entity choosing to apply paragraph 1A(1) of Schedule 1 to the Regulations and adapt one of the balance sheet formats. [FRS 102.4.2A(k)]. However, items forming part of cash and cash equivalents may not all be shown as a single line item in the statement of financial position. Therefore, disclosure is required to reconcile the line items in the statement of financial position to the amount of cash and cash equivalents in the statement of cash flows.

For example, as discussed in 3.2.2.D above, there are circumstances in which bank overdrafts repayable on demand are included as a component of cash and cash equivalents. In the statement of financial position, the bank overdrafts will be presented as financial liabilities, separate from cash, unless a legal right of set off exists. Therefore, a reconciliation will be needed.

4.1.2 Cash held by the entity, but which is not available for use by the entity

Extract from Section 7

7.21 An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the entity. Cash and cash equivalents held by an entity may not be available for use by the entity because of, among other reasons, foreign exchange controls or legal restrictions.

It is possible for an entity to have amounts held in a bank account that meet the definition of cash but for which use is restricted. Examples include cash and cash equivalents held by a subsidiary operating under exchange controls or other legal restrictions that prevent their general use by the parent or other subsidiaries.

In addition, there may be other circumstances that restrict how cash and cash equivalents can be used by an entity such as those discussed in 3.2.1.A above.

In these circumstances, the standard requires disclosure of the amount of significant cash and cash equivalent balances held by an entity that are not available for use by the entity, together with a commentary by management to explain the circumstances of the restriction. [FRS 102.7.21].

4.2 Disclosure of supplier finance arrangements

The 2024 Periodic Review of FRS 102 introduced new disclosure requirements in respect of supplier finance arrangements which are applicable for reporting periods beginning on or after 1 January 2025. [FRS 102.BC.A.83]. Transitional requirements are dealt with in 4.2.5 below. The new disclosure requirements are similar, but not identical, to the disclosures that were brought into IAS 7 for periods beginning on or after 1 January 2024. There are disclosure exemptions for qualifying entities under FRS 102, provided equivalent disclosures have been included in the consolidated financial statements in which the qualifying entity is included. [FRS 102.1.12]. See Chapter 3 for more details.

Supplier finance arrangements are characterised by one or more finance providers offering to pay amounts an entity owes its suppliers and the entity agreeing to pay according to the terms and conditions of the arrangements at the same date as, or a date later than, suppliers are paid. These arrangements provide the entity with extended payment terms, or the entity's suppliers with early payment terms, compared to the related invoice payment due date. Supplier finance arrangements are often referred to as supply chain finance, payables finance or reverse factoring arrangements. Arrangements that are solely credit enhancements for the entity (e.g., financial guarantee contracts) or instruments used to settle directly with a supplier the amounts owed (e.g., credit cards) are not supplier finance arrangements. [FRS 102.7.20B].

See 3.4.5 above for discussion of the presentation of cash flows arising from supplier finance arrangements.

Extract from Section 7

7.20C An entity shall disclose in aggregate for its supplier finance arrangements:

- (a) the key terms and conditions of the arrangements (e.g., extended payment terms, interest charges, and security or guarantees provided). However, an entity shall disclose separately the key terms and conditions of arrangements that have dissimilar key terms and conditions.
- (b) as at the end of the reporting period:
 - (i) the carrying amounts and associated line items presented in the entity's statement of financial position of the financial liabilities that are part of a supplier finance arrangement.
and
 - (ii) the range of payment due dates (e.g., 30-40 days after the invoice date) for both the financial liabilities disclosed under sub-paragraph (i) and comparable trade payables that are not part of a supplier finance arrangement. Comparable trade payables are, for example, trade payables within the same line of business or jurisdiction as the financial liabilities disclosed under sub-paragraph (i). If ranges of payment due dates are wide, an entity shall disclose explanatory information about those ranges or disclose additional ranges (eg stratified ranges).
- (c) the type and effect of non-cash changes in the carrying amounts of the financial liabilities disclosed under sub-paragraph (b)(i). Examples of non-cash changes include the effect of business combinations, exchange differences or other transactions that do not require the use of cash or cash equivalents (see paragraph 7.18).

4.2.1 Disclosure of the terms and conditions of the arrangements

This disclosure is to inform users of the financial statements that such arrangements are in place and to explain their nature. An entity must disaggregate information about terms and conditions of significant individual arrangements when they are dissimilar. This may include the extended payment terms, security or guarantees provided, and any other terms and conditions that will enable users of financial statements to assess the effects of those arrangements on the entity's liabilities, cash flows and on the entity's exposure to liquidity risk.

4.2.2 Disclosure of carrying amounts

An entity must provide quantitative information about the carrying amount of supplier finance arrangement financial liabilities and the line items in the statement of financial position in which those liabilities are presented. See 4.2.5 below for discussion of transitional reliefs that apply in the first year of application.

4.2.3 Disclosure of the range of payment due dates

An entity is required to disclose the range of payment due dates (for example, 30 to 40 days after the invoice date) for payables within the supplier finance arrangements and for comparable trade payables. The comparable trade payables are the trade payables with the same line of business or jurisdiction, but which have not been included in any supply finance agreements. When those payment due date ranges are wide, explanatory information about those ranges or additional ranges, must be provided. [FRS 102.7.20C(b)(ii)]. See 4.2.5 below for discussion of transitional reliefs that apply in the first year of application.

Illustration 3-2 below is based on an example in the IASB's "Investor Perspectives: Supplier finance - New disclosure requirements to aid investors" document,⁹¹ which shows one possible way of how a company might satisfy the requirements. [FRS 102.7.20C(b)(ii)].

Illustration 3.2: Range of payments due dates

Range (days) of payment due dates	20X6	20X5
Liabilities that are part of the arrangement	85-90 days after invoice date	80-90 days after invoice date
Compare trade payable that are not part of an arrangement	60-70 days after invoice date	60-65 days after invoice date

4.2.4 Disclosure of the type and effect of non-cash changes

The disclosure of the type and effect of non-cash changes in the carrying amounts of the financial liabilities that are part of a supplier finance arrangement are non-cash changes which includes the effect of business combinations, exchange differences or other transactions that do not require the use of cash or cash equivalents. [FRS 102.7.20C(c)]. Disclosure of this information enables users of financial statements to assess the carrying amounts of financial liabilities on a more comparable basis from one reporting period to the next and to understand how these non-cash changes affect the entity's cash flows.

See 3.4.5 above for discussion of the presentation of cash flows arising from supplier finance arrangements.

4.2.5 Effective date and transitional arrangements

The supplier finance arrangement disclosure requirements are effective for annual reporting periods beginning on or after 1 January 2026; early adoption is permitted if disclosed. [FRS 102.1.38]. The amendments contain some transitional reliefs from disclosures in the first year of application, meaning that in the annual reporting period in which the amendments are first applied comparative information is not required for the disclosures in paragraphs 7.20C(a), 7.20C(b)(ii) or 7.20C(c). [FRS 102.1.42]. There is no transitional exemption for the disclosure required by paragraph 7.20C(b)(i) of the carrying amounts and associated line items presented in the entity's statement of financial position of the financial liabilities that are part of a supplier finance arrangement. Therefore, this information must be presented in the first year of application, for both the current period and the comparative period.

⁹¹ [Investors Perspectives - Supplier finance: new disclosure requirements to aid investors](#), May 2023, available on the IFRS Foundation's website.

4.3 Disclosure of analysis of changes in net debt

Extract from Section 7

- 7.22** An entity shall disclose an analysis of changes in net debt from the beginning to the end of the reporting period showing changes resulting from:
- (a) the cash flows of the entity;
 - (b) the acquisition and disposal of subsidiaries;
 - (c) new leases entered into;
 - (d) other non-cash changes; and
 - (e) the recognition of changes in market value and exchange rate movements.
- When several balances (or parts thereof) from the statement of financial position have been combined to form the components of opening and closing net debt, sufficient detail shall be shown to enable users to identify these balances. This analysis need not be presented for prior periods

Net debt consists of the borrowings of an entity, together with any related derivatives and obligations under leases, less any cash and cash equivalents. [FRS 102 Appendix I].

Illustration 3.3:⁹² The example below demonstrates one way in which the analysis of changes in net debt could be presented.

	At 1 Jan 20X1	Cash flows	New leases	Other non-cash change	At 31 Dec 20X1
	CU'000'	CU'000'	CU'000'	CU'000'	CU'000'
Cash and cash equivalents					
Cash	536	(112)	-	-	424
Overdrafts	(256)	44	-	-	(212)
Cash equivalents	250	165	-	-	415
	530	97	-	-	627
Borrowings					
Leases due within one year	(149)	58	(70)	(49)	(210)
Leases due after one year	(175)	-	(130)	45	(260)
Bank loans due within one year	(100)	108	-	(208)	(200)
Bank loans due after one year	(900)	-	-	200	(700)
	(1,324)	166	(200)	(12)	(1,370)
Total	(794)	263	(200)	(12)	(743)

4.4 Disclosure requirements of other standards

4.4.1 Direct cash flows arising from insurance contracts

FRS 103 - Insurance Contracts - requires that, when an insurance entity presents its operating cash flows using the direct method, it must separately disclose cash flows arising from insurance contracts.

[FRS 103.4.5(a)].

4.4.2 Cash flows arising from the exploration of mineral resources

An entity applying FRS 102 which is engaged in the exploration for and/or evaluation of mineral resources must apply IFRS 6 - Exploration for and Evaluation of Mineral Resources. IFRS 6 requires that an entity discloses the amounts of operating and investing cash flows arising from the exploration for and evaluation of mineral resources. [IFRS 6.24(b)].

⁹² FRC Factsheets: FRS 102 Factsheet 3 - Statement of Cash Flows.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Entities exempt from preparing a statement of cash flows.	▪ Qualifying entities. ▪ mutual life assurance companies. ▪ retirement benefit plans. And ▪ investment funds that meet certain conditions. ▪ In addition, financial institutions that undertake insurance contracts must include cash flows in respect of their long-term business only to the extent of cash transferred and available to meet the obligations of the company or group as a whole. ▪ Small entities are not required to comply with the requirements of Section 7.	No exemptions available.
Alternative presentation of indirect method	Not permitted.	IAS 7 allows an alternative presentation for the indirect method whereby net cash flows from operating activities may be presented by showing revenues and expenses disclosed in the statement of comprehensive income and changes in inventories and operating receivables and payables.
Presentation of cash flows from discontinued operations	No specific disclosure requirements.	Net cash flows attributable to operating, investing and financing cash flows of discontinued operations must be disclosed.
Supplier finance arrangements	New disclosure requirements about supplier finance arrangements effective 1 January 2025 which are similar (although not identical) to the amendments made to IAS 7. Disclosure exemptions are available for qualifying entities, provided equivalent disclosures have been included in the consolidated financial statements in which the qualifying entity is included.	For annual reporting periods beginning on or after 1 January 2024, with earlier application permitted, an entity is required to disclose information about its supplier finance arrangements that enables users of financial statements to assess the effects of those arrangements on the entity's liabilities and cash flows and on the entity's exposure to liquidity risk. These disclosures include information on: ▪ Terms and conditions of the arrangements. ▪ Carrying amounts of the liabilities. ▪ Payment due dates. ▪ Non-cash changes in the liabilities.

FRS 102		IFRS
Net debt disclosure	Requirement to disclose an analysis of changes in net debt from the beginning to the end of the reporting period, showing changes resulting from specified categories of cash flows and non-cash changes. Net debt is defined as the borrowings of an entity, together with any related derivatives and obligations under finance leases, less any cash and cash equivalents. This analysis need not be presented for prior periods	Requirement to provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes, with changes presented by categories specified in IAS 7. Comparative information is required.
Contingent consideration paid on business combinations	Apart from any element of discounting to reflect the time value of money, the payment of the contingent consideration must be presented as an investing cash flow.	The treatment under IAS 7 is different, because IFRS 3 - Business Combinations has different requirements for subsequent changes in measurement of contingent consideration. This means that any excess cash flow above the value of the contingent consideration recognised at the acquisition date is classified as an operating activity, as IAS 7 stipulates that only expenditures resulting in a recognised asset are eligible for classification as investing activities.

Appendix A - Defined terms

Extract from FRS 102 Appendix I Glossary

Definitions

cash	Cash on hand and demand deposits
cash equivalents	Short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.
cash flows	Inflows and outflows of cash and cash equivalents.
financing activities	Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.
operating activities	The principal revenue-producing activities of the entity and other activities that are not investing or financing activities
investing activities	The acquisition and disposal of long-term assets and other investments not included in cash equivalents
statement of cash flows	Financial statement that provides information about the changes in cash and cash equivalents of an entity for a period, showing separately changes during the period from operating, investing and financing activities.

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Overview

Section 9 *Consolidated and Separate Financial Statements* addresses the preparation of consolidated financial statements and the accounting for investments in subsidiaries, associates and jointly controlled entities in individual and separate financial statements. It also includes indicators of control of special purpose entities and the accounting for intermediate payment arrangements. The accounting for associates and joint ventures in consolidated financial statements is addressed in Chapter 17 Investments in associates and Chapter 18 Investments in Joint ventures respectively.

What you need to know

- A parent entity is required to present consolidated financial statements in which it consolidates all its subsidiaries unless exempt. A subsidiary is an entity controlled by the parent, i.e., the parent has the power to govern its financial and operating policies so as to obtain benefits from its activities. The consolidated financial statements present financial information about the group as a single economic entity. However, Section 9 permits or requires the exclusion of certain subsidiaries from the consolidated financial statements.
- The exemptions from preparation of consolidated financial statements mirror those available in UK company law. A parent entity reporting under the Companies Act 2006 need only prepare consolidated financial statements if it is a parent at the year end. A company not reporting under the Companies Act 2006 need not prepare consolidated financial statements if not required under its statutory framework.
- A parent, investor or venturer preparing separate or individual financial statements accounts for its investments in subsidiaries, associates and jointly controlled entities in its separate financial statements at either:
 - Cost less impairment
 - Fair value with gains or losses through other comprehensive income (OCI) or profit and loss (the same model as used for revaluations of property, plant and equipment)
 - Or
 - Fair value through profit or loss

1 Introduction

Section 9 addresses the preparation of consolidated financial statements, including guidance on consolidation of special purpose entities, and guidance on consolidation of special purpose entities. It also describes how to account for investments in subsidiaries, associates and jointly controlled entities in individual and separate financial statements and the specific scenarios of exchanging businesses or assets for an interest in a subsidiary, jointly controlled entity or associate and intermediate payment arrangements.

Section 9 is based on the IFRS for SMEs, amended to comply with the requirements of UK Company Law, and expanded to reflect guidance contained in several sources of previous UK GAAP and UK Company Law. By using the IFRS for SMEs as its basis, Section 9 incorporates some IFRS guidance that existed prior to the issuance of IFRS 10 *Consolidated Financial Statements*, being IAS 27 *Consolidated and Separate Financial Statements* (IAS 27 (2012)) and SIC 12 *Consolidation Special Purpose entities*.

As part of the *Amendments to FRS 102 Triennial review 2017 Incremental improvements and clarifications* (Triennial review 2017), issued in December 2017, the FRC considered making amendments to update FRS 102 for the control model in IFRS 10. However, following feedback, the FRC concluded that no changes should be made other than an additional disclosure requirement regarding unconsolidated structured entities (see 3.9.1 below). [FRS 102.BC.B9.2]. The FRC did not consider this matter further for the Periodic Review 2024.

Therefore, in contrast to most sections of FRS 102, the requirements of Section 9 are not based on current IFRS.

2 Comparison between Section 9 and IFRS

As explained above, Section 9 is an amalgamation of requirements that existed in previous UK GAAP and IFRS extant before the issuance of IFRS 10. This means that there are several significant differences compared with IFRS. These are discussed below.

2.1 Requirement to prepare consolidated financial statements

Section 9 contains various exemptions from the basic requirement that a parent prepare consolidated financial statements. These exemptions are aligned with UK Company Law (see 3.1.1 below).

IFRS 10 has different exemptions from consolidation compared to those exemptions permitted by Section 9. [IFRS 10.4]. In particular, the financial statements in which an intermediate parent is consolidated must be prepared under IFRS (although, in certain circumstances, the exemption is available more widely). In contrast, the UK Company Law exemption (see 3.1.1 below) requires these financial statements to be prepared in an 'equivalent GAAP'. IFRS also has no exemption from consolidation for small groups.

Under FRS 102, a parent is required to prepare consolidated financial statements only if it is a parent at the end of the financial year. [FRS 102.9.2]. It is our view, under IFRS 10, that consolidated financial statements must be prepared if an entity is a parent at any time during its financial year (unless otherwise exempt), even if it is no longer a parent at the end of the reporting period (see the EY publication, International GAAP®).

More parents are, therefore, likely to be exempt from preparing consolidated financial statements under FRS 102 than under IFRS.

2.2 Investment entities

Section 9 states that a subsidiary held as part of an investment portfolio is not consolidated but, instead, recognised at fair value through profit or loss (see 3.4.2 below). [FRS 102.9.9C(a)].

IFRS 10 states that a parent must determine whether it is an investment entity. [IFRS 10.27]. An investment entity measures all subsidiaries (other than certain subsidiaries providing investment-related services) at fair value through profit or loss. [IFRS 10.31, IFRS 10.32]. IFRS 10 also has more detailed conditions for the use of the exception to consolidation than Section 9. [IFRS 10.B85A].

There could be differences between FRS 102 and IFRS in respect of investment entities since the Section 9 exception applies to a subsidiary whereas the IFRS exception applies to a parent. IFRS 10 also has more detailed conditions for the use of the exception than Section 9.

2.3 Definition of control

Section 9 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [FRS 102.9.4].

IFRS 10 states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. [IFRS 10.6].

The difference in the definition of control (and related application guidance) results in circumstances when an entity is controlled by a parent under FRS 102 and not controlled under IFRS 10 (and *vice versa*). Likely areas of difference include potential voting rights, control exercised through an agent, control of special purpose entities (see 2.4 below), interests held as trustee or fiduciary and *de facto* control.

2.4 Special purpose entities and structured entities

Section 9 describes circumstances that indicate control of a special purpose entity, which is an entity created to establish a narrow objective (see 3.3 below). [FRS 102.9.10]. A risks and rewards model applies for special purpose entities which is different from the single control model in IFRS 10. Disclosure of the nature and extent of, and risks associated with, interests in unconsolidated special purpose entities is required. [FRS 102.9.23(f)].

IFRS 12 *Disclosure of Interests in Other Entities* defines a structured entity as an entity designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. [IFRS 12 Appendix A]. No specific guidance is given on circumstances that indicate when an entity may control a structured entity because reporting entities are expected to apply the single control model in IFRS 10 in determining the entities they control. Detailed disclosures are required in respect of structured entities in which a reporting entity has an interest. [IFRS 12.14, IFRS 12.15, IFRS 12.16, IFRS 12.17].

A special purpose entity under FRS 102 will not always be a structured entity under IFRS and *vice versa*, and the entity might be consolidated under FRS 102 but not consolidated under IFRS 10 (and *vice versa*). IFRS 12 is likely to lead to more extensive disclosure than FRS 102.

2.5 Subsidiaries excluded from consolidation

Section 9 states that subsidiaries are excluded from consolidation if they operate under severe long-term restrictions or are held exclusively with a view to subsequent resale (see 3.4 below). [FRS 102.9.9]. These exceptions are aligned with UK Company Law.

IFRS 10 does not have similar exceptions. However, a subsidiary that operates under severe long-term restrictions might fail to meet the definition of a subsidiary in IFRS 10 (due to lack of control) and therefore the effect might be the same. Differences between IFRS 10 and Section 9 in respect of investment entities (subsidiaries held as part of an investment portfolio are included in Section 9's definition of subsidiaries held exclusively with a view to resale) are discussed at 2.2 above.

2.6 Accounting for a retained interest in a disposal where control is lost in consolidated financial statements

Section 9 states that when a parent loses control of a subsidiary, but the former parent continues to hold an investment in that entity then the carrying amount of the net assets (and goodwill) attributable to the investment at the date that control is lost is regarded as the cost on initial measurement of the retained investment (see 3.6.3.A below). [FRS 102.9.19].

IFRS 10 states that when a parent loses control of a subsidiary any retained interest in the former subsidiary must be recognised at fair value on the date that control is lost. [IFRS 10.25(b)].

2.7 Accounting for exchange differences on the disposal of a foreign operation in consolidated financial statements

Section 9 states that the cumulative amount of any exchange differences that relate to a foreign subsidiary recognised in equity are not recycled to profit or loss on disposal (i.e., loss of control) of the subsidiary (see 3.6.3 below). [FRS 102.9.18A].

IAS 21 *The Effects of Changes in Foreign Exchange Rates* states that exchange differences that relate to a foreign subsidiary recognised in equity are reclassified to profit or loss on disposal (i.e., loss of control). [IAS 21.48].

2.8 Initial measurement of NCI in consolidated financial statements

Section 9 states that NCI is initially recognised and measured as the NCI's share in the identifiable net assets as recognised and measured in accordance with the requirements for a business combination (see 3.7.1 below). [FRS 102.9.13(d), FRS 102.19.14A].

IFRS 3 *Business Combinations* allows an accounting policy choice (for each business combination) for the acquirer to recognise NCI (that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation) initially at either the net amount of the identifiable assets or at fair value. All other components of NCI are initially measured at their acquisition-date fair values unless another measurement basis is required by IFRSs. [IFRS 3.19].

There is no policy choice under FRS 102 to measure NCI at fair value. Neither does FRS 102 distinguish between different categories of NCI and so implies that all NCIs are measured the same way based on present ownership interest (see 3.7.1 below).

2.9 Accounting for exchanges of business or other non-monetary assets for an interest in a subsidiary in consolidated financial statements

Section 9 addresses the accounting where a reporting entity exchanges a business or other non-monetary assets for an interest in another entity, which thereby becomes a subsidiary of the reporting entity. See Chapter 17 at 2.5 and Chapter 18 at 2.6 where the interest in another entity thereby becomes an associate or joint venture.

To the extent that the reporting entity retains an ownership interest in the business or other non-monetary assets exchanged, that retained interest is treated as having been owned by the reporting entity throughout the transaction and included at its pre-transaction carrying amount.

A gain is recognised to the extent that the fair value of the consideration received exceeds the carrying value of the part of the business or other non-monetary assets exchanged and no longer owned by the reporting entity, together with any related goodwill and cash given up. Any unrealised gains arising are reported in OCI.

A loss is recognised to the extent that the fair value of the consideration received is less than the carrying value of the part of the business or other non-monetary assets exchanged no longer owned by the reporting entity, together with any related goodwill and cash given up (see 3.8 below). [FRS 102.9.31].

IFRS does not contain explicit guidance for the scenario in which a business (or other non-monetary assets) is exchanged for an interest in an entity that becomes a subsidiary as a result of the transaction. However, IFRS 10 contains guidance on loss of control of a subsidiary, which, although not directly relevant, does not distinguish between realised and unrealised gains and requires the gain or loss, realised or unrealised, to be recognised in profit or loss. [IFRS 10.B98]. In the context of a business combination in which the acquirer transfers assets as part of consideration transferred, assets that remain controlled by the acquirer after the business combination are measured at their carrying amount immediately before the transfer and no gain or loss is recognised. [IFRS 3.38]. This differs from the FRS 102 requirement to recognise a gain or loss to the extent that the business (or other non-monetary assets) contributed is no longer owned.

2.10 Cost of investment in a subsidiary in separate financial statements

When an investment in subsidiary is measured using the cost model and merger relief or group reconstruction relief is available in respect of shares issued as consideration, these reliefs can be applied to the initial carrying amount of the investment. This results in the investment being stated initially at either:

- The previous carrying amount of the investment in the transferor's books (if group reconstruction relief is available).

Or

- The nominal value of the shares issued (if merger relief is available). [FRS 102.A3.24]. See 4.2.1.A below

In certain types of group reorganisation when a new parent is established, IAS 27 *Separate Financial Statements* requires the new parent to measure the cost of its investment in a subsidiary at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent (or original entity). [IAS 27.13, IAS 27.14]. Otherwise, 'cost' is normally interpreted as defined by the Glossary to IFRS (i.e., the amount of cash equivalents paid or the fair value of the consideration given). There is no option to use the nominal value of the shares issued, nor generally the previous carrying amount of the investment in the transferor's books, as cost. However, one situation where we believe it would be acceptable to measure cost based on the carrying amount of the investment in the transferor's books under IFRS is in a common control transaction where an investment in a subsidiary constituting a business is acquired in a share-for-share exchange.

This means that, in circumstances when an entity using the cost model for measuring investments in subsidiaries is entitled to use group reconstruction relief or merger relief, the 'cost' is likely to be different under FRS 102 and IFRS.

2.11 Use of the equity method for accounting for investments in subsidiaries, associates and jointly controlled entities in separate or individual financial statements

FRS 102 does not permit the use of the equity method for accounting for investments in subsidiaries, associates and jointly controlled entities in separate financial statements. [FRS 102.BC.A.28(a)].

IAS 27 permits the use of the equity method for accounting for investments in subsidiaries, associates and joint ventures in separate financial statements. [IAS 27.10(c)]. See 2.12 below.

2.12 Accounting for classes of investments in separate financial statements

FRS 102 requires an entity to apply the same accounting policy (i.e., cost less impairment, fair value through OCI or fair value through profit or loss) to all investments in a single class. Examples of classes of investments are investments in subsidiaries held as part of an investment portfolio, investments in subsidiaries not held as part of an investment portfolio, associates and jointly controlled entities. [FRS 102.9.26]. Although the examples given for separate classes of investments differentiate between subsidiaries held as part of an investment portfolio and those that are not so held, in our view, this does not preclude the election of a different accounting policy for different classes of subsidiaries bringing closer alignment with IAS 27, see 4.2 below.

IAS 27 requires an entity to apply the same accounting policy (i.e., cost, in accordance with IFRS 9 *Financial Instruments* or using the equity method) for each category of investments. [IAS 27.10]. The term 'category' is not defined. However, it is our view that investments in subsidiaries, associates, and joint ventures can be further divided into more granular categories, only if a category can be defined clearly and objectively and results in information that is relevant and reliable. Judgement is exercised to define criteria to identify categories more granularly and should be consistently applied. See the EY publication, International GAAP®.

2.13 Intermediate payment arrangements in separate financial statements

Section 9 describes an intermediate payment arrangement. When an entity has control, or *de facto* control, of such an arrangement the entity accounts for it as an extension of its own business in its separate financial statements (see 4.5 below). [FRS 102.9.34, FRS 102.9.35].

IFRS has no guidance on accounting for intermediate payment arrangements. A specific example of an intermediate payment arrangement is an employee benefit trust. It is our view that, in the separate financial statements of the entity that has *de facto* control of the employee benefit trust, it can be accounted for either as an extension of the entity or as an investment in a subsidiary. See the EY publication, International GAAP®,

2.14 Disclosure differences

Disclosure differences between FRS 102 and IFRS are discussed at 5 below.

3 Consolidated financial statements

Consolidated financial statements extend the reporting entity to include other entities subject to its control. They treat the net assets and activities of subsidiaries held by the parent entity as part of the parent entity's own net assets and activities. The aim is to present the results and position of the group as a single entity.

Key terms in Section 9 are defined in the Glossary. [FRS 102 Appendix I]. See Appendix A below.

3.1 Requirement to present consolidated financial statements

The basic legal framework for consolidated financial statements in the UK is found in the Companies Act 2006 (CA 2006). A company that is a parent company at the end of a financial year is required to prepare group accounts for that year unless it is exempt from the requirement. [s399(2)]. The group accounts are consolidated and must give a true and fair view of the state of affairs as at the end of the financial year and the profit or loss for the financial year of the undertakings included in the consolidation as a whole. [s404(1), s404(2)].

Section 9 replicates the requirements of the CA 2006 by requiring that, unless exempt, an entity that is a parent at its reporting date presents consolidated financial statements in which it consolidates all its subsidiaries in accordance with FRS 102. [FRS 102.9.2]. An entity that was a parent at the beginning of a year and sold all of its subsidiaries during the year is not required to present consolidated financial statements for that year. It would prepare individual financial statements for that year with comparatives from the separate financial statements prepared for the previous year, not the consolidated financial statements for the previous year.

Parents that do not report under the CA 2006 (e.g., overseas entities) are required to comply with the requirements of Section 9 and those of the CA 2006 that are referred to in Section 9, except to the extent these requirements are not permitted by any statutory framework under which such entities report.

[FRS 102.9.1].

Consolidated financial statements are the financial statements of a parent and its subsidiaries presented as a single economic entity.

Extract from Section 9

9.4 A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
[FRS 102.9.4].

The CA 2006 defines a subsidiary slightly differently from Section 9 although the FRC clearly intended that the same conclusion would be reached except in very exceptional circumstances. This is discussed at 3.2 below.

When an entity is not controlled by an investor, but that investor has an interest in the entity, the investment in that entity will be accounted for as follows:

- Where the investing entity does not have significant influence or joint control the investment will be accounted for as a financial instrument using one of the accounting policy choices permitted under Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*.
 - Where the investing entity has significant influence but not joint control the investment will be accounted for as an associate under Section 14 *Investments in Associates*.
- And
- Where the investing entity has joint control, the investment will be accounted for under Section 15 *Investments in Joint Ventures*.

3.1.1 Exemptions from preparing consolidated financial statements

There are several provisions that exempt parent companies from having to prepare consolidated financial statements. Most of these exemptions replicate those permitted under the CA 2006 and specific reference is made by Section 9 to the legislation. An entity reporting under the CA 2006 is not exempt from preparing consolidated financial statements if any of its transferable securities are admitted to trading on a UK regulated market. [FRS 102.9.3A]

A parent entity (including an intermediate parent entity) is exempt from the requirement to prepare consolidated financial statements if one or more of the following situations apply: [FRS 102.9.3, FRS 102.9.3A]

- The parent entity, and the group headed by it, qualify as small as set out in section 383 of the CA 2006 and are eligible for the exemption as determined by reference to sections 384 and 399(2A) of the CA 2006 (see 3.1.1.D below). [FRS 102.9.3(a)].
- All the parent entity's subsidiaries are either required to be excluded from consolidation by paragraph 9 of section 9 or permitted to be excluded from consolidation by paragraph 9A of section 9 (see 3.4 below) (referring to section 402 of the CA 2006, see 3.1.1.E below). [FRS 102.9.3(b)].
- For a parent entity not reporting under the CA 2006, if its statutory framework does not require the preparation of consolidated financial statements (see 3.1.1.F below). [FRS 102.9.3(c)].

An immediate parent reporting under the CA 2006 is exempt from the requirement to prepare consolidated financial statements if one or more of the following situations applies (provided that the intermediate parent entity complies with further conditions set out in company law) (see 3.1.1.A, 3.1.1B and 3.1.1.C below):

- Its intermediate parent is established under the law of any part of the UK and: [s400(2), FRS 102.9.3A(a)]
 - The intermediate parent entity is a wholly-owned subsidiary of that immediate parent.
 - The immediate parent entity's immediate parent holds 90% or more of the allotted shares in the entity and the remaining shareholders have approved the exemption.
 - The intermediate parent entity's immediate parent holds more than 50% (but less than 90%) of the allotted shares in the intermediate parent entity, and notice requesting the preparation of consolidated financial statements has not been served on the intermediate parent entity by shareholders holding in aggregate at least 5% of the allotted shares in the intermediate parent entity (such notice must be served at least six months before the end of the financial year to which it relates). [s400(1)(c)].
- Its parent is not established under the law of any part of the UK and: [s400(2), FRS 102.9.3A(b)]
 - The intermediate parent entity is a wholly-owned subsidiary of that parent.
 - The intermediate parent entity's parent holds 90% or more of the allotted shares in the intermediate parent entity and the remaining shareholders have approved the exemption.
 - The intermediate parent entity's parent holds more than 50% (but less than 90%) of the allotted shares in the intermediate parent entity, and notice requesting the preparation of consolidated financial statements has not been served on the intermediate parent entity by shareholders holding in aggregate at least 5% of the allotted shares in the intermediate parent entity (such notice must be served at least six months before the end of the financial year to which it relates). [s401(1)(c)].

When an immediate parent (section 400) or parent (section 401) holds more than 90% but less than 100% of the allotted shares, the wording above implies that all the other shareholders must approve the exemption from preparing consolidated financial statements otherwise the exemption cannot be applied. Neither section 400 nor section 401 explain the form of the approval required.

For this purpose, shares held by a wholly-owned subsidiary of the parent or held on behalf of the parent undertaking or a wholly-owned subsidiary, are attributed to the parent undertaking. [s400(3), s401(3)]. Shares held by directors of a company for the purpose of complying with any share qualification requirement are disregarded for determining whether the company (seeking exemption) is a wholly-owned subsidiary. [s400(5), s401(5)].

The term 'allotted shares' is not restricted and includes all classes of shares and not just ordinary shares or voting shares, including shares that are classified as a liability under FRS 102 (see Chapter 12 at 4.2). The term 'allotted shares' rather than 'allotted share capital' suggests that it is the number of shares rather than their monetary amount that should be considered although this is not clear.

As noted above, the exemptions in respect of sections 400 and 401 of CA 2006 referred to above do not apply if any of the entity's transferable securities are admitted to trading on a UK regulated market (i.e., a 'traded company' as defined by section 474(1) of CA 2006). [FRS 102.9.3A]. This requirement repeats a restriction already contained within both sections 400 and 401 although not within sections 400(2) and 401(2) referred to in 3.1.1.A to 3.1.1.B below. [s400(4), s401(4)].

3.1.1.A Parent that is a subsidiary of an immediate UK parent

The exemption from preparing consolidated financial statements for intermediate parents that are wholly or majority owned subsidiaries of an immediate UK parent is conditional on compliance with certain further conditions as set out below: [s400(2)]

- (a) The company must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking (referred to below as 'parent') established under the law of any part of the UK.
- (b) Those accounts must be drawn up and audited, and that parent's annual report must be drawn up:
 - (i) If the parent is a company, in accordance with the requirements of Part 15 of the CA 2006, or, if the parent is not a company, the legal requirements that apply to the preparation of consolidated accounts for that parent.
 - Or
 - (ii) In accordance with UK-adopted international accounting standards (see 3.1.1.C).
- (c) The company must disclose in the notes to its individual accounts that it is exempt from the obligation to prepare and deliver group accounts.
- (d) The company must state in its individual accounts the name of the parent that draws up the group accounts referred to above, and:
 - (i) The address of the parent's registered office.
 - Or
 - (ii) If it is unincorporated, the address of its principal place of business.
- (e) The company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
 - (i) Those group accounts.
 - And
 - (ii) The parent's annual report, together with the auditor's report on them
- (f) There must be a certified translation of any document delivered to the registrar under (e) above if they are not in English.

UK company law states that 'included in the consolidation', in relation to group accounts, or 'included in consolidated group accounts' means that the undertaking is included in the accounts by the method of full (and not proportional) consolidation, and references to an undertaking excluded from consolidation are determined accordingly. [s474(1)]. Therefore, if a parent is included at fair value through profit or loss in the financial statements of an investment entity parent it would not be entitled to the exemption.

The exemption might not be available in the accounting period when a parent company becomes a subsidiary of another UK company. Under the legislation, the exemption is available only if the company has been included in a set of consolidated accounts of the new parent prepared to the same, or an earlier, reporting date as the company. [s400(2)(a)]. I.e., it is not sufficient that the company will be included in the new parent's consolidated accounts at a future reporting date, see Illustration 3-1 below.

Illustration 3-1: Accounting period in which parent entity becomes a subsidiary

Entity A (a parent) is acquired by Entity B (a parent undertaking established in the UK) in October 20X6. Entity A has an accounting period ending 31 December 20X6. Entity B has an accounting period ending 31 March 20X7.

Entity A is unable to use the section 400 exemption from preparing consolidated financial statements for its accounting period ending 31 December 20X6 because it has not been included in consolidated accounts drawn up to 31 December 20X6 or earlier in that financial year.

Even where the year ends of the intermediate parent company and the parent company are the same, problems can arise. The intermediate parent company must state in its individual financial statements that it is exempt from the obligation to prepare consolidated financial statements. However, some of the necessary conditions might not have been met at the time the directors approve the financial statements of the intermediate parent. For example, the consolidated accounts in which the intermediate parent is to be included might not have been prepared and audited, say if the intermediate parent company has a timetable that requires audited accounts to be submitted prior to the audit report on the consolidated accounts being signed.

3.1.1.B Intermediate parents that are subsidiaries of non-UK parents

The exemption from preparing consolidated financial statements for intermediate parents that are wholly or majority owned subsidiaries of non-UK parents is conditional on compliance with certain further conditions as set out below: [s401(2)]

- (a) The company and all of its subsidiary undertakings must be included in consolidated accounts for a larger group drawn up to the same date, or to an earlier date in the same financial year, by a parent undertaking.
- (b) Those accounts and, where appropriate, the group's annual report, must be drawn up:
 - (ii) In a manner equivalent to consolidated accounts and consolidated annual reports drawn up in accordance with Part 15 of the CA 2006.
 - (iii) In accordance with UK-adopted international accounting standards.

Or

 - (iv) In accordance with accounting standards which are equivalent to such international accounting standards, as determined pursuant to Commission Regulation (EC) No. 1569/2007 of 21 December 2007 (the 2007 Commission Regulation) establishing a mechanism for the determination of equivalence of accounting standards applied by third country issuers of securities pursuant to Directives 2003/71/EC and 2004/109/EC of the European Parliament and of the Council.
- (c) The group accounts must be audited by one or more persons authorised to audit accounts under the law under which the parent undertaking which draws them up is established.
- (d) The company must disclose in its individual accounts that it is exempt from the obligation to prepare and deliver group accounts.
- (e) The company must state in its individual accounts the name of the parent undertaking that draws up the group accounts referred to above and:
 - (i) The address of the undertaking's registered office (whether in or outside the United Kingdom).

Or

 - (ii) If it is unincorporated, the address of its principal place of business.
- (f) The company must deliver to the registrar, within the period for filing its accounts and reports for the financial year in question, copies of:
 - (i) The group accounts.

And

 - (ii) Where appropriate the consolidated annual report, together with the auditor's report on them.
- (g) There must be a certified translation of any document delivered to the registrar under (f) above if they are not in English.

The condition described at (a) above is different from the equivalent condition for intermediate parents that are subsidiaries of a UK parent (see 3.1.1.A above) because it requires all subsidiaries of the intermediate parent to be included in the larger consolidation. As discussed at 3.1.1.A above, UK company law states that 'included in the consolidation' means included by way of full consolidation.

The comments at 3.1.1.A above, including Illustration 3-1, apply here also.

The concept of equivalence for the purposes of (b)(ii) and (b)(iv) above is discussed at 3.1.1.C below.

3.1.1.C Equivalence for the purposes of the section 401 exemption for intermediate parents that are subsidiaries of non-UK parents

The exemption from preparing consolidated financial statements for intermediate parents that are subsidiaries of non-UK parents is conditional on the higher parent's consolidated financial statements being drawn up either:

- (a) In a manner equivalent to the requirements of Part 15 of the Act.
 - (b) In accordance with UK-adopted international accounting standards.
- Or
- (a) In accordance with accounting standards which are *equivalent* to such international accounting standards as determined pursuant to the 2007 Commission Regulation.

The Application Guidance to FRS 100 *Application of Financial Reporting Requirements* states that use of the exemptions requires an analysis of whether the framework (or specified elements of it) applied in practice is equivalent to another framework (or specified elements of it). The Application Guidance aims to assist companies and their auditors in this assessment and avoid an overly cautious approach in response to uncertainty about whether exemptions can be used. [FRS 100.AG5].

It is generally accepted that references to equivalence to another framework do not mean compliance with every detail of that framework. Rather, it is necessary to consider whether the basic requirements of that framework are met (such as the requirement to give a true and fair view), without implying strict conformity with each and every provision. A qualitative approach is more in keeping with the deregulatory nature of the exemption than a requirement to consider the detailed requirements on a checklist basis. [FRS 100.AG6].

Whether the condition in (b) above is met is straight-forward to determine, since it is a matter of fact. [FRS 100.AG7].

In relation to condition (c), the test of equivalence with international accounting standards, the UK government has recognised the equivalence to UK-adopted international accounting standards of the following GAAPs. [FRS 100.AG9]. This means that these GAAPs are equivalent to UK-adopted international accounting standards as a matter of law.

Equivalent GAAP

GAAP of Japan

GAAP of the United States of America

GAAP of the People's Republic of China

GAAP of Canada

GAAP of the Republic of Korea

EU-adopted IFRS

IFRS as issued by the IASB

If neither of the conditions (b) or (c) are met, the directors can assess the consolidated financial statements of the higher parent for equivalence with condition (a), the test of equivalence with Part 15. [FRS 100.AG11]. The assessment must include whether those financial statements meet the basic requirements of Part 15 of the Act, in particular the requirement to give a true and fair view. [FRS 100.AG13]. Consolidated financial statements of the higher parent will meet this test if they are intended to give a true and fair view and are prepared: [FRS 100.AG14]

- In accordance with FRS 102.
- Or
- Using GAAPs which are closely related to IFRS accounting standards, subject to the consideration of the effect of any differences from UK-adopted international accounting standards.

Consolidated financial statements of the higher parent prepared in any other manner are assessed for equivalence with Part 15 of the Act based on the particular facts, including the similarities to and differences from the requirements of Part 15 of the Act. However, meeting the condition of equivalence for use of the exemption does not depend on equivalence have been formally granted by the UK government. Directors may make their own assessment of equivalence in determining whether the company qualifies for the exemption. [FRS 100.AG8].

3.1.1.D Exemption from preparing consolidated financial statements for small groups

A company is exempt from the requirement to prepare group accounts if, at the end of its financial year, the company: [s399(2A)(a)]

- Is subject to the small companies regime.
- Or
- Would be subject to the small companies regime but for being a public company.

This exemption is further conditional on the company not being a member of a group which, at any time during the financial year, includes an undertaking falling within section 399(2B) as a member (see Chapter 5 at 3.2 for a list of these ineligible undertakings). [s399(2A), s399(2B)].

Consequently, a parent is exempt from preparing consolidated financial statements if both the parent and the group headed by it qualify as small as set out in section 383 and the parent and the group are considered eligible for the exemption as determined by reference to sections 384 and 399(2A) - (2B). [FRS 102.9.3(a)]. This means that some companies subject to the small companies regime will not be able to take advantage of the exemption.

The detailed criteria for a small company and a small group are discussed in Chapter 5 at 2.

3.1.1.E Exemption due to all subsidiaries excluded from consolidation

A company is exempt from the requirement to prepare group accounts if all of the entity's subsidiaries are either required to be excluded from consolidation by paragraph 9 of section 9 of or permitted to be excluded from consolidation by paragraph 9A of section 9. [FRS 102.9.3(b)]. This exemption is similar to the exemption in the CA 2006 which states that a parent is exempt from the requirement to produce group accounts if, under section 405, all of its subsidiary undertakings could be excluded from consolidation in Companies Act group accounts. [s402].

The circumstances in which subsidiaries can be excluded from consolidation, including differences between the CA 2006 and FRS 102, are discussed at 3.4 below.

3.1.1.F Exemption under statutory framework

This exemption applies to those entities not required to report under the CA 2006. It applies only if preparation of consolidated financial statements is not required by the applicable statutory framework.

[FRS 102.9.3(c)].

3.2 The definition of a subsidiary

The definition of a subsidiary is fundamental to the concept of consolidated financial statements and also to the subject of off-balance sheet financing, i.e., whether or not to include certain assets and liabilities that management might wish to exclude from the consolidated financial statements.

Section 9 states:

Extract from Section 9

9.4 A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
[FRS 102.9.4]

The definition comprises of two criteria:

- Power over the financial and operating policies.
- And
- Benefits from the entity's activities to be obtained from that power.

Although FRS 102 does not define what financial and operating policies are, they are generally understood to include such areas as budgeting, capital expenditure, treasury management, dividend policy, production, marketing, sales and human resources.

How we see it

Although no guidance is given as to what 'benefits' means, in our view, these are not restricted to gains resulting from the entity's activities such as dividends or increases in the value of the investment in the entity, but could also include benefits, such as cross-selling, received by the investor as a result of its power over the entity.

There is no requirement for the investor to utilise its power and exercise control. The requirement is to have the power to do so. Hence, a passive investor that has the necessary power still controls a subsidiary.

There is a rebuttable presumption that control exists when the parent owns, directly or indirectly, more than half of the voting power of an entity. That presumption can be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control. [FRS 102.9.5]. No examples of such exceptional circumstances are provided, and it appears to be a high hurdle to overcome this presumption.

Control also exists when the parent owns half or less of the voting power, but it has power: [FRS 102.9.5]

- Over more than half of the voting rights by virtue of an agreement with other investors.
- To govern the financial and operating policies of the entity under a statute or an agreement.
- To appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body.

Or

- To cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

These points above extend the control concept from control of a company in a general meeting to control of the board, or control of an entity by other means.

Control can also be achieved by having options or convertible instruments that are currently exercisable. [FRS 102.9.6]. See 3.2.1 below.

Control can also be exercised by having an agent with the ability to direct the activities for the benefit of the controlling entity. [FRS 102.9.6]. See 3.2.2 below.

Control can also exist when the parent has the power to exercise, or actually exercises, dominant influence or control over the undertaking or it and the undertaking are managed on a unified basis. [FRS 102.9.6A]. No further guidance is provided by FRS 102 in respect of dominant influence. However, the CA 2006 states that an undertaking shall not be regarded as having the right to exercise a dominant influence over another undertaking unless it has a right to give directions with respect to the operating and financial policies of that other undertaking which its directors are obliged to comply with whether or not they are for the benefit of that other undertaking. [7 Sch 4(1)].

Entities that are not controlled by voting or similar rights or those that are created with legal arrangements that impose strict requirements over their operations pose special problems. As a result, Section 9 provides guidance on determining who controls these types of entity, described as 'special purpose entities'. See 3.3 below.

For UK companies, the CA 2006 defines an entity as a parent undertaking in relation to another undertaking, a subsidiary undertaking, if it: [s1162(2)]

- Holds a majority of the voting rights in the undertaking.
- Is a member of the undertaking and has the right to appoint or remove a majority of its board of directors.
- Has the right to exercise a dominant influence over the undertaking:
 - By virtue of provisions contained in the undertaking's articles.
 Or
 - By virtue of a control contract.
 Or
- Is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.

For this purpose, an entity is treated as a member of another undertaking if any of its subsidiary undertakings is a member of that undertaking or if any shares in that other undertaking are held by a person acting on behalf of the undertaking or any of its subsidiary undertakings. [s1162(3)].

An undertaking is also a parent undertaking in relation to a subsidiary undertaking if: [s1162(4)]

- It has the power to exercise, or actually exercises, dominant influence or control over it
- Or
- It and the subsidiary undertaking are managed on a unified basis

A parent undertaking shall be treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings and references to its subsidiary undertakings shall be construed accordingly. [s1162(5)].

Schedule 7 to CA 2006 provides supplementary guidance supporting the definition of a subsidiary.

How we see it

Although there are slight differences in wording emphasis between the CA 2006 definition of a subsidiary and the requirements in FRS 102, in our view, it is unlikely that many conflicts will arise in practice between FRS 102 and the CA 2006 that would require the use of a true and fair override.

3.2.1 Potential voting rights

Control can be achieved by having options or convertible instruments that are currently exercisable. [FRS 102.9.6]. These instruments may be shares, warrants, share call options, debt or equity instruments that are convertible into instruments that have the potential, if exercised or converted, to give the entity power or reduce another party's voting power over the financial and operating policies of another entity.

The existence and effect of potential voting rights must be considered when assessing whether an entity has the power to govern the financial and operating policies of another entity so as to obtain benefits from its activities. When an option to acquire a controlling interest in an entity has not yet been exercised but can be freely exercised by its holder (that is, it could be exercised and, if exercised, would give the holder control), the holder in effect has the power of veto and has the power to govern the entity's financial and operating policies.

Potential voting rights are not currently exercisable or convertible when they cannot be exercised or converted until a future date or until the occurrence of a future event. Illustration 3-2 shows the meaning of currently exercisable.

Illustration 3-2: Potential voting rights - meaning of currently exercisable

An entity (A) holds 40% of another entity (B). It also holds loan notes in B convertible, at A's option, into further shares in B, which if issued would give A a 60% interest in B. A can require conversion of its loan notes into shares at any time on or after the fifth anniversary of their issue.

Until that fifth anniversary occurs, A cannot exercise its conversion rights. Therefore, before that date, they are not currently exercisable and B is not (absent other circumstances) controlled by A and therefore not a subsidiary of A. Once the fifth anniversary has occurred, A's option to convert the loan into shares of B is currently exercisable. Therefore, at that date, A has control over the majority of the voting rights of B, such that B therefore becomes a subsidiary of A at that date.

An entity exercises judgement when determining whether potential voting rights are currently exercisable. A literal reading might suggest that unless the potential voting right is exercisable immediately, the entity ignores the potential voting right when assessing control. In practice, however, many potential voting rights are not exercisable immediately but only after giving notice (e.g., options over the shares of unlisted entities often include a notice period of several days or a week). A short notice period is usually ignored when assessing whether the rights are currently exercisable.

FRS 102 provides no guidance on whether the intention of management or the financial ability to exercise or convert a potential voting right are considerations when assessing whether those rights give control. In the absence of guidance, under the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* an entity could look to the requirements and guidance in adopted IFRS relating to similar issues. In this case, there are two possible sources of reference, IFRS 10 (the extant standard) and IAS 27 (2012) (the standard on which much of Section 9's control model is based). Both IFRS 10 and IAS 27 (2012) are clear that the intention of management should be ignored in assessing whether potential voting rights give control. [IFRS 10.B22, IAS 27(2012).15]. In respect of the financial ability to exercise or convert a potential voting right, IFRS 10 states that the financial ability of an investor to pay the exercise price should be considered when evaluating whether an option is substantive. [IFRS 10.B23(a)]. In contrast, IAS 27(2012) stated that the financial ability to exercise or convert a potential voting right is not considered in assessing control. [IAS 27(2012).15].

3.2.2 Control exercised through an agent

Control can be achieved by having an agent with the ability to direct the activities for the benefit of the controlling entity. [FRS 102.9.6].

The overall relationship between the investor and the agent must be assessed to determine whether the 'agent' is acting as an agent for the controlling entity or as a principal in its own right.

3.2.3 Interests held as trustee or fiduciary, or as security

A reporting entity might hold, as a trustee or fiduciary on behalf of others, an interest in another entity that either on its own or when combined with any interest held on its own account, gives the reporting entity control of the majority of the voting rights in, or the ability to appoint or remove a majority of the members of the board of, the other entity. This raises the question of whether the reporting entity controls that other entity.

How we see it

In our view, interests held in another entity on behalf of others generally do not give a reporting entity control over that other entity.

Control is “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities” (emphasis added). [FRS 102.9.4]. A trustee or other fiduciary exercises any decision-making powers relating to assets under its management so as to obtain benefits not for itself, but for those on whose behalf it exercises the powers. The CA 2006 states that rights held by a person in a fiduciary capacity shall be treated as not held by that person. Similarly, rights held by a person as nominee for another (if such rights are exercisable only on that other person’s instructions or with that other person’s consent or concurrence), are regarded as held by the other. [7 Sch 6, 7 Sch 7].

Rights attached to shares by way of a security are normally treated as held by the person providing the security if, apart from the ability to exercise them for the purpose of preserving the value of the security, rights are only exercisable upon that person’s instructions. The same applies when shares are held in connection with the granting of loans as part of normal business activities. [7 Sch 8, 7 Sch 9(2), 7 Sch 9(3)].

Rights are treated as held by a parent undertaking if they are held by any of its subsidiary undertakings. [7 Sch 9(1)].

As demonstrated in Illustration 3-3, consolidation is still required if an entity legally owns and controls an investment, even if the risks and rewards have been passed on to a third party. Determining whether an entity controls an investment or merely holds an interest in a fiduciary capacity requires a careful assessment of the facts and circumstances.

Illustration 3-3: Control over investment vehicle by an insurance entity

An insurance entity makes certain investments on behalf of unit-linked contract holders. One of those investments is an interest of more than 50% in an investment fund. The unit-linked contract holders are not the legal owner of the investment in the fund. In addition, the insurance entity is under no obligation to return the shares in the underlying investment to the unit-linked contract holders upon termination of the contract. The insurance entity is the legal owner and the unit-linked contract holders have no direct relationship with (and decision-making powers over) the investment fund.

The unit-linked contracts do not diminish the insurance entity’s ability to control the investment fund. Therefore, the presumption is that the insurance entity consolidates the investment fund unless it can be demonstrated that it does not have control. While the insurance entity holds a matched position of units in the investment fund and unit-linked contracts, it is under no obligation to hold an investment in the units of the investment fund. Conversely, the unit-linked contract holders have no direct legal rights that entitle them to the units in the investment fund that are owned by the insurance entity. In other words, the insurance entity does not hold the units in the investment fund in a fiduciary capacity.

3.2.4 De facto control

De facto control over an entity by a minority shareholder (e.g., a shareholder holding less than a majority of the voting rights) could arise in several ways. A common example is when other shareholders are widely dispersed and when enough of them regularly fail to exercise their rights as shareholders (e.g., to vote at general meetings), such that the minority shareholder wields the majority of votes actually cast.

Although mentioned in the context of intermediate payment arrangements (see 4.5 below), *de facto* control is not explained by FRS 102. The definition of control refers to the power to govern the financial and operating policies of an entity and power is explained as representing the ability to do or effect something, whether actively or passively (see 3.2 above). It follows from the definition of control that it involves the ability to:

- Make decisions without the support or consent of other shareholders.
- And
- Give directions with respect to the operating and financial policies of the entity concerned, with which directions the entity’s directors are obliged to comply.

Accordingly, control does not exist where an investor must obtain the consent of one or more other shareholders in order to govern the operating and financial policies of the investee.

To have the ability to govern the financial and operating policies of an entity, an investor must be able to hold the management of the entity accountable. It is therefore unlikely that *de facto* control over an entity can exist unless the investor has the power to appoint and remove a majority of its governing body (i.e., normally the board of directors in the case of a company). This power is normally exercisable by holders of the voting shares in a general meeting.

How we see it

In our view, FRS 102 does not necessarily require consolidation of entities subject only to *de facto* control, unless the investor can demonstrate it has the ability to govern the financial and operating policies of an entity.

In practice, *de facto* control is most likely to be evidenced where an investor with less than a 50% voting interest can have its chosen candidates (re)nominated for election to an entity's board of directors and its votes exceed 50% of the votes typically cast in the entity's election of directors. For example, if typically only 70% of the eligible votes are cast on resolutions for the appointment of directors, a minority holding of 40% might give *de facto* control if the remaining shares are widely held (for example, no party has an interest of sufficient size either of itself or with a small number of others, to block decisions).

It is highly unlikely that *de facto* control exists when a minority voting interest represents less than 50% of votes typically cast in elections of directors. For example, a voting interest of 30% where, typically, 70% of the eligible votes are cast in elections. As control is unilateral, when assessing whether *de facto* control exists, the entity does not consider the possibility that other shareholders will cast their votes in the same way as the entity.

The determination of whether *de facto* control exists is based on facts and circumstances. It is unlikely to be sufficiently certain that *de facto* control exists until actions taken provide evidence of control, i.e., control must be actively exercised. In general, the more the legal or contractually-based powers held in relation to an entity fall short of 50% of the total powers, the greater is the need for evidence of actively exercised *de facto* control.

3.3 Special purpose entities (SPEs)

FRS 102 describes an SPE:

Extract from Section 9

9.10 An entity may be created to accomplish a narrow objective (e.g., to effect a lease, undertake research and development activities, securitise financial assets or facilitate employee shareholdings under remuneration schemes, such as Employee Share Ownership Plans (ESOPs)). Such a special purpose entity (SPE) may take the form of a corporation, trust, partnership or unincorporated entity. Often, SPEs are created with legal arrangements that impose strict requirements over the operations of the SPE. [FRS 102.9.10]

The requirements for SPEs do not apply to a post-employment benefit plan or other long-term employee benefit plans to which Section 28 *Employee Benefits* applies. [FRS 102.9.12].

An intermediate payment arrangement, a type of SPE, is discussed at 4.5 below.

How we see it

In our view, the description of an SPE is broader than a separate legal entity. For example, a parcel of 'ring fenced' assets and liabilities within a larger legal entity, such as a cell in a protected cell entity, might be an SPE. A portfolio of securitised assets and the related borrowings might also be an SPE.

The sponsor (or entity on whose behalf the SPE was created) frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other parties ('capital providers') may provide funding to the SPE. An entity that engages in transactions with an SPE (frequently the creator or sponsor) may in substance control the SPE. For example, an entity might have a beneficial interest in an SPE, which may take the form of a debt instrument, an equity instrument, a participation right, a residual interest or a lease. Some beneficial interests provide the holder with a fixed or stated rate of return, while others give the holder rights or access to other future economic benefits of the SPE's activities. In most cases, the creator or sponsor (or the entity on whose behalf the SPE was created) retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity.

Unless a parent is not required to prepare consolidated financial statements (see 3.1 above), a parent entity prepares consolidated financial statements that include the entity and any SPEs that are controlled by that entity. In addition to the circumstances described at 3.2 above, the following circumstances may indicate that an entity controls an SPE (this is not an exhaustive list): [FRS 102.9.11]

- The activities of the SPE are being conducted on behalf of the entity according to its specific business needs.
- The entity has ultimate decision-making powers over the activities of the SPE even if the day-to-day decisions have been delegated.
- The entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE.

And

- The entity retains the majority of the residual or ownership risks related to the SPE or its assets.

Activities are likely to be conducted on behalf of the entity according to its specific business needs when the reporting entity created the SPE, directly or indirectly.

Day to day decisions might be delegated by, for example, setting up an auto pilot mechanism. Ultimate decision-making powers might still be retained in this circumstance by, for example, having the power to unilaterally dissolve the SPE or the power to change, or veto proposed changes to, the SPE's charter or byelaws.

Rights to obtain benefits and exposure to risks incidental to the activities of the SPE might arise through statute, contract, agreement, trust deed or any other scheme, arrangement or device. Such rights to benefits in an SPE might be indicators of control when they are specified in favour of an entity that is engaged in transactions with an SPE and that entity stands to gain those benefits from the financial performance of the SPE.

Residual or ownership risks might arise through the guarantee of a return or credit protection directly or indirectly through the SPE to outside investors who provide substantially all of the capital to the SPE. As a result of the guarantee, the entity could retain residual or ownership risks and the investors are, in substance, only lenders because their exposure to gains and losses is limited.

No relative weight is given to the various indicators when determining whether an SPE is consolidated. However, control of an entity comprises the ability to govern the entity's financial and operating policies so as to obtain benefits from the activities of the entity. [FRS 102.9.4]. The ability to control decision-making alone is not sufficient to establish control, it must be accompanied by the objective of obtaining benefits from the entity's activities. For example, a third party such as a charitable trust might own all the voting rights in an SPE. However, if the trust does not obtain any real benefit from the SPE, (which is typically the case) this indicates that the trust does not control the SPE.

3.3.1 Benefits need not necessarily be financial

As discussed at 3.3 above, the first indicator of an SPE is that its activities are being conducted on behalf of the reporting entity according to its specific business needs.

How we see it

In our view, this indicator does not necessarily require that the reporting entity has any direct financial benefit. The 'benefit' might be the avoidance of negative outcomes, or operational benefits.

3.3.2 Majority of the benefits and risks

The third and fourth indicators at 3.3 above refer to the majority of benefits and risks.

How we see it

In our view, the reference to the majority of benefits and risks means the majority of those likely to arise in practice, rather than the majority of all theoretically possible benefits and risks.

This is demonstrated by Illustration 3-4.

Illustration 3-4: Assessment of majority of benefits and risks of an SPE

An SPE is established to undertake a securitisation of financial assets. The SPE has only nominal equity, but issues £1,000 of debt: £100 subordinated debt to the reporting entity and £900 senior debt to a financial institution. The SPE buys £1,000 of receivables from the reporting entity.

The terms of the two classes of debt have the effect that the reporting entity bears the first £100 of any credit losses and the financial institution the remainder. This could suggest that the financial institution is bearing the majority of the risks, since it has £900 of the possible £1,000 bad debt risk. However, if bad debt risk falls within a typical range of, say, 5% to 7%, all the losses that are likely to occur will be borne by the reporting entity as the holder of the subordinated debt. Therefore, the reporting entity bears the majority of residual or ownership risks of the SPE.

3.3.3 Subsequent reassessment of control of an SPE

FRS 102 is silent on whether an entity reassesses control of an SPE after inception.

How we see it

Ordinarily, control of an SPE does not change after inception. However, in our view, a reporting entity reassesses whether it continues to control an SPE when:

(a) There is a change in the contractual arrangements between the parties to the SPE.

Or

(b) Any one of the parties takes steps to strengthen its position and, in doing so, acquires a greater level of control.

Reassessment of which party controls an SPE requires judgement, each situation is assessed based on its facts and circumstances.

Illustration 3-5: Action by the liquidity provider to an SPE triggers reassessment of control

An SPE experiences a period of financial difficulty in which commercial paper cannot be reissued for longer than a certain period. The SPE's governing agreement requires the assets to be liquidated in this circumstance. The liquidity provider, knowing that a sale of the assets in that difficult environment is likely to result in losses, decides to extend the life of the structure by buying a new issue of commercial paper. This action was not anticipated in the original agreement between the SPE and the liquidity provider and might indicate that the liquidity provider has changed the relative contractual positions of the parties to the SPE and taken control of it.

So long as the initial control assessment is not called into question (e.g., because it was based on incomplete or inaccurate information), subsequent changes in the relationship due to changes in risk profile or market events do not necessarily indicate a transfer of control between the parties. For example, reassessment of control is not necessarily triggered by:

- Impairment of the assets owned by an SPE.

Or

- Losses incurred by an SPE exceeding the capital provided to it (such that the residual risk now lies with another party, for example the SPE sponsor).

However, when events like these occur, the party bearing the residual risk often takes steps to protect its position, which in turn might trigger a reassessment of whether that party controls, and therefore consolidates, the SPE.

3.3.4 Securitisation transactions

SPEs are commonly found in, but are not unique to, the financial services sector, where they are used as vehicles for securitisation of financial assets such as mortgages or credit card receivables. The effect of these requirements combined with the derecognition provisions of Section 11 might be that an asset is not derecognised. This is because, although a securitisation transaction might qualify as a sale of the financial asset (which is, in principle, derecognised), the 'buyer' is an SPE set up by the entity which sold the financial asset. Therefore, the asset is immediately re-recognised through consolidation of the SPE.

3.4 Subsidiaries excluded from consolidation

In general, a parent consolidates all subsidiaries in its consolidated financial statements. However, there are various circumstances in which it is appropriate not to consolidate particular subsidiaries and instead either deal with them in some other manner or exclude them from the consolidated financial statements altogether.

The CA 2006 permits subsidiaries to be excluded from consolidation on certain grounds. [s405]. Within the constraints of the CA 2006, FRS 102 requires exclusion from consolidation on certain grounds and interprets how the CA 2006 is to be applied.

A subsidiary is excluded from consolidation when: [FRS 102.9.9]

- Severe long-term restrictions substantially hinder the exercise of the rights of the parent over the assets or management of the subsidiary (see 3.4.1 below).
- Or
- The interest in the subsidiary is held exclusively with a view to subsequent resale and the subsidiary has not previously been consolidated in the consolidated financial statements prepared in accordance with FRS 102 (see 3.4.2 below).

In addition, aligning FRS 102 with the identical exclusion permitted by section 405(2) of the CA 2006. [s405(2), FRS 102.9.9A].

Extract from Section 9

9.9A A subsidiary may be excluded from consolidation when its inclusion is not material for the purpose of giving a true and fair view (but two or more subsidiaries may be excluded only if they are not material taken together).

The CA 2006 permits subsidiaries to be excluded from consolidation in extremely rare circumstances when the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay. [s405(3)(b)]. However, FRS 102 does not permit a subsidiary to be excluded for this reason alone unless its inclusion is not material (individually or collectively for more than one subsidiary) for the purpose of giving a true and fair view in the context of the group. [FRS 102.9.8A]. Therefore, in this scenario, exclusion is permitted only on materiality grounds as described in paragraph 9A of section 9.

A subsidiary is not excluded from consolidation because its business activities are dissimilar to those of other entities within the consolidation. In the opinion of the FRC, relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. [FRS 102.9.8].

3.4.1 Subsidiaries excluded from consolidation due to severe long-term restrictions

A subsidiary excluded from consolidation because of severe long-term restrictions is accounted for in the consolidated financial statements as if it is an investment in a subsidiary in separate financial statements unless the parent exercises significant influence over the subsidiary, in which case it is treated as an associate. [FRS 102.9.9B].

When the investment excluded from consolidation is a subsidiary, the parent has an accounting policy choice (see 4.2 below) to measure the subsidiary at: [FRS 102.9.26]

- Cost less impairment.
- Fair value with changes in fair value recognised through OCI (or profit or loss, to the extent that it reverses revaluation movements in profit or loss or where the revaluation reserve would otherwise be negative).
- Or
- Fair value with changes in fair value recognised in profit and loss.

If the investment excluded from consolidation is treated as an associate, the equity method is used in the consolidated financial statements.

How we see it

In our view, consistent with the requirements for disposal when control is lost (see 3.6.3 below), the initial cost of the investment in the subsidiary in these circumstances is the carrying amount of the net assets (and goodwill) attributable to the investment on the date that the severe long term restrictions affected the parent's exercise of its rights over the subsidiary.

A true and fair override might be required for subsidiaries excluded from consolidation that are held at fair value through profit or loss as this accounting is not permitted by the CA 2006 in circumstances in which it would not be permitted by IFRS 10. [FRS 102.A3.17, 1 Sch 36].

FRS 102 does not provide any examples of situations in which a subsidiary might be subject to severe long-term restrictions that hinder the exercise of the parent's rights over the assets or management of the subsidiary. However, examples might include:

- Insolvency or administration of the subsidiary.
 - Veto powers held by a third party (e.g., powers held by a lender due to covenant breaches).
- And
- The existence of severe restrictions over remittance of funds (e.g., dividends) if they prevent the parent from obtaining benefits of the subsidiary.

FRS 102 provides no guidance as to the accounting if the severe long-term restrictions cease and the parent's rights are restored.

How we see it

In our view, consistent with the guidance contained in previous UK GAAP, when the severe long-term restrictions cease and the parent's rights are restored, the amount of the unrecognised profit or loss that accrued during the period of restriction for that subsidiary should be separately disclosed in the consolidated profit and loss account of the period in which control is resumed. Similarly, any amount previously charged for impairment that needs to be written back in profit or loss in the period in which control is resumed, as a result of restrictions ceasing, is separately disclosed.

This is different from the accounting for a subsidiary in which control has been lost whereby the regaining of control would be treated as a business combination achieved in stages (a step acquisition) under Section 19 *Business Combinations and Goodwill* (see Chapter 22 at 3.11).

3.4.2 Subsidiaries held exclusively with a view to subsequent resale

A subsidiary held exclusively with a view to subsequent resale is an interest: [FRS 102 Appendix I]

- For which a purchaser has been identified or is being sought, and which is reasonably expected to be disposed of within approximately one year of its date of acquisition.
 - That was acquired as a result of the enforcement of a security, unless the interest has become part of the continuing activities of the group or the holder acts as if it intends the interest to become so.
- Or
- Which is held as part of an investment portfolio (see 3.4.2.A below).

For a subsidiary to be classified as held exclusively with a view to subsequent resale it must not have been consolidated previously in the consolidated financial statements prepared under FRS 102. [FRS 102.9.9(b)].

A subsidiary excluded from consolidation on the grounds that is held exclusively for resale is accounted for in the consolidated financial statements as follows: [FRS 102.9.9C]

- A subsidiary held as part of an investment portfolio is measured at fair value with changes in fair value recognised in profit or loss.
- And
- A subsidiary not held as part of an investment portfolio is measured using an accounting policy choice in accordance with paragraph 26 of section 9 (i.e., as if it was an investment in a subsidiary in separate financial statements, see 4.2 below).

A true and fair override might be required for subsidiaries excluded from consolidation that are held at fair value through profit or loss (whether or not these are subsidiaries held as part of an investment portfolio) as this accounting is not permitted by the CA 2006 in circumstances in which it would not be permitted by IFRS 10. [FRS 102.A3.17, 1 Sch 36].

FRS 102 provides no guidance if a subsidiary is no longer considered to be held exclusively with a view to subsequent resale.

How we see it

In our view, if a subsidiary is no longer considered to be held exclusively with a view to subsequent resale, it is consolidated from the date of the change in circumstances, using the fair values of the identifiable assets and liabilities of the subsidiary at the date of the original acquisition with a catch-up adjustment to reflect subsequent movements up to the date that the subsidiary is no longer held exclusively with a view to subsequent resale. This is because the subsidiary has always been controlled by the parent from the date of the original acquisition. This is also consistent with the requirement in the Regulations that identifiable assets and liabilities acquired are included in the consolidated balance sheet at their fair values at the date of the acquisition.

3.4.2.A Subsidiary held as part of an investment portfolio

A subsidiary is held as part of an investment portfolio if its value to the investor is through fair value as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out business. A basket of investments is indirectly held if an investment fund holds a single investment fund in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments. [FRS 102 Appendix I].

The concept that an interest held as part of an investment portfolio meets the definition of an interest held exclusively with a view to subsequent resale is an interpretation of company law. The Basis for conclusions which accompanies FRS 102 explains it as a means for investment entities to avoid having to prepare EU-adopted IFRS in order to be exempt from consolidating their investments. [FRS 102.BC.B9.6].

The entities most likely to be affected by this exception are:

- Subsidiaries of private equity or venture capital funds.
- And
- Investment fund subsidiaries of banks, insurers, asset managers and property managers.

The investment portfolio exception from consolidation is considerably different from the investment entity exception in IFRS 10. It applies to an individual subsidiary rather than to a parent, contains no requirement for the parent to have an exit strategy for its investment portfolio and the definition explicitly refers to indirectly held investments.

How we see it

It is likely that the investment portfolio exception from consolidation will have a wider application than the investment entity exception in IFRS 10 and there could be considerable diversity in practice, especially in the financial services industry, as to what is considered to be an interest in an investment portfolio.

The last sentence of the definition of a subsidiary 'held as part of an investment portfolio' clarifies that, in some circumstances (e.g., when an investment fund is first established), it might be appropriate for a single investment to be considered an investment portfolio. This clarification is consistent with IFRS 10, which does not preclude an entity from meeting the definition of an investment entity simply because it has only one investment. [IFRS 10.B85P].

Many investment group structures have intermediate holding companies that are established for tax optimisation purposes or to provide investment-related services and activities. There is no explicit guidance as to whether such intermediate holding companies are treated as interests held as part of an investment portfolio (and therefore measured at fair value through profit or loss) or whether they are not considered as such (and therefore consolidated). For a subsidiary to be held as part of an investment portfolio, FRS 102 requires the value of the interest to the investor to be through fair value, rather than as a media through which the investor carries out business.

How we see it

In our view, if an entity is holding an investment in a subsidiary as a means of carrying on business, it appears not to be holding it with a view to resale. Similarly, if an intermediate holding company is performing substantial investment-related services and activities it appears not to be held as part of an investment portfolio. When an intermediate holding company within an investment group structure is considered to be a media through which the parent carries on business it would be consolidated by the parent, but the parent would look through the intermediate holding company and account for the underlying investments in the subsidiaries of the intermediate holding company as indirectly held portfolio investments.

3.4.3 Limited partnerships

A limited partnership is made up of one or more 'general partners' and one or more 'limited partners'. Limited partnerships that are 'qualifying partnerships' are required to prepare statutory financial statements in accordance with the CA 2006. FRS 102 has no specific consolidation guidance for limited partnerships. Under the Limited Partnership Act 1907, a limited partner is prevented from taking an active role in the affairs of the entity. Therefore, when a company is the sole general partner of a limited partnership, the limited partnership might meet the definition of a subsidiary (see 3.2 above). However, the general partner's investment in a limited partnership is often only nominal in amount and the funding is often provided by the limited partners.

How we see it

In our view, determining whether the general partner consolidates a limited partnership requires judgement and consideration of the facts and circumstances. Guarantees given by the limited partnership which might, if called, fall due to the general partner might indicate that consolidation is appropriate if the general partner is subject to the majority of risks of the partnership. Conversely, if the general partner can be dismissed without cause by the limited partner, this might indicate that consolidation is not appropriate.

3.5 Consolidation procedures

FRS 102 describes the process of consolidation: [FRS 102.9.13]

Extract from Section 9

- 9.13** The consolidated financial statements present financial information about the group as a single reporting entity. In preparing consolidated financial statements, an entity shall:
- (a) combine the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses;
 - (b) eliminate the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary;
 - (c) measure and present non-controlling interest in the profit or loss of consolidated subsidiaries for the reporting period separately from the interest of the owners of the parent; and
 - (d) measure and present non-controlling interest in the net assets of consolidated subsidiaries separately from the parent shareholders' equity in them. Non-controlling interest in the net assets consists of:
 - (i) the amount of the non-controlling interest's share in the identifiable net assets (consisting of the identifiable assets, liabilities and contingent liabilities as recognised and measured in accordance with Section 19 *Business Combinations and Goodwill*, if any) at the date of the original combination; and
 - (ii) the non-controlling interest's share of changes in equity since the date of the combination or other acquisition.

The proportions of profit or loss and changes in equity allocated to owners of the parent and to the NCI are determined on the basis of existing ownership interests and do not reflect the possible exercise or conversion of options or convertible instruments. [FRS 102.9.14]. Therefore, although a parent might have control of an entity through the ability to exercise a currently exercisable option (see 3.2.1 above) the parent's and NCI's allocation of profit and loss and equity are not affected until the option is exercised. Illustration 3-6 demonstrates this principle.

Illustration 3-6: Potential voting rights

Entities A and B hold 40% and 60%, respectively, of the equity of Entity C. A also holds a currently exercisable option over one third of B's shareholding in C, which, if exercised, would give A a 60% interest in C. This would, absent exceptional circumstances, lead to the conclusion that C is a subsidiary of A. However, in preparing its consolidated financial statements, A attributes 60% of the results and net assets of C to NCI.

The following is discussed in more detail below:

- Intragroup balances and transactions - see 3.5.1
- Uniform reporting dates and reporting period - see 3.5.2
- Uniform accounting policies - see 3.5.3
- Consolidating foreign operations - see 3.5.4

Accounting for NCI is discussed further at 3.7 below.

3.5.1 Intragroup balances and transactions

Intragroup balances and transactions, including income, expenses and dividends, are eliminated in full. Profits and losses resulting from intragroup transactions that are recognised in assets, such as inventory and property, plant and equipment, are also eliminated in full. [FRS 102.9.15]. Illustration 3-7 below shows this.

Illustration 3-7: Eliminating intragroup transactions

Entity A holds a 75% interest in Entity B. A sold inventory with a cost of £100 to B for £200 (i.e., a profit of £100). B held the inventory at the reporting date.

As well as the intragroup sale between A and B, the unrealised profit of £100 is eliminated from the group's point of view in consolidation (the consolidation adjustment is DR turnover in A £200, CR inventory in B £100, CR cost of sales in A £100). The profit from the sale of inventory of £100 is reversed against the group profit or loss. As the parent made the sale, no amount of the eliminated profit is attributed to the NCI.

If the fact pattern were reversed such that B sold inventory to A, and A held the inventory at reporting date, the same consolidation journal entries above would be reversed in the consolidated financial statements. However, in this instance, as the subsidiary made the sale, £25 of the eliminated profit (i.e., the NCI's 25% share of the £100 profit) would be allocated to the NCI.

If the inventory held by B had been sold to a third party for £300 before the end of the reporting period (resulting in a profit in A of £100 for the sale to B at £200 and a profit in B of £100 for the sale to a third party at £300) no intragroup elimination of profit is required. The group has sold an asset with a cost of £100 for £300 creating a profit to the group of £200. In this case, the intra-group elimination is limited to the sale between A and B (Dr turnover in A £200, Cr cost of sales in B £200).

Even though losses on intragroup transactions are eliminated in full, they might still indicate an impairment under Section 27 *Impairment of Assets* that requires recognition in the consolidated financial statements. [FRS 102.9.15]. For example, if a parent sells a property to a subsidiary at fair value and this is lower than the carrying amount of the asset, the transfer might indicate that the property (or the cash-generating unit to which that property belongs) is impaired in the consolidated financial statements, unless the asset's value-in-use is sufficient to support the higher carrying value. See Chapter 29 at 4.1.

Intragroup transactions give rise to a tax expense or benefit in the consolidated financial statements under Section 29 *Income Tax* which applies to timing differences that arise from the elimination of profits and losses arising from intragroup transactions. [FRS 102.9.15]. See Chapter 31 at 6.1.

3.5.2 Uniform reporting dates and reporting period

The directors of a parent company have an obligation under the CA 2006 to secure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiary undertakings coincides with the company's own financial year. [s390(5)].

Similarly, FRS 102 requires that the financial statements of the parent and its subsidiaries are prepared at the same reporting date and for the same reporting period, unless it is impracticable to do so. [FRS 102.9.16]. Impracticability is discussed in Chapter 9 at 3.3.2.

When the reporting date and reporting period of a subsidiary are not the same as the parent's reporting date and reporting period, the consolidated financial statements must be made up from: [FRS 102.9.16]

- The financial statements of the subsidiary as of its last reporting date before the parent's reporting date, adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements, provided that the reporting date is no more than three months before that of the parent.

Or

- Interim financial statements prepared by the subsidiary as at the parent's reporting date.

This is consistent with the requirements of the Regulations. [6 Sch 2(2)].

3.5.3 Uniform accounting policies

Consolidated financial statements are prepared using uniform accounting policies for like transactions and other events and conditions in similar circumstances. Therefore, if a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financial statements. [FRS 102.9.17].

However, as an exception to this rule, using non-uniform accounting policies for insurance contracts (and related deferred acquisition costs and related intangible assets, if any) is permitted if this is a continuation of an accounting policy used under previous GAAP. [FRS 103.2.6(c)].

Other than for insurance contracts, non-uniform accounting policies are not permitted (unless the directors invoke a true and fair override) by FRS 102. The Regulations are more lenient and allow non-uniform accounting policies if it appears to the directors that there are special reasons for it and these reasons and their effect are disclosed, but an entity must comply with both FRS 102 and the Regulations. [6 Sch 3(2)].

3.5.4 Consolidating foreign operations

Section 9 does not address how to consolidate subsidiaries that are foreign operations. Section 30 *Foreign Currency Translation* states that when a group contains individual entities with different functional currencies, the items of income and expense and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented. [FRS 102.30.17].

How we see it

No guidance is given as to whether the financial statements of a foreign operation are translated directly into the presentation currency of the group (known as the direct method) or translated into the functional currency of any intermediate parent and then translated into the presentation currency of the group (known as the step-by-step method). In our view, either method is acceptable provided it is applied consistently.

Normal consolidation procedures are followed, such as the elimination of intragroup balances and intragroup transactions, when consolidating a foreign operation. However, an intragroup monetary asset, whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without reflecting the foreign exchange gain or loss in the consolidated financial statements in either profit or loss or OCI as appropriate. [FRS 102.30.22].

3.6 Acquisitions and disposals of subsidiaries

In consolidated financial statements, the income and expenses of a subsidiary are included from the acquisition date until the date on which the parent ceases to control the subsidiary (except when a business combination is accounted for using the merger accounting method (see Chapter 22 at 5.3) and certain public benefit entity combinations accounted for under Section 34 *Specialised Activities*. [FRS 102.9.18].

A parent might cease to control a subsidiary with or without a change in absolute or relative ownership levels, for example, when a subsidiary becomes subject to the control of a government, court, administrator or regulator. [FRS 102.9.18]. Deemed disposals that could result in loss of control also arise for other reasons, including when:

- A group does not take up its full allocation in a rights issue by a subsidiary in the group.

- A subsidiary declares scrip dividends that are not taken up by its parent, so that the parent's proportional interest is diminished.
 - Another party exercises its options or warrants issued by a subsidiary.
 - A subsidiary issues shares to a third party.
- And
- A contractual arrangement by which a group obtained control over a subsidiary is terminated or changed.

Illustration 3-11 at 3.6.3.A below shows an example of a deemed disposal.

The Basis for conclusions states that FRS 102's requirements for acquisitions and disposals of subsidiaries in consolidated financial statements are based on the 2004 version of IFRS 3. These are considered to provide a coherent model for increases and decreases in stakes held in another entity that is consistent with UK company law. [FRS 102.BC.B9.11].

3.6.1 Accounting for an acquisition where control is achieved in stages

When a parent acquires control of a subsidiary in stages, the requirements of paragraphs 11A and 14 of section 9 are applied at the date control is achieved. [FRS 102.9.19B]. Therefore, when control is achieved in stages, the cost of the business combination is the aggregate of the fair values of the assets given, liabilities assumed and equity instruments issued by the acquirer at the date of each transaction in the series. [FRS 102.19.11A]. See Chapter 22 at 3.11.

3.6.2 Accounting for an increase in a controlling interest in a subsidiary

When a parent increases its controlling interest in a subsidiary, the identifiable assets and liabilities and a provision for contingent liabilities of the subsidiary are not revalued to fair value and no additional goodwill is recognised at the date the controlling interest is increased. [FRS 102.9.19C].

The increase is accounted for as a transaction between equity holders and the NCI is adjusted to reflect the change in the parent's interest in the subsidiary's net assets and any difference between that amount and the fair value of the consideration paid is recognised directly in equity and attributed to equity holders of the parent. No gain or loss is recognised on these changes in equity, nor any change in the carrying amounts of assets (including goodwill) or liabilities. [FRS 102.9.19D, FRS 102.9.20A]. Illustration 3-8 shows the accounting for increasing a controlling interest in a subsidiary.

Illustration 3-8: Increase in controlling interest in subsidiary

A parent with a 70% controlling interest in a subsidiary purchases an additional 20% interest in that subsidiary for cash proceeds of £250. Following the purchase, the parent has a 90% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets excluding goodwill is £450 and there is £50 of goodwill remaining from the subsidiary's acquisition.

The parent accounts for the acquisition of the additional 20% interest as follows:

	Dr	Cr
Cash		£250
NCI (20% of £450)	£90	
Equity	£160	

The guidance on reattribution of items of OCI and accounting for transaction costs discussed at 3.6.4 below applies here also.

3.6.3 Accounting for a disposal of a subsidiary when control is lost

When a parent ceases to control a subsidiary, a gain or loss is recognised in profit or loss calculated as the difference between: [FRS 102.9.18A]

- The proceeds from the disposal (or the event that resulted in the loss of control).
- And
- The proportion of the carrying amount of the subsidiary's net assets, including any related goodwill, disposed of (or lost) as at the date of disposal (or date control is lost).

The gain or loss includes amounts that have been recognised in OCI in relation to that subsidiary, where those amounts are required to be reclassified to profit or loss upon disposal in accordance with other sections of FRS 102. This is commonly referred to as recycling. Amounts that are not required to be reclassified to profit or loss upon disposal of the related assets or liabilities are transferred directly to retained earnings. [FRS 102.9.18B].

The cumulative amount of any exchange differences that relate to a foreign subsidiary recognised in equity in accordance with Section 30 is not recognised in profit or loss as part of the gain or loss on disposal of the subsidiary and is transferred directly to retained earnings. [FRS 102.9.18A].

FRS 102 permits only the following unrealised gains and losses recognised in OCI to be recycled through profit or loss upon disposal of a subsidiary:

- Unrealised gains and losses on available-for-sale (AFS) investments (if the entity has elected to use IAS 39 *Financial Instruments: Recognition and Measurement* for recognition and measurement of financial instruments). [FRS 102.11.2(b), FRS 102.12.2(b)].
- Unrealised gains and losses on debt instruments at fair value through OCI (if the entity has elected to use IFRS 9 for recognition and measurement of financial instruments). [FRS 102.11.2(c), FRS 102.12.2(c)].
- Unrealised gains and losses on cash flow hedges (except for the portion attributable to a hedge of a net investment in a foreign operation). [FRS 102.12.23, FRS 102.12.24].

And

- Unrealised gains and losses arising from the application of shadow accounting for insurance contracts. [FRS 103.2.11].

No other unrealised gains and losses that have been recognised in OCI are recycled upon disposal of a subsidiary.

How we see it

FRS 102 does not specify the amount to be recycled when there is a disposal of the NCI in a subsidiary. One approach is to recycle only the parent's interest in the relevant amount recognised in OCI. An alternative is to recycle the full amount recognised in OCI, including the NCI's interest.

Illustration 3-9 shows the two approaches:

Illustration 3-9: Recycling OCI when there is an NCI in the subsidiary disposed of

A parent sells its entire 90% interest in a subsidiary to a third party for a cash consideration of £31,000.

At the date of disposal, the net assets of the subsidiary were £30,000. Included within those net assets, the subsidiary had recognised, in its own financial statements, derivative financial assets of £3,200 (designated in a cash flow hedge) that have resulted in a cash flow hedge reserve of £3,000.

In the parent's consolidated financial statements, the parent has recognised 90% of this reserve in an equivalent equity reserve balance, with the 10% attributable to the NCI included as part of the carrying amount of the NCI.

The impact of the subsidiary on the statement of financial position included in the parent's consolidated financial statements immediately prior to the disposal is as follows:

	Dr	Cr
Net assets	£30,000	
Equity attributable to the parent:		
Cash flow hedge reserve		£2,700
Other equity		£24,300
NCI		£3,000

Recycling the parent's interest only in the cash flow hedge reserve, the impact of the disposal on the parent's consolidated accounts is as follows:

	Dr	Cr
Cash proceeds	£31,000	
Derecognition of NCI	£3,000	
Derecognition of net assets of subsidiary		£30,000
Reserves reclassified to profit or loss:		
Cash flow hedge reserve	£2,700	
Gain on disposal attributable to parent		£6,700

Using the alternative approach, the entire cash flow hedge reserve including NCI component (total £3,000) is recycled, with the £300 NCI portion allocated to NCI profit (not profit or loss attributable to the parent). Other entries remain as shown above.

3.6.3.A Loss of control with a retained interest

If an entity ceases to be a subsidiary but the former parent continues to hold:

- An investment that is not an associate or a jointly controlled entity, that investment is accounted for as a financial asset in accordance with Section 11 or Section 12 (see Chapter 13) from the date the entity ceases to be a subsidiary.
- An associate, it is accounted for in accordance with Section 14 (see Chapter 17).

Or

- A jointly controlled entity, it is accounted for in accordance with Section 15 (see Chapter 18).

The carrying amount of the net assets (and goodwill) attributable to the subsidiary at the date that control is lost is regarded as cost on initial measurement of the financial asset, investment in associate or jointly controlled entity, as appropriate. In applying the equity method to investments in associate or jointly controlled entities as required above, the requirements to recognise implicit goodwill and fair value adjustments (see Chapter 17 at 3.3.1.A) are not applied. [FRS 102.9.19].

When the retained interest is a financial asset measured at fair value through profit or loss, an immediate gain or loss might arise as a result of remeasurement to fair value, as shown in Illustration 3-10 below:

Illustration 3-10: Disposal of a subsidiary

A parent sells an 85% interest in a wholly owned subsidiary as follows:

- After the sale the parent accounts for its remaining 15% interest at fair value as an other financial instrument under Section 12
- The subsidiary did not recognise any amounts in OCI
- Net assets of the subsidiary before the disposal including goodwill are £500
- Cash proceeds from the sale of the 85% interest are £750

The parent accounts for the disposal of the 85% interest as follows:

	Dr	Cr
Other financial instrument (15% of the net assets before disposal of £500)	£75	
Cash	£750	
Net assets of the subsidiary derecognised (summarised)		£500
Gain on loss of control of subsidiary		£325

The gain recognised on the loss of control of the subsidiary is calculated as follows:

Cash proceeds on disposal of 85% interest	£750
Carrying amount of 85% interest (85% × £500)	(£425)
	<u>£325</u>

In this example, the cost on initial measurement of the financial instrument is not its fair value. Therefore, when that financial instrument is subsequently measured at fair value, there will be a 'Day 2' gain or loss as the cost of the investment is adjusted to fair value.

A deemed disposal that results in loss of control of a subsidiary is accounted for as a regular disposal. This is shown in Illustration 3-11 below.

Illustration 3-11: Deemed disposal through share issue by subsidiary

A parent entity P owns 600,000 of the 1,000,000 shares issued by its subsidiary S, giving it a 60% interest. The carrying value of S's net identifiable assets in the consolidated financial statements of P is £120 million. The NCI is £48 million (40% of £120 million). In addition, goodwill with a carrying value of £15 million remains from the acquisition.

Subsequently, S issues 500,000 shares to a new investor for £80 million. As a result, P's 600,000 shares now represent 40% of the 1,500,000 shares issued by S in total and S becomes an associate of P.

This results in a gain of £3 million on disposal, calculated as follows:

	Dr	Cr
Interest in S ⁽¹⁾	£90m	
NCI	£48m	
Gain on disposal		£3m
Net assets of S (previously consolidated)		£120m
Goodwill (previously shown separately)		£15m

(1) 40% of increased net assets of £200 million plus 40/60 of goodwill of £15 million

As this is a deemed disposal resulting from the share issue of a subsidiary, P considers whether the profit resulting is realised or unrealised. If unrealised, the profit would be taken to OCI and not to profit or loss.

3.6.4 Accounting for a part disposal of a subsidiary when control is retained

Where a parent reduces its holding in a subsidiary and control is retained, it is accounted for as a transaction between equity holders and the carrying amount of the NCI is adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between that amount and the fair value of the consideration paid or received, if any, is recognised directly in equity and attributed to equity holders of the parent. No gain or loss is recognised at the date of disposal, nor any change in the carrying amounts of assets (including goodwill) or liabilities. [FRS 102.9.19A, FRS 102.9.20A].

FRS 102 is not clear whether a portion of goodwill should be regarded as now being attributable to the NCI in computing the difference to be taken to equity in these circumstances.

How we see it

In our view, the most logical treatment is for the parent to reallocate a proportion of the goodwill between parent equity and NCI when there is a decrease in the parent's ownership interest without loss of control. Otherwise, any gain or loss recognised upon a subsequent loss of control or goodwill impairment would not reflect the ownership interest applicable to that NCI.

Illustration 3-12 below demonstrates the accounting for a disposal where control is retained.

Illustration 3-12: Disposal of a subsidiary where control is retained

A parent sells a 20% interest in a wholly owned subsidiary for cash proceeds of £250. Parent retains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets excluding goodwill is £450 and there is £50 of goodwill remaining from the subsidiary's acquisition.

In the consolidated financial statements, the parent accounts for this transaction as follows, reallocating goodwill to the NCI:

	Dr	Cr
Cash	£250	
NCI ⁽¹⁾		£100
Equity		£150

(1) 20% of £500, i.e., including goodwill

FRS 102 is silent as to whether amounts recognised in OCI and equity should be reattributed to or from NCI when a change in ownership in a subsidiary occurs that does not result in the loss of control.

How we see it

In our view, it is logical to reattribute amounts recognised in OCI and equity. This is consistent with the requirement in Section 30 for a foreign operation that is consolidated but not wholly-owned, that the accumulated exchange differences arising from translation that are attributable to the NCI are allocated to, and recognised as part of, NCI.

Although FRS 102 is clear that changes in a parent's ownership interest in a subsidiary that do not result in loss of control of the subsidiary are equity transactions, it does not specifically address how to account for related transaction costs.

How we see it

In our view, any directly attributable costs incurred to sell NCI in a subsidiary (in a transaction without loss of control) are deducted from equity. Whether the costs are attributable to the parent or to the NCI depends on whether the costs have been incurred by the parent (in which case the costs are attributable to parent equity) or the subsidiary with the NCI (in which case the cost would be allocated between parent equity and NCI based on their respective shares).

3.7 NCI in subsidiaries

NCI is the equity in a subsidiary not attributable, directly or indirectly, to a parent. [FRS 102 Appendix I]. The reference to 'equity' in the definition of NCI refers to those 'equity instruments' of a subsidiary that are not held, directly or indirectly, by its parent. This also means that financial instruments that are legally equity but classified as a liability in accordance with Section 22 *Liabilities and Equity* are not included within the definition of NCI.

The principle underlying accounting for NCI is that all residual economic interest holders of any part of the consolidated entity have an equity interest in that consolidated entity. This principle applies regardless of the decision-making ability of that interest holder and where in the group that interest is held. Therefore, any equity instruments issued by a subsidiary that are not owned by the parent (apart from those that are required to be classified as financial liabilities) are NCI, including:

- Ordinary shares
- Convertible debt and other compound financial instruments
- Preference shares (including both those with, and without, an entitlement to a *pro rata* share of net assets on liquidation)
- Warrants
- Options over own shares
- And
- Options under share-based payment transactions

Options and warrants are NCI, regardless of whether they are vested and of the exercise price (e.g., whether they are 'in-the-money').

The definition of NCI in FRS 102 is wider than the definition in the Regulations which states that NCI in the statement of financial position must show the amount of capital and reserves attributable to shares in subsidiary undertakings (i.e., the definition in the CA 2006 is restricted to shares). [6 Sch 17(2)]. When differences arise between the definitions used in FRS 102 and the Regulations, it might be necessary to disclose both FRS 102 and CA 2006 amounts for NCI. See Chapter 6 at 3.5.

3.7.1 Accounting and presentation of NCI

NCI in the net assets of a subsidiary is initially measured at the NCI's share of the identifiable net assets (consisting of the identifiable assets, liabilities and contingent liabilities as recognised and measured in accordance with the requirements for a business combination, if any, see Chapter 22 at 3.8 and Illustration 3-17) at the date of the original combination. [FRS 102.9.13(d), FRS 102.19.14A]. There is no option under FRS 102 to measure NCI at fair value.

FRS 102 does not distinguish between NCI that is a present ownership interest and entitles holders of that interest to a proportionate share of the entity's net assets in the event of liquidation and other components of NCI (e.g., perpetual debt classified as equity under Section 22). The implication is that all NCI is measured the same way based on present ownership interest. This means that any NCI, such as options, are valued at nil if they are not entitled to a present ownership interest. See Chapter 22 at 3.8.

NCI is presented within equity, separately from equity of the owners of the parent, in the consolidated financial statement of financial position. [FRS 102.9.20].

NCI in the profit or loss of the group is required to be disclosed separately in the statement of comprehensive income (or income statement, if presented). [FRS 102.9.21].

Profit or loss and each component of OCI is attributed to the owners of the parent and to NCI. Total comprehensive income is attributed to the owners of the parent and to NCI even if this results in NCI having a deficit balance. [FRS 102.9.22]. This approach is consistent with the fact that the parent and NCI participate proportionately in the risks and rewards of an investment in the subsidiary. When the NCI in a subsidiary is in deficit, there is no requirement to make a provision in the group financial statements for any legal or commercial obligation (whether formal or implied) to provide for finance that may not be recoverable in respect of the accumulated losses attributable to the NCI.

A proportion of profit or loss, OCI and changes in equity is only attributed to those ownership instruments included within NCI if they give rise to an existing (or present) ownership interest. NCI that includes potential voting rights that require exercise or conversion (such as options, warrants, or share-based payment transactions) generally does not receive an allocation of profit or loss (see 3.2.1 above). [FRS 102.9.14, FRS 102.9.22].

Where a subsidiary has granted options over its own shares under an equity-settled share-based payment transaction, the share-based payment expense recognised in profit or loss will be attributable to the parent and any other NCI that has a present legal ownership in the subsidiary.

FRS 102 is silent on the accounting for shares of profit or loss on undeclared dividends in respect of outstanding cumulative preference shares classified as equity that are held by an NCI.

How we see it

In our view, an entity has an accounting policy choice in respect of dividends on outstanding cumulative preference shares classified as equity, to allocate to the NCI a portion of the profit or loss after adjusting for:

- Dividends, whether or not declared
- Or
- Declared dividends only

The first option is the one required by IFRS 10.

3.7.1.A Measurement of NCI when an associate holds an interest in a subsidiary

FRS 102 does not explain how to account for NCI when the group owns an associate which has a holding in a subsidiary. It is therefore unclear whether NCI is computed based on the ownership interests held by the group (i.e., by the parent and any consolidated subsidiary), or whether it also reflects the indirect ownership of the subsidiary held by the associate. The reciprocal interests can also give rise to a measure of double-counting of profits and net assets between the investor and its associate.

How we see it

In our view, there are two possible approaches to determine the amount of NCI in the subsidiary:

- (a) The NCI is determined after considering the associate's ownership of the subsidiary ('look through approach').
- Or
- (b) The NCI is determined based on the holdings of the group in the subsidiary ('black box approach').

An entity applies the chosen approach consistently.

In applying the 'look through approach', the parent does not recognise the share of the subsidiary's results recognised by the associate applying the equity method, in order to avoid double-counting. The 'black box approach' often leads to reporting higher consolidated net assets and results than when using the 'look through approach' because this adjustment is not made, although the amounts attributed to owners of the parent must be the same under both approaches. The two approaches are shown in Illustration 3-13 below.

Illustration 3-13: Measurement of NCI when an associate accounted using the equity method holds an interest in a subsidiary

Parent P owns directly 60% of subsidiary S. P also directly owns 40% of associate A that in turn holds a 30% interest in S. S has earned profits of £1,000,000 in the period and has net assets of £3,000,000 (which are consolidated in both P's consolidated financial statements and equity accounted by A) at the reporting date. A has net assets of £1,100,000 (excluding its share of the net assets of S). There are no transactions between A and S (which was not acquired in a business combination).

Approach 1 ('look through approach')

This approach involves determining the ownership attributable to the NCI after considering A's ownership of S. This approach views the equity method as primarily a method of consolidation (albeit on a single line).

Therefore, under the 'look through' approach, P's total ownership interest in S is 72% (and the NCI's interest is 28%). P's effective ownership interest of 72% in S represents 60% held directly and an additional effective interest of 12% ($40\% \times 30\%$) via A.

Therefore, P consolidates the profits of S of £1,000,000, with:

Profits of S attributable to owners of P	£720,000 ($£1,000,000 \times 72\%$)

Profits of S attributable to the NCI	£280,000 ($£1,000,000 \times 28\%$)

However, when equity accounting for A, P does not recognise its share of S's results recognised by the associate A of £120,000 ($£1,000,000 \times (40\% \times 30\%)$). This is to avoid double counting as S's results have already been consolidated and P's effective ownership of 12% of S that is indirectly held via A has been attributed to owners of the parent.

The assets and liabilities of S are consolidated, with:

Net assets of S attributable to owners of P	£2,160,000 ($72\% \times £3,000,000$)

Net assets of S attributable to the NCI	£840,000 ($28\% \times £3,000,000$)

Investment in A ⁽¹⁾	£440,000

(1) When equity accounting for A, P does not recognise its share of S's net assets recognised by A of £360,000 ($£3,000,000 \times (40\% \times 30\%)$) to avoid double-counting as the net assets of S owned by A have already been included in the amounts attributable to the owners of P. Therefore, the investment in A is reported at P's 40% share of A's net assets (excluding A's share of S), i.e., $40\% \times £1,100,000$.

Approach 2 ('black box approach')

Under this approach (the 'black box approach'), when determining NCI, P considers the ownership interests in S not held by the group (i.e., by P and its subsidiaries). This approach views the equity method as primarily a method of valuing an investment.

Accordingly, P's ownership interest is 60% and the NCI's ownership interest is 40%.

Therefore, P consolidates the profits of S of £1,000,000, with:

Profits of S attributable to owners of P	£600,000 ($60\% \times £1,000,000$)

Profits of S attributable to the NCI	£400,000 ($40\% \times £1,000,000$)

The assets and liabilities of S are consolidated, with:

Net assets of S attributable to owners of P	£1,800,000 ($60\% \times £3,000,000$)

Net assets of S attributable to the NCI	£1,200,000 ($40\% \times £3,000,000$)

Investment in A ⁽²⁾	£800,000

- (2) When equity accounting for A, P does not eliminate its share of S's results of £120,000 and net assets of £360,000. Therefore, the investment in A is reported at P's 40% share of A's net assets (including the associate's share of S), i.e., $40\% \times (£1,100,000 + (30\% \times £3,000,000))$.

The results and net assets in respect of S that are attributed to owners of P are the same as in Approach 1. However, the total consolidated results and net assets exceed those reported in Approach 1 by £120,000 and £360,000 respectively (being P's effective ownership interest of 12% in S's profits and net assets that are equity accounted in Approach 2). While this approach has the merit that the attribution of S's profits and net assets to NCI reflects the 40% ownership interests in S not held by the group, a downside is the double counting of 12% of S's profits that are equity accounted by A.

3.7.2 Call and put options over NCI

Some business combinations involve options over some or all of the outstanding shares. For example, the acquirer might have a call option, i.e., the right to acquire the outstanding shares at a future date for a particular price. Alternatively, the acquirer might have granted a put option to other shareholders whereby they have the right to sell their shares to the acquirer at a future date for a particular price. In some cases, there may be a combination of put and call options, the terms of which may be equivalent or different.

FRS 102 gives no guidance on how to account for such options when entered into as part of, or following, a business combination. Therefore, when determining the appropriate accounting in such situations, Sections 9, 11, 12 and 22 must be considered.

How we see it

Sometimes, the operation of put and/or call options over NCI are subject to employment conditions. Typically, such put and/or call options over NCI arise as part of a business combination. The guidance in 3.7.2.A to 3.7.2.C below is intended to apply to put and/or call options over NCI held in the holder's capacity as a shareholder.

Accounting for put and/or call options over NCI subject to employment conditions (holders of such instruments are referred to below as 'employee-shareholders') involves a careful analysis of how the requirements of FRS 102 apply to the specific transaction. Such arrangements could, in whole or in part, constitute an employee benefit (accounted under Section 28, see Chapter 30) or share-based payment arrangement (accounted under Section 26 *Share-based Payment*, see Chapter 28). In addition, Section 19 contains guidance on distinguishing payments to acquire a business from remuneration, see Chapter 22 at 2.5.3.

Judgement is often required in determining whether and to what extent there is a remuneration element to be accounted for and whether the company or the NCI have a present ownership interest in the shares that are legally owned by the NCI.

Examples of situations which might indicate a remuneration element include where:

- There is a discount on the NCI put exercise price if the employee-shareholder leaves before completing a specified period of service.
- The entity can exercise a call at a lower exercise price than the exercise price on the NCI put if the employee-shareholder leaves.

In certain arrangements, an employee-shareholder is entitled to a minimum amount even if no service was provided and it might be appropriate to account for part of the arrangement in line with the guidance for NCI puts and calls (in sections 3.7.2.A to 3.7.2.C below), and part as an employee benefit or share-based payment arrangement. See Chapter 30 at 3.1, and Chapter 28 at 11.3 for a discussion of when cash-settled awards may fall within the scope of Section 28 or Section 26.

Even if the NCI put held by employee-shareholders has an exercise price equal to fair value of the shares at the date of exercise, this does not necessarily mean that the NCI has a present ownership interest in the shares legally owned at the date of the business combination. For example, it might be the case that the NCI are able to benefit from dividends and/or fair value gains accreting to the shares only after completion of a period of service. In such cases, it might be considered that the shares have not economically vested in the NCI at the date of the business combination. This assessment will be very dependent on the particular facts and circumstances.

3.7.2.A Call options only

Call options are considered when determining whether an entity has obtained control as discussed at 3.2.1 above. This discussion, and at 3.7.2.B below, focuses on call and put options entered into at the same time as control of the subsidiary is obtained.

Once it is determined whether an entity has control over another entity, the proportions of profit or loss and change in equity allocated to the parent and NCI are based on the existing (or present) ownership interests and do not reflect the possible exercise or conversion of potential voting rights under call options. [FRS 102.9.14].

A call option is likely to give the acquiring entity present access to returns associated with the ownership interest only in limited circumstances:

- The option price is fixed with an exercise price sufficiently low in relation to the fair value of the underlying shares (that substantially all expected variations in the fair value of the underlying shares will be realised by the acquirer) and either (i) it is agreed between the parties that no dividends will be paid to the other shareholders (or the acquiring entity can control that no dividends will be paid prior to the exercise of the option) or (ii) the dividend payments lead to an adjustment of the option exercise price.

Or

- The terms are set such that the other shareholders effectively receive only a lender's return.

The acquiring entity has present access to the returns associated with ownership interest in these circumstances because any accretion in the fair value of the underlying ownership interest under the option (for example, due to improved financial performance of the acquiree subsequent to the granting of the call option) is likely to be realised by the acquirer.

How we see it

If a call option gives the acquiring entity present access to returns over all of the shares held by non-controlling shareholders, then there will be no NCI presented in equity. The acquirer accounts for the business combination as though it acquired a 100% interest. The acquirer also recognises a financial liability for the present value of the exercise price to the non-controlling shareholders under the call option.

Changes in the carrying amount of the financial liability are recognised in profit or loss. If the call option expires unexercised, then the acquirer has effectively disposed of a partial interest in its subsidiary in return for the amount recognised as the liability at the date of expiry. If the entity continues to control the subsidiary, it accounts for the transaction as a change in ownership interest without a loss of control, as discussed at 3.6.4 above. If the lapse of the call option leads to a loss of control, this is accounted for as discussed at 3.6.3, above.

A call option is not expected to give the acquirer present access to the returns associated with that ownership interest in the shares subject to the call where, for example, the option's terms contain one or more of the following features:

- The option exercise price has not yet been determined or will be the fair value (or an amount that approximates fair value) of the underlying shares at the date of exercise.
- The option exercise price is not sufficiently low in relation to the fair value of the underlying shares (that substantially all expected variations in the fair value of the underlying shares will be realised by the acquirer).
- The option exercise price is based on expected future results or net assets of the subsidiary at the date of exercise.
- It has been agreed between the parties that, prior to the exercise of the option, all retained profits are to be freely distributed to the existing shareholders according to their current shareholdings (and there is no adjustment to the option exercise price for dividends paid).

If a call option does not give the acquirer present access to the returns associated with the ownership interest in the shares subject to the call, the instruments containing the potential voting rights are accounted for as a derivative financial asset by the holder in accordance with Sections 11 and 12 unless the derivative meets the definition of an equity instrument of the entity in Section 22.

Where settlement is not exclusively by an exchange of a fixed number of shares for a fixed amount of cash (or another financial asset), the purchased call option does not meet the definition of an equity instrument in Section 22 and is treated as a derivative financial asset. [FRS 102.22.3, FRS 102.22.3(b)(ii)]. Therefore, the option is a financial asset, unless both the fixed-for-fixed criterion is met and the option is gross-settled in the subsidiary's equity instruments.

Financial asset - A purchased call option is initially recognised as a financial asset at its fair value, with any subsequent changes in its fair value recognised in profit or loss. If the call option is exercised, the fair value of the option at that date is included as part of the consideration paid for the acquisition of the NCI (see 3.6.2 above). If it lapses unexercised, any carrying amount is expensed in profit or loss.

Equity instrument - A call option over the NCI's shares will be gross settled, so the initial fair value of the option is recognised as a debit to equity (and is not subsequently remeasured). If the call option is exercised, this initial fair value is included as part of the consideration paid for the acquisition of the NCI (see 3.6.2 above). If a call option lapses unexercised, there is no entry required within equity.

The above discussion addresses the initial debit entry on recognising the call option at fair value (as a financial asset, or within equity). However, the related initial credit entry will depend on the transactions giving rise to the call option. For example, the entity may have paid consideration for the option in a separate transaction or as part of a larger transaction (such as where a business combination involves an outright purchase of shares as well as the acquisition of a call option over the remaining shares). In the latter case, part of the consideration paid in the larger transaction needs to be allocated to the acquisition of the call option. [FRS 102.19.11, FRS 102.19.11B].

3.7.2.B Put options only

In the context of the consolidated financial statements, a put option held by the NCI is a form of puttable instrument because it gives the holder the right to sell the shares in the subsidiary (presented as equity of the group) back to the group. A put option is usually recognised as a liability and the following matters must also be determined:

- The measurement of the liability under the NCI put.
 - Whether or not the terms of the NCI put give the parent a present ownership interest in the shares subject to the put.
- And
- Whether or not NCI continues to be recognised if the liability is measured based on its redemption amount, i.e., whether the parent recognises both the NCI and the financial liability for the NCI put.

Section 22 offers no guidance as to how the put option liability is measured. Section 22 does not contain the requirement in IAS 32 *Financial Instruments: Presentation* that an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, the present value of the forward purchase price, option price or other redemption amount). [IAS 32.23]. However, a put option is a derivative and Section 12 sets out the accounting for derivatives (see Chapter 12 at 2.1.1). Derivatives are measured at fair value and so will generally result in a smaller liability for the put option compared to measurement at the present value of the redemption amount.

How we see it

In our view, the financial liability for the put option is a derivative that is measured at fair value according to Sections 11 and 12, except when the substance of the transaction is a purchase of NCI with deferred consideration. An example of this is described below. [FRS 102.2.14]

In the same way as for call options, in determining appropriate accounting, we believe that an entity considers whether the terms of the transaction give it present access to the returns associated with the shares subject to the put option.

Factors to consider in determining whether the NCI put might provide a present ownership interest to the acquirer include:

- **Pricing** - to the extent that the price is fixed or determinable, rather than being at fair value (or an amount that approximates fair value) of the underlying share, so that substantially all the variations in fair value of the underlying share accrete to the acquirer. However, in situations where there is only an NCI put, the level of the exercise price needs to be sufficiently high compared to the fair value of the underlying shares to exceed likely fair value variations in order to provide a present ownership interest. If the exercise price is low compared to fair value of the underlying shares, it is unlikely that the NCI will exercise the put. Even if the exercise price exceeds fair value of the underlying shares at the outset, reasonably possible upward fair value movements might mean that the NCI put does not provide a present ownership interest to the acquirer.
- **Voting rights and decision-making** - to the extent that the voting rights or decision-making connected to the shares concerned are restricted.

- *Dividend rights* - to the extent that the dividend rights attached to the shares concerned are restricted. It is likely that the NCI retains a present ownership interest where it has been agreed between the parties that, prior to the exercise of the option, all retained profits are to be freely distributed to the existing shareholders according to their current shareholdings (and there is no adjustment to the option exercise price for dividends paid). However, in many cases, dividend rights do not affect the assessment as the parent (through its control) can generally prevent distributions to the NCI prior to exercise or the exercise price of the NCI put is adjusted downwards for payment of any dividends to the NCI.
- *Issue of call options* - a combination of NCI puts and calls, with the same period of exercise and same or similar pricing indicates that the arrangement has the nature of a forward contract. Therefore, the instrument is highly likely to be exercised by one of the counterparties in situations where the exercise price is not at fair value (or an amount that approximates fair value) of the underlying shares.

The parent generally obtains a present ownership interest if there is an NCI put and call with matching terms and a fixed exercise price (or a fixed price forward contract to purchase the entity's shares held by the NCI). Where the pricing of the NCI put and call is at fair value (or an amount that approximates fair value), the present ownership generally remains with the NCI. Other situations, including where the exercise price is based on a formula, are likely to require further analysis, based on the factors outlined above.

How we see it

If the acquirer has a present ownership interest in the shares subject to the put, the substance of the transaction is an acquisition of NCI with deferred consideration. Thus, if the acquirer has granted a put option over all of the remaining shares as part of a business combination, the business combination is accounted for as if the acquirer has obtained a 100% interest in the acquiree. [FRS 102.2.14]

In our view, in this scenario, the acquirer:

- Reflects the acquisition of those underlying shares and does not recognise NCI when completing the purchase price allocation and determining goodwill.
- And
- Recognises a liability for the present value of the amount required to be paid under the put option to obtain the interest (i.e., the redemption amount), rather than measuring it as a derivative.

Changes in the carrying amount of the financial liability are recognised in profit or loss. If the put option is exercised, the financial liability is extinguished by the payment of the exercise price. If the put option is not exercised, then the entity has effectively disposed of a partial interest in its subsidiary, without loss of control, in return for the amount recognised as the financial liability at the date of expiry. The entity accounts for the transaction as discussed at 3.6.4 above and measures the NCI as of the date that the put option expires.

When the terms of the transaction do not provide a present ownership interest in the shares subject to the put option, the entity initially recognises both the NCI based on present ownership interest and the financial liability under the put at fair value as a derivative. If the put option is exercisable at fair value, then the fair value of the derivative liability is zero. All subsequent changes in the liability are recognised in profit or loss.

3.7.2.C Combination of put and call options

In some business combinations, there might be a combination of call and put options, the terms of which might be equivalent or might be different.

How we see it

The appropriate accounting for a combination of call and put options over NCI is determined based on the discussions in 3.7.2.A and 3.7.2.B above. However, where there is a call and put option with matching terms, particularly at a fixed price, the combination of the options is more likely to mean that they give the acquirer a present ownership interest. Where the exercise price is at fair value (or an amount that approximates fair value), however, the returns of ownership arising from fair value movements will accrete to the NCI and consequently, this situation is unlikely to give the acquirer a present ownership interest.

In cases where the combination of call and put options gives the acquirer a present ownership interest and when the options are over all of the shares not held by the parent, the acquirer has effectively acquired a 100% interest in the subsidiary at the date of the business combination. The entity is likely to be economically in a similar position as if it had acquired a 100% interest in the subsidiary with either deferred consideration (where the exercise price is fixed) or contingent consideration (where the settlement amount is not fixed but is dependent upon a future event).

3.7.2.D Call and put options entered into in relation to existing NCI

The discussion at 3.7.2.A to 3.7.2.C above focused on call and put options entered into at the same time as control is gained of the subsidiary. However, an entity might enter into the options with non-controlling shareholders after gaining control.

How we see it

The appropriate accounting policy for call and put options over existing NCI is based on the discussions at 3.7.2.A to 3.7.2.C above.

Where the entity already has a controlling interest and the option(s) result in a present ownership interest in the remaining shares concerned, the NCI is no longer recognised within equity. The transaction is accounted for as an acquisition of the NCI, i.e., it is accounted for as an equity transaction (see 3.6.2 above), because such acquisitions are not business combinations under Section 19.

3.8 Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, jointly controlled entity or associate

A reporting entity might exchange a business, or other non-monetary assets, for an interest in another entity and that other entity becomes a subsidiary, jointly controlled entity or associate of the reporting entity. The reporting entity needs to determine whether to use fair value or previous book values to account for the interest acquired and how any gain on the transaction is reported.

The following accounting treatment applies in the consolidated financial statements of the reporting entity. For ease, this guidance refers to an exchange of a business, but applies equally to an exchange of non-monetary assets: [FRS 102.9.31]

- No remeasurement to fair value of any retained interest: to the extent that the reporting entity retains an ownership interest in the business exchanged (even if held through the other entity), that retained interest, including any related goodwill, is included at its pre-transaction carrying amount. I.e., it is treated as having been owned by the reporting entity throughout the transaction.
- Goodwill arises on the reporting entity's new ownership interest: goodwill is recognised as the difference between:
 - The fair value of the consideration given
 - And
 - The fair value of the reporting entity's share of the pre-transaction identifiable net assets of the other entity
- Consideration given might be best estimated via the value of what is acquired: the consideration given for the interest acquired in the other entity includes that part of the business exchanged and no longer owned by the reporting entity. The consideration might also include cash or monetary assets to achieve equalisation of values. If it is difficult to value the consideration given, the best estimate of its value might be the value of what is acquired.
- Any unrealised gain arising on the exchange is recognised in OCI: to the extent that the fair value of the consideration received exceeds what is given up, being:
 - The carrying value of the part of the business exchanged and no longer owned
 - Any related goodwill
 - And
 - Cash

The reporting entity recognises an unrealised gain in OCI because qualifying consideration has not been received.

- Losses are recognised in profit or loss: to the extent that the fair value of the consideration received is less than what is given up (as described above), the reporting entity recognises a loss. Any impairment loss is recognised first in accordance with Section 27 and any further loss in profit or loss.

The accounting treatment is shown in Illustration 3-14 and Illustration 3-15 below:

Illustration 3-14: Creation of subsidiary by contribution of existing business (1)

A and B are two pharmaceutical companies, which agree to form a new company (Newco) to hold a particular part of each of their businesses. B will own 60% of Newco, which is a controlling interest. A will own 40%. The parties agree that the total value of the new business is £250m.

B's contribution to Newco is one of its businesses, the net assets of which are included in B's consolidated balance sheet at £85m (including remaining unamortised goodwill of £15m). The fair value of the identifiable net assets of the business contributed by B is £120m, which consists of £140m of gross assets less a £20m bank loan. The implicit fair value of the business contributed is £150m (60% of total fair value £250m).

The identifiable net assets of the business to be contributed by A have a carrying amount of £50m, but their fair value is considered to be £80m. A also has unamortised goodwill remaining of £10m. The implicit fair value of the business contributed is £100m (40% of total fair value £250m).

The book and fair values of the businesses contributed by A and B can therefore be summarised as follows:

(in £m)	A		B	
	Book value	Fair value	Book value	Fair value
Identifiable net assets	50	80	70	120
Goodwill	10	20	15	30
Total	60	100	85	150

How should B account for this transaction in its consolidated financial statements?

B's accounting reflects that it has retained 60% of its existing business and has exchanged a 40% interest in that business for a 60% interest in the business contributed by A. It continues to record the 60% retained at book value and recognises a gain or loss on disposal of the 40%, calculated as the difference between the book value of the net assets and the consideration received (being the fair value of the 60% interest in A's business). The difference between the fair value of the 40% interest in the business given up and the new net assets acquired (i.e., the 60% of A's former assets) represents goodwill.

This gives rise to the following accounting entries.

	Dr	Cr
Net assets of Newco ⁽¹⁾	£150m	
NCl in Newco ⁽²⁾		£60m
Goodwill ⁽³⁾	£21m	
Net assets contributed to Newco ⁽⁴⁾		£85m
OCI (gain on disposal) ⁽⁵⁾		£26m

(1) Book value of B's identifiable net assets + fair value of A's identifiable net assets (£70m + £80m) = £150m. These would be consolidated on a line-by-line basis.

(2) 40% of (book value of B's identifiable net assets + fair value of A's identifiable net assets) i.e., $40\% \times (£70m + £80m) = £60m$.

(3) Fair value of business given up by B less fair value of identifiable net assets of A's business acquired, i.e., 40% of £150m less 60% of £80m = £12m, plus 60% of B's goodwill of £15m retained (£9m) = £21m.

(4) Previous carrying amount of net assets contributed by B (including goodwill), now deconsolidated (although now reconsolidated in accounting for Newco). These would be deconsolidated on a line-by-line basis.

(5) Fair value of business received, less book value of assets disposed of, 60% of £100m - 40% of £85m = £26m.

The gain on the transaction in Illustration 3-14 is unrealised because qualifying consideration has not been received. Therefore, the gain is accounted for in OCI as only realised profits can be recognised in profit or loss. [1 Sch 13]. Where part or all of the gain is realised then that portion can be taken to profit and loss. This is illustrated in Illustration 3-15 below:

Illustration 3-15: Creation of subsidiary by contribution of existing business (2)

Assume the same fact pattern as in Illustration 3-14 above, except that B receives only 50% in Newco (but still has control) and that A pays £25m direct to B in compensation for the reduction in the stake from 60% to 50%. As in Illustration 3-14 above, the identifiable net assets of B (book value of £120m) include a bank loan of £20m which is equal to its fair value.

How should B account for this transaction in its consolidated financial statements?

B's accounting reflects that it has retained 50% of its existing business and has exchanged a 50% interest in that business for a 50% interest in the business contributed by A plus cash of £25m. It continues to record the 50% retained at book value and recognises a gain or loss on disposal of the 50%, calculated as the difference between the book value of the net assets and the consideration received (being the fair value of the 50% interest in A's business plus cash of £25m). The difference between the fair value of the 50% interest in A's business given up and the new net assets acquired (i.e., the 50% of A's former assets) represents goodwill.

This gives rise to the following accounting entries.

	Dr	Cr
Net assets of Newco ⁽¹⁾	£150m	
NCl in Newco ⁽²⁾		£75m
Cash	£25m	
Goodwill ⁽³⁾	£17.5m	
Net assets contributed to Newco ⁽⁴⁾		£85m
Profit and loss (gain on disposal) ⁽⁵⁾		£5m
OCI (gain on disposal) ⁽⁵⁾		£27.5m

(1) Book value of B's identifiable net assets + fair value of A's identifiable net assets (£70m + £80m) = £150m. These would be consolidated on a line-by-line basis.

(2) 50% of (book value of B's identifiable net assets + fair value of A's identifiable net assets) i.e., $50\% \times (£70m + £80m) = £75m$.

(3) Fair value of business given up by B (net of amount of cash of £25m received from A to achieve equalisation of values) less fair value of identifiable net assets of A's business acquired, i.e., 50% of £150m less £25m, less 50% of £80m = £10m, plus 50% of B's goodwill of £15m retained (£7.5m) = £17.5m.

(4) Previous carrying amount of net assets (including goodwill) contributed by B, now deconsolidated (although now consolidated in accounting for Newco). These would be deconsolidated on a line-by-line basis.

(5) Fair value of business received (50% of £100m) plus cash received of £25m less book value of assets disposed of i.e., (50% of £85m), The gain on disposal of £32.5m has been split based on an allocation between 'realised' and 'unrealised' as explained below.

FRS 102 does not explain how to distinguish a realised gain from an unrealised gain. Illustration 3-15 above uses a 'top slicing' approach whereby the proportion of the total gain that is backed by net cash is treated as realised (i.e., £5m). 'Top slicing' is the recommended approach to determining realised profits for exchanges of assets in paragraph 3.18 of the ICAEW/ICAS Technical Release 02/17BL - *Guidance on Realised and Distributable Profits under the Companies Act 2006* (TECH 02/17BL). Paragraph 3.18A of TECH 02/17BL states that when the consideration received comprises a combination of assets and liabilities, the profit will be realised only to the extent of any net balance (i.e., cash less liabilities) of qualifying consideration received. In Illustration 3-15 above, the realised profit of £5m consists of the cash received of £25m less the bank loan assumed of £20m.

No gain or loss is recognised in those rare cases where the artificiality or lack of substance of the transaction is such that a gain or loss on the exchange cannot be justified. In this scenario, disclosure of the circumstances is required. [FRS 102.9.32]. There is no elaboration as to the circumstances where this might be applicable.

3.9 Disclosures in consolidated financial statements

3.9.1 Disclosures in consolidated financial statements required by Section 9 of FRS 102

The following disclosures in respect of consolidated financial statements, which supplement those already required by the Regulations (see 3.9.2 below), are required by Section 9 of FRS 102: [FRS 102.9.23]

Extract from Section 9

9.23 The following disclosures shall be made in consolidated financial statements:

- (a) the fact that the statements are consolidated financial statements;
- (b) the basis for concluding that control exists when the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power;
- (c) any difference in the reporting date of the financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements;
- (d) the nature and extent of any significant restrictions (e.g., resulting from borrowing arrangements or regulatory requirements) on the ability of subsidiaries to transfer funds to the parent in the form of cash dividends or to repay loans;
- (e) the name of any subsidiary excluded from consolidation and the reasons for its exclusion; and
- (f) the nature and extent of its interests in unconsolidated special purpose entities, and the risks associated with such entities.

In addition, where a gain or loss on an exchange of a business or other non-monetary asset for an investment in a subsidiary, associate or jointly controlled entity has not been recognised because of the artificiality or lack of substance of the transaction, these circumstances must be explained (see 3.8 above). [FRS 102.9.32].

The disclosure regarding unconsolidated special purpose entities is a principle-based disclosure derived from IFRS 12. [FRS 102.BC.B9.4]. IFRS 12 refers to disclosure of information that enables users of the financial statements to understand the nature and extent of interests in unconsolidated structured entities and to evaluate the nature of, and changes in, risks associated with those interests. [IFRS 12.24]. This principle-based requirement is followed by detailed disclosure requirements in paragraphs 25 - 31 of IFRS 12. Considering the different wording in FRS 102, which omits a requirement to disclose 'changes in risk' and the reference in the Basis for conclusions to a 'principle-based disclosure', the intention seems to be less detailed disclosure under FRS 102 compared to IFRS 12. However, management might consider the requirements and guidance in IFRS 12 useful in determining what type of detail to provide. Unlike IFRS, FRS 102 does not require any specific disclosures in respect of consolidated structured entities, nor is this disclosure required in separate or individual financial statements.

3.9.2 Disclosures in consolidated financial statements in respect of subsidiary undertakings required by the Regulations

The following disclosures are required by the Regulations in consolidated financial statements in respect of subsidiaries:

- The name of each subsidiary undertaking and the address of the undertaking's registered office (whether in or outside the United Kingdom) and, if unincorporated, the address of its principal place of business. There is no relief available to limit this disclosure to those of the principal subsidiaries if it is of excessive length. This applies to both direct and indirect subsidiaries. [4 Sch 1]
- For each subsidiary, there must be stated the identity of each class of shares held and the proportion of the nominal value of that class of shares held, with separate information on the interest held by the parent and by the group, if different. [4 Sch 17]
- For entities that are subsidiaries other than because the immediate parent holds a majority of the voting rights which are in the same proportion of the shares held, the reasons why the subsidiary has been consolidated. [4 Sch 16(3)]
- For each subsidiary not included in the consolidation the reasons for excluding the subsidiary from the consolidation. [4 Sch 16(2)]
- For each subsidiary not included in the consolidated accounts: [4 Sch 2]

- The aggregated amount of its capital and reserves as at the end of its relevant financial year
And
- Its profit or loss for that year

This information is not required if the subsidiary is included in the consolidated accounts under the equity method of accounting or if the subsidiary is not required by the CA 2006 to deliver a copy of its balance sheet for its relevant financial year and does not otherwise publish its balance sheet anywhere in the world and the company's holding is less than 50% of the nominal value of the shares (or if the information is not material).

- When during the financial year, there has been a disposal of an undertaking or group which significantly affects the figures in the group accounts: *[6 Sch 15]*
 - The name of the undertaking or of the parent undertaking of the disposed group
And
 - The extent to which the profit or loss shown in the group accounts is attributable to profit or loss of that undertaking or group

This disclosure need not be given for an undertaking which is either established outside the United Kingdom or carries on business outside the United Kingdom if the disclosure is seriously prejudicial to the business of that undertaking or of the parent company or any of its subsidiary undertakings and the Secretary of State agrees. *[6 Sch 16]*

- Any differences of accounting rules as between a parent's individual accounts for a financial year and its group accounts, and the reason for the differences. *[6 Sch 4].*
- The number, description and amount of shares in the parent company held by or on behalf of subsidiary undertakings. *[4 Sch 3].*

See Chapter 17 at 4.2.4 and Chapter 18 at 3.10.3.A for disclosures required by the Regulations in consolidated financial statements for investments in associates and jointly controlled entities.

Requirements for business combinations are provided in Chapter 22.

4 Individual and separate financial statements

The CA 2006 requires accounts to be prepared for each financial year. These are referred to as the company's individual accounts. [s394]. Other statutory frameworks apply to those entities not required to produce Companies Act individual accounts. [FRS 102.9.23A].

The key terms, 'individual financial statements' and 'separate financial statements' are defined in the FRS 102 Glossary, [FRS 102 Appendix I], see Appendix A below.

Both individual and separate financial statements as defined by FRS 102 are Companies Act individual accounts.

An entity that is not a parent (i.e., an entity that does not have subsidiaries) prepares individual financial statements and not separate financial statements. [FRS 102.9.24].

4.1 Accounting for associates and jointly controlled entities in individual financial statements of an entity that is not a parent

An entity that is not a parent accounts for investments in associates and jointly controlled entities using either: [FRS 102.9.25, FRS 102.14.4, FRS 102.15.9]

- A cost model, i.e., at cost less impairment
 - A fair value model, i.e., at fair value with changes in fair value recognised in OCI (or profit or loss to the extent that it reverses revaluation movements in profit or loss or where the revaluation reserve would otherwise be negative)
- Or
- At fair value with changes in fair value recognised in profit or loss

There is no option to use equity accounting in individual financial statements prepared under FRS 102 (although this option exists under IFRS and Schedule 1 to the Regulations). [FRS 102.BC.A.28(a)]. However, the individual financial statements of an investor that is not a parent disclose summarised financial information about investments in associates and jointly controlled entities, along with the effect of equity accounting for those investments. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement. [FRS 102.14.15A, FRS 102.15.21A].

In its individual financial statements, an entity that is not a parent need not measure associates using the same accounting model as jointly controlled entities. However, Sections 14 and 15 do not explicitly address whether all associates or all jointly controlled entities must be accounted for using the same model. There is an explicit requirement in Section 9 for an entity that is a parent to apply the same accounting policy to all investments in a single class. [FRS 102.9.26].

How we see it

As discussed at 4.2 below, in our view, associates or jointly controlled entities held as part of an investment portfolio could be considered as a separate class from other associates or jointly controlled entities in the separate financial statements of a parent. While Sections 14 and 15 do not specifically refer to different classes of associates and jointly controlled entities, we believe that an entity that is not a parent may similarly adopt a different accounting policy in accounting for associates and jointly controlled entities held as part of an investment portfolio to that applied to other associates and jointly controlled entities in its individual financial statements.

The cost and fair value measurements for associates and jointly controlled entities are further discussed in Chapter 17 and Chapter 18.

4.2 Accounting for subsidiaries, associates and jointly controlled entities in separate financial statements of an entity that is a parent

Separate financial statements are those presented by a parent in which the investments in subsidiaries, associates or jointly controlled entities are accounted for at either cost or fair value, rather than on the basis of the reported results and net assets of the investees. [FRS 102.9.24].

A parent preparing separate financial statements adopts a policy of accounting for investments in subsidiaries, associates and jointly controlled entities at either: [FRS 102.9.26]

- Cost less impairment
- Fair value with changes in fair value recognised in OCI (or profit or loss) in accordance with paragraphs 15E and 15F of Section 17 *Property, Plant and Equipment*

Or

- Fair value with changes in fair value recognised in profit or loss

Guidance on fair value is provided in Section 2A *Fair Value Measurement* (see Chapter 10). A policy of measuring subsidiaries, associates and jointly controlled entities at fair value through profit or loss is permitted by paragraph 36(4) of Schedule 1 to Regulations (and its equivalents in Schedules 2 and 3) without the use of a true and fair override. However, additional disclosures are required, see 4.6.1 below.

There is no option to use equity accounting in separate financial statements prepared under FRS 102 (although this option exists under IFRS and Schedule 1 to the Regulations). [FRS 102.BC.A.28(a)].

A parent that is exempt from the requirement to prepare consolidated financial statements (see 3.1.1 above) and therefore presents separate financial statements as its only financial statements also accounts for its investments in subsidiaries, associates and jointly controlled entities as above. [FRS 102.9.26A].

A parent must apply the same accounting policy for all investments in a single class (for example subsidiaries that are held as part of an investment portfolio, those subsidiaries not held as part of an investment portfolio, associates or jointly controlled entities) but it can elect different policies for different classes. [FRS 102.9.26]. Although not mentioned as an example of a class of investments, it appears that associates and jointly controlled entities which are held as part of an investment portfolio (and therefore required to be measured at fair value through profit or loss) could also be a separate class from associates and jointly controlled entities which are not held as part of an investment portfolio. Otherwise, an investor with, say, an associate held as part of an investment portfolio - that wished to maintain the same accounting in the consolidated and separate financial statements - would be required to measure all associates at fair value through profit or loss.

This restriction means that a parent cannot use a different accounting policy for a class of investments even where individual investments within that class have different characteristics. A subsidiary excluded from consolidation which is held as part of an investment portfolio is a separate class of investment. [FRS 102.9.26]. Subsidiaries that are excluded from consolidation because they are held as part of an investment portfolio are measured at fair value through profit or loss. [FRS 102.9.9C(a)]. While the term 'class' has not been referenced to Appendix I: Glossary to FRS 102, generally, a class is taken to mean a grouping of assets of a similar nature and use in an entity's operations.

How we see it

Although the examples given for separate classes of investments differentiate between subsidiaries held as part of an investment portfolio and those that are not so held, in our view, this does not preclude the election of a different accounting policy for different classes of subsidiaries. For example, an entity might consider it appropriate to account for investments in subsidiaries held exclusively with a view to resale (including those not held as part of an investment portfolio) at fair value, while applying the cost model to other investments in subsidiaries.

If an entity measures subsidiaries at fair value but the fair value of one or more subsidiaries is not reliably measurable its carrying amount at the last date the asset was reliably measurable becomes its new cost. The entity measures the asset at this cost less impairment, if any, until a reliable measure of fair value becomes available. [FRS 102.2A.23].

There is no option under FRS 102 to use a directors' valuation (typically, net assets), an out-of-date market value (except when a reliable measure of fair value is no longer available for an asset measured at fair value) or current cost to value an investment in a subsidiary, associate or jointly controlled entity in individual or separate financial statements where such measurements are not the equivalent of fair value at the reporting date.

FRS 102 does not distinguish between different types of entity (e.g., banking entities, insurance entities and other entities). The cost model is not permitted by Schedule 3 to the Regulations for individual or separate financial statements, so an insurer is able to use only fair value measurement for investments in subsidiaries. [3 Sch 21].

4.2.1 Cost of investment in a subsidiary, associate or jointly controlled entity

Section 9 does not define 'cost' of investment. However, Section 2 *Concepts and Pervasive Principles* states that the historical cost of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. [FRS 102.2.69]. The Regulations state that the purchase price of an asset is determined by adding to the actual price paid any expenses incidental to its acquisition (and then subtracting any incidental reductions in the cost of acquisition). [1 Sch 27(1)]. This definition in the Regulations is consistent with Section 17 and the requirements for exchanges of businesses or other non-monetary assets for an interest in a subsidiary, jointly controlled entity or associate (see 3.8 above), which describe cost as normally either the purchase price paid (including directly attributable costs) or the fair value of non-monetary assets exchanged. [FRS 102.9.31, FRS 102.17.10]. The purchase price generally represents the fair value of the consideration given to purchase the investment consistent with the guidance in respect of exchanges of businesses or other non-monetary assets (see 3.8 above) and the requirements in respect of measuring the cost of a business combination (see Chapter 22 at 3.6).

4.2.1.A Cost of investment in a subsidiary, associate or jointly controlled entity acquired in exchange for shares

When shares have been issued as consideration for the investment and the cost model is adopted, sections 611 to 615 of the CA 2006 set out the treatment where 'merger relief' or 'group reconstruction relief' is available. These reliefs are primarily concerned with the recognition of share premium on the issue of shares, but also affect the amount recognised as cost of investment in a subsidiary, associate or jointly controlled entity in certain circumstances. [s615].

Extract from the CA 2006

s615 The amount of the premium which is not included in the share premium account by virtue of either group reconstruction relief or merger relief may also be disregarded in determining the amount at which any shares or other consideration provided for the shares issued is to be included in the company's balance sheet. [s615].

When using the cost model, section 615 permits the initial carrying amount of the investment to be adjusted downwards so it is equal to either the previous carrying amount of the investment in the transferor's books (in most circumstances) or the nominal value of the shares issued, depending on which relief applies. This relief is not available where the fair value model is used, so in that case, the investment's carrying amount cannot be reduced, although the effect of the reliefs on share premium remains relevant. [FRS 102.A3.24].

How we see it

In our view, the decision whether or not to use this relief in the CA 2006 to measure cost is an accounting policy choice that must be applied consistently for all transactions of this type. When the relief is not taken, consistent with the discussion at 4.3 below, we believe that the initial cost of the investment is its fair value.

Section 615 permits the relief to be reflected in determining the amount at which the shares or other consideration provided for the shares issued are recognised. Therefore, when applying the cost method, any non-cash consideration other than shares transferred can also be measured at an amount which reflects the relief available. [FRS 102.A3.24A].

Merger relief and group reconstruction relief are reliefs from the basic rule that a company issuing shares accounts for the issue at the value of the consideration received. Where this includes a premium (i.e., the value of the consideration received exceeds the nominal amount of the shares issued) the premium on those shares is transferred to a share premium account. [s610].

Group reconstruction relief applies when the company issuing shares is:

- A wholly owned subsidiary of another company (the holding company)
- And
- Allots shares:
 - To the holding company
- Or

- To another wholly-owned subsidiary of the holding company in consideration for the transfer of non-cash assets of a company (the transferor company) that is a member of the group of companies that comprises the holding company and all its wholly-owned subsidiaries

When the shares in the issuing company allotted in consideration are issued at a premium, the issuing company (i.e., the subsidiary) is not required to transfer any amount in excess of the minimum premium value (i.e., the amount, if any, by which the base value of the consideration exceeds the aggregate nominal value of the shares) to the share premium account.

The base value of the consideration for the shares allotted is the amount by which the base value of the assets transferred (i.e., the cost of the assets to the transferor company or, if less, the amount at which those assets are stated in the transferor company's accounting records immediately before the transfer) exceeds the base value of any liabilities (i.e., the amount at which they are stated in the transferor company's accounting records immediately before the transfer) of the transferor company as part of the consideration for the assets transferred. [s611].

In many cases, the subsidiary issuing shares recognises share capital and premium equal to the transferor's carrying value of the non-cash assets given in exchange for the shares, and any additional amount is credited to either share premium or another reserve (because group reconstruction relief is optional). This is shown at Illustration 4-1.

Merger relief applies when a company that issues shares (the issuing company) has secured at least a 90% equity holding in another company in pursuance of an arrangement providing for the allotment of equity shares in the issuing company on terms that the consideration for the share allotted is to be provided: [s612]

- By the issue or transfer to the issuing company of equity shares in the other company.
- Or

- By the cancellation of any such shares not held by the issuing company.

If the equity shares (i.e., shares in a company's equity share capital [s548]) in the issuing company allotted pursuant to this arrangement are issued at a premium the requirements of the CA 2006 relating to the establishment of a share premium account do not apply to the premiums on those shares.

In a share-for-share exchange, any credit that would normally be recognised as share premium is credited to another reserve. Merger relief is mandatory, so, in contrast to group reconstruction relief, the credit subject to the relief cannot be taken to share premium.

In addition, when the arrangement also provides for the allotment of any shares in the issuing company on terms that the consideration for those shares is to be provided:

- By the issue or transfer to the issuing company of non-equity shares in the other company.
- Or
- By the cancellation of any such shares in that company not held by the issuing company.

The relief relating to the establishment of the share premium account extends to any shares in the issuing company on those terms in pursuant of the arrangement. E.g., if the issuing company is receiving both non-equity shares and equity shares of the acquiree in exchange for its own issue, merger relief applies to its full issue of shares and not just the proportion issued in exchange for the equity shares of the acquiree.

Merger relief cannot be used in a transaction falling within the scope of group reconstruction relief. I.e., where both would apply, group reconstruction relief takes precedence.

For the purpose of determining the 90% equity holding for the purposes of merger relief: [s613]

- It does not matter whether any of the shares acquired in the other company were in pursuance of the arrangement. I.e., merger relief applies in a transaction that takes the issuing company's interest from below to above 90%.
- Shares in the other company held as treasury shares are excluded in determining the nominal amount of that other company's share capital.
- Where there is more than one class of shares, a 90% or more equity holding must be met in relation to each class.
- Shares in the other company held by the issuing company's holding company, subsidiary, or a subsidiary of the issuing company's holding company or by its nominees are treated as being held by the issuing company.
- Illustration 4-1 and Illustration 4-2 show the application of group reconstruction relief and merger relief on the cost of an investment in a subsidiary.

Illustration 4-1: Group reconstruction relief and cost of investment

Company B (a wholly owned subsidiary of Company A) issues 100 £1 ordinary shares to its holding company, A, in return for an investment in Company C held by A. The investment in C was previously carried by A as its original cost of £400. The fair value of C (and the shares issued by A) at the date of the transaction is £1,000. How does B account for this transaction in its separate financial statements?

If B's accounting policy is to carry its investments in subsidiaries at cost less impairment, then B has an accounting policy choice to determine cost as either the previous carrying value of the investment in the transferor's books (by taking group reconstruction relief) or at fair value as follows:

	Dr	Cr
Investment in subsidiary	£400	
Share capital		£100
Share premium		£300
OR		
Investment in subsidiary	£1,000	
Share capital		£100
Share premium		£300
Merger reserve		£600

If B's accounting policy is to carry its investments at fair value (whether or not gains and losses on remeasurement are taken through profit and loss or through other comprehensive income) then the investment in subsidiary must be measured initially at fair value.

As discussed above, regardless of the accounting policy election, section 611 permits the investor to restrict the amount transferred to share premium to the minimum premium value (i.e., the amount by which the base cost of assets transferred exceeds the base value of any liabilities transferred). In this example, B has elected to restrict the amount transferred to share premium in this way.

Illustration 4-2: Merger relief and cost of investment

Company A issues 100 £1 ordinary shares to a third party for 100% of the ordinary shares of Company B and pays cash of £200. The fair value of Company B (and the total consideration paid by Company A) is £1,000. How does A account for this transaction in its separate financial statements?

If A's accounting policy is to carry its investments in subsidiaries at cost less impairment, then A has an accounting policy choice as follows:

	Dr	Cr
Investment in subsidiary	£300	
Share capital		£100
Cash		£200
OR		
Investment in subsidiary	£1,000	
Share capital		£100
Merger reserve		£700
Cash		£200

As discussed above, Appendix III of FRS 102 states that where the cost model is applied section 615 allows the initial carrying amount to be adjusted downwards so that it reflects the nominal value of the shares issued (and any minimum share premium required by group reconstruction relief) depending on the relief applied. Alternatively, an entity could ignore this option to reduce the carrying amount and use the fair value of B as its cost.

If A's accounting policy is to carry its investments at fair value (whether or not gains and losses on remeasurement are taken through profit and loss or through other comprehensive income) then the investment in subsidiary must be measured initially at fair value.

In the illustrations above, when the investment is initially measured at its fair value, the excess of the consideration is described as a 'merger reserve'. Neither the CA 2006 nor FRS 102 specify the title of this reserve.

How we see it

Given that the share premium requirements of the CA 2006 do not apply when merger relief is used, in our view, it is not appropriate to describe a merger reserve as 'share premium'.

4.2.1.B Contingent consideration

Section 9 provides no guidance on accounting for contingent consideration on the acquisition of a subsidiary, associate or jointly controlled entity in individual or separate financial statements.

How we see it

In our view, the guidance on contingent consideration (and adjustments to the cost of the combination) in a business combination discussed in Chapter 22 at 3.6.2 is applied to the cost of investment in subsidiary in the parent's separate financial statements.

This means that the cost at the acquisition date includes the estimated amount of the contingent consideration if it is probable and can be measured reliably. [FRS 102.19.12]. If contingent consideration is not recognised at the acquisition date but subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the investment. [FRS 102.19.13]. If future events that at the acquisition date were expected to occur do not occur, or the estimate needs to be revised, the cost of the investment is adjusted accordingly. [FRS 102.19.13A].

4.2.1.C Cost of investment in a subsidiary, associate or jointly controlled entity acquired in stages

An investment in a subsidiary, associate or jointly controlled entity might be acquired in stages so that, up to the date on which control, significant influence or joint control is first achieved the initial investment is accounted for as a financial asset at fair value under one of the accounting policy choices for recognition and measurement of financial instruments (i.e., Sections 11 and 12, IFRS 9 or IAS 39 - see Chapter 13 at 3). [FRS 102.11.2, FRS 102.12.2]. This raises the question of what the initial carrying amount of the subsidiary, associate or jointly controlled entity is in the separate financial statements when the cost method is applied.

How we see it

In our view, the cost of the investment is the sum of the consideration given for each tranche. This is because 'historical cost' of an asset when it is acquired or created is the value of the costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs.

Any difference between the sum of the consideration given and the fair value of the investment is reversed and reflected in OCI resulting in an adjustment to the component of equity containing the cumulative valuation gains and losses, (see Chapter 13 at 3), i.e.,:

- Retained earnings if the investment had been treated as at fair value through profit or loss.
- The 'available-for-sale reserve' where the investment has been treated as available-for-sale by an entity using the recognition and measurement provisions of IAS 39.

Or

- The revaluation reserve where the investment has been measured at fair value through OCI using the recognition and measurement provisions of IFRS 9.

If changes to the carrying amount of the investment had resulted from an impairment charge, this charge is not necessarily reversed because the investment is considered for impairment in the separate financial statements of the investor. Therefore, the investor determines whether Section 11 or Section 27 permit reversals of impairment and whether there are indicators that the impairment can be reversed, based on the classification of the investment.

4.2.1.D Returns of capital

Returns of capital are not directly addressed by Section 9. They are an example of a 'distribution', the broader term applied when an entity gives away its assets to its members. FRS 102 contains no guidance on the distinction between a dividend (a return on capital) and a return of capital. However, guidance in IFRS 9 (which can be referred to via the hierarchy at paragraph 6 of section 10) distinguishes between a dividend from an equity investment that is recognised in profit or loss and one that 'clearly represents a recovery of part of the cost of the investment', which is effectively credited directly to the equity investment.

How we see it

A return of capital is accounted for as a direct credit to the carrying value of the investment in the separate financial statements. Dividend income is reflected in profit or loss or other comprehensive income (depending on whether the dividend income represents a realised profit or not). Whether a payment is dividend income or a return of capital is a matter of judgement and depends on the facts and circumstances. The two frequently cannot be easily distinguished.

Subsequent to the receipt of a dividend, a parent tests its investment in the subsidiary for impairment under Section 27.

4.3 Group reorganisations

Group reorganisations involve the restructuring of the relationships between companies in a group by, for example, setting up a new holding company, changing the direct ownership of a subsidiary with a group or transferring businesses from one company to another. FRS 102 provides no explicit guidance on how to account for group reorganisations in separate financial statements, although some common scenarios that arise in separate financial statements are in scope of FRS 102's group reconstruction guidance, see Chapter 22 at 5. When the group reorganisation involves investments in subsidiaries, the requirements of Section 9 to account for investment in subsidiaries at either cost or fair value (see 4.2 above) apply. When the cost model is applied, the discussion at 4.2.1A to 4.2.1.C above is relevant.

Illustration 4-3 below shows three scenarios for the accounting in the separate financial statements of a parent which measures investments in subsidiaries at cost less impairment and transfers one subsidiary to another subsidiary.

Illustration 4-3: Cost of investment in subsidiary following transfer of subsidiary to another subsidiary

Parent A has two direct, wholly owned subsidiaries, B and C, measured at cost less impairment. Both Subsidiary B and Subsidiary C have a carrying amount of £30 prior to the transaction.

Parent A transfers Subsidiary B to Subsidiary C.

In these scenarios, it is assumed that Subsidiary B has a recoverable amount of not less than £30 prior to the transaction, and that the increased investment in Subsidiary C is also recoverable.

Scenario 1 - transfer for nil consideration

The total cost of Parent A's investment in its subsidiaries does not change. Parent A's investment in Subsidiary B is not impaired as Parent A still owns and controls Subsidiary B (indirectly) via Subsidiary C.

Therefore, the accounting entries for Parent A are:

	Dr	Cr
Investment in Subsidiary C	£30	
Investment in Subsidiary B		£30

Parent A's total cost of investment in Subsidiary C is now £60 which reflects the commercial substance of the transaction.

Scenario 2 - transfer for fair value, £40 consideration (intragroup receivable)

Parent A has received a financial asset as consideration for the sale of Subsidiary B to Subsidiary C. In accordance with Section 11 of FRS 102, Parent A recognises the financial asset at transaction price (also its initial fair value) of £40, derecognises the investment in Subsidiary B and recognises a gain of £10 in profit or loss if the receivable is considered to be qualifying consideration (if not, the gain is recognised in OCI).

Therefore, the accounting entries for Parent A are:

	Dr	Cr
Receivable from Subsidiary C	£40	
Investment in Subsidiary B		£30
Profit or loss		£10

Scenario 3 - transfer for an amount less than fair value, £20 consideration (intragroup receivable)

Parent A has received a financial asset as consideration for the sale of Subsidiary B to Subsidiary C. In accordance with Section 11 of FRS 102, Parent A recognises the financial asset at transaction price (also its initial fair value) of £20, derecognises the investment in Subsidiary B of £30 and recognises an increase in its investment in Subsidiary C of £10. No loss is recognised by Parent A because Parent A still owns and controls Subsidiary B (indirectly).

Therefore, the accounting entries for Parent A are:

	Dr	Cr
Receivable from Subsidiary C	£20	
Investment in Subsidiary B		£30
Investment in Subsidiary C	£10	

Accounting for a group reorganisation that is the acquisition of an unincorporated business is discussed in Chapter 22 at 5.4.

4.4 Common control transactions in individual and separate financial statements

Transactions often take place between a parent entity and its subsidiaries, or between subsidiaries within a group, that may or may not be carried out at fair value. FRS 102 provides no accounting guidance on such transactions.

The CA 2006 states that where a company makes a distribution consisting of or including, or treated as arising in consequence of, the sale, transfer or other disposition of a non-cash asset such a distribution can be made at an undervalue only if the company has positive distributable reserves at the time of the distribution. [s845]. When a company makes a distribution of a non-cash asset, any part of that asset which represents an unrealised profit, can be treated as a realised profit for the purpose of determining the lawfulness of the distribution. [s846].

In addition, group reconstruction relief can be applied when a subsidiary issues shares in exchange for a non-cash asset (see 4.2.1.A above).

The following sections deal with typical transactions between entities under common control. See also Chapter 22 at 5.4 for accounting for group reconstructions in individual financial statements.

4.4.1 Capital contributions

One form of transaction which is sometimes made within a group is a 'capital contribution', where one company injects funds in another (usually its subsidiary) in the form of a non-returnable gift. Capital contributions can result in complex tax considerations to be addressed.

Capital contributions have no legal status in the UK - the term is not used anywhere in the CA 2006 or in FRS 102. This has led to uncertainty over the appropriate accounting treatment in the financial statements of both the giver and the receiver of the capital contribution.

4.4.1.A Treatment in the financial statements of the paying company

In the most common situation, where the contribution is made by a parent to one of its subsidiaries, the amount of the contribution is added to the cost of the investment in the subsidiary. As with any fixed asset, it assessed for impairment, particularly when subsequent dividends are received from the subsidiary. The dividend could be regarded as having been met out of the capital contribution and hence representing a return of it.

How we see it

When the contribution is made by a subsidiary to a fellow-subsubsidiary, the paying company determines whether it is made at the direction of the entities' common parent. If so, consistent with the guidance issued by the FRC in FRS 102 Factsheet 4 in respect of fixed term loans with no interest or a below market rate of interest (see Chapter 13 at 7.2.2 and Chapter 13 at 7.2.3), we believe the paying subsidiary accounts for the transaction in equity as if it were a distribution to the parent. If not, then the contribution is accounted for as an expense through profit or loss.

It is not possible to regard the contribution as an asset of any kind; it is neither an investment in the other company, nor can it be treated as a monetary receivable, since by definition there is no obligation on the part of the recipient to return it.

There may be circumstances in which the nature of the transaction gives rise to a funding commitment and therefore the recognition of a liability. Funding commitments are discussed in Chapter 24 at 3.10.

4.4.1.B Treatment in the financial statements of the receiving company

A subsidiary recognises a capital contribution received from its parent within equity, commonly as a credit to a separate reserve, such as 'capital contribution', or 'capital reserve'.

Depending on the nature of the contribution, it may or may not be regarded as a realised profit and available for distribution. TECH 02/17BL regards the contribution of assets from owners in their capacity as such as giving rise to a 'profit', but whether it is realised or not depends on whether the assets contributed meet the definition of qualifying consideration. Therefore, a contribution received in the form of a non-monetary asset is unlikely to represent a realised profit. When a contribution is regarded for distribution purposes as a realised profit, it might be appropriate to reclassify the reserve to retained earnings, although established practice is to maintain a separate reserve.

How we see it

When a capital contribution is received by a subsidiary from a fellow-subsubsidiary, the receiving company determines whether it is made at the direction of the entities' common parent. If so, consistent with the guidance issued by the FRC in FRS 102 Factsheet 4 in respect of fixed term loans with no interest or a below market rate of interest, we believe the receiving company accounts for the transaction in equity as if it were a capital contribution from the parent. If not, then the contribution is accounted for as income through profit or loss (if the contribution is a realised profit for distribution purposes) or OCI (if the contribution is not a realised profit).

4.4.1.C Treatment in the common parent

When a capital contribution is made between fellow subsidiaries, in the common parent of the paying and receiving companies, it is established practice to recognise no entry. This is on the basis that it is not party to the transaction.

4.4.1.D Contribution and distribution of non-monetary assets

These transactions involve transfers of inventory, property, plant and equipment, intangible assets, investment property and investments in subsidiaries, associates and joint ventures from one entity to another for no consideration, sometimes referred to as 'in specie' transactions (since not cash). These arrangements are not contractual but are equity transactions: either in specie capital contributions (an asset is gifted by a parent to a subsidiary) or non-cash distributions (an asset is given by a subsidiary to its parent). This guidance does not apply to assets transferred as part of a group reconstruction to which merger accounting is applied, see Chapter 22 at 5.4.2.

The relevant sections of FRS 102 (Section 13 *Inventories*, Section 16 *Investment Property*, Section 17 and Section 18 *Intangible Assets other than Goodwill*) refer to assets being recognised at cost. Similarly, investments in subsidiaries, associates and jointly controlled entities may be recognised at cost as discussed at 4.1 and 4.2 above.

How we see it

In our view, cost is determined by recognising the transaction at:

- The consideration agreed between the parties (i.e., at zero).
Or
- At fair value, regardless of the agreed consideration of zero, with the difference between zero and fair value recognised as an equity transaction (capital contribution).

It is more common for an entity that has received an asset in an equity transaction to recognise it at fair value.

When fair value is used to determine cost, part of the difference between fair value and zero might reflect additional goods and services but, once they have been accounted for, any remaining difference is a contribution or distribution of equity for a subsidiary or an increase in the investment held, or distribution received by the parent.

The paying entity must reflect the transaction. A parent that makes a capital contribution to its subsidiary recognises an increase in investment in that subsidiary provided the increase does not result in impairment. The amount of the increase in investment, at either carrying amount or fair value of the non-monetary asset given up, depends on whether the transaction is considered to have substance or not, since the parent has simply swapped a direct investment in a non-monetary asset for an indirect investment in the same asset via its subsidiary. If the subsidiary is newly incorporated or wholly owned, this might indicate that the transaction lacks substance. Consequently, the parent recognises the additional cost of investment in the subsidiary at the carrying amount of the non-monetary asset given up. If the transaction has substance to the parent, it could recognise its additional investment in the subsidiary at the fair value of the consideration given, i.e., the fair value of the non-monetary asset given up. Any gain recognised would be unrealised and recognised in OCI, since the additional investment received in the subsidiary, an unquoted subsidiary, would not be regarded as qualifying consideration (see also Chapter 22 at 5.4.4.A).

A subsidiary that makes a distribution in specie to its parent accounts for the transaction by derecognising the distributed asset at its carrying value against retained earnings. The Basis for conclusions explains that a distribution to a shareholder does not generate a profit and therefore FRS 102 does not include a requirement to recognise a liability to pay a dividend at fair value (as opposed to carrying value).

[FRS 102.BC.B22.1]. However, disclosure of the fair value of dividends is required (except when the non-cash assets are ultimately controlled by the same parties both before and after the distribution - as would generally be the case for a dividend from a subsidiary to a parent). [FRS 102.22.18]. As the distribution received by the parent is a non-monetary asset, it is unlikely to represent 'qualifying consideration' under TECH 02/17BL and so is an unrealised profit and therefore reflected in the parent's OCI rather than the income statement.

Consistent with the treatment of capital contributions discussed at 4.4.1.A and 4.4.1.B above, contributions and distributions of non-monetary assets between fellow subsidiaries are generally made at the direction of the entities' common parent and are therefore also accounted for as equity transactions.

4.4.1.E Incurring expenses and settling liabilities without recharges

Entities frequently incur costs that provide a benefit to fellow group entities, e.g., audit, management or advertising fees, and do not recharge the costs. The beneficiary is not party to the transaction and does not directly incur an obligation to settle a liability. It can elect to recognise the cost, in which case it will charge profit or loss and credit retained earnings with equivalent amounts; there will be no change to its net assets. If the expense is incurred by the parent, the parent could elect to increase the investment in the subsidiary rather than expensing the amount. This could lead to a carrying value that might be impaired. However, if the expense relates to a share-based payment, there is no policy choice; expenses incurred for a subsidiary must be added to the carrying amount of the parent and recognised by the subsidiary (see Chapter 28 at 13). Consistent with the treatment of transactions discussed at 4.4.1.A to 4.4.1.D above, incurring expenses without recharges on behalf of fellow subsidiaries is often at the direction of the entities' parent and therefore, if recognised, are also accounted for as equity transactions.

Many groups recharge expenses indirectly, by making management charges, or recoup the funds through intra-group dividends, and in these circumstances, it is inappropriate to recognise the transaction in any entity other than the one that makes the payment.

A parent or other group entity might settle a liability on behalf of a subsidiary. If this is not recharged, the liability will have been extinguished in the subsidiary's accounts, resulting in a gain and a question of where to recognise it, profit or loss or equity. Except in unusual circumstances, the forgiveness of debt is a contribution from owners and therefore recognised in equity. It is usually appropriate for a parent to add the payment to the investment in the subsidiary as a capital contribution, subject to any impairment of the investment.

How we see it

If one subsidiary settles a liability of its fellow subsidiary, the settling company determines whether it is made at the direction of the entities' common parent. If so, consistent with the guidance at 4.4.1.A above, we believe the settling subsidiary accounts for the transaction in equity as a distribution to the parent. If not, then the settlement is accounted for as an expense through profit or loss.

4.4.2 Transactions involving non-monetary assets

4.4.2.A The parent exchanges property, plant and equipment for a non-monetary asset of the subsidiary

The exchange of an asset for another non-monetary asset is accounted for by recognising the received asset at fair value unless the transaction lacks commercial substance or the fair value of neither the asset received, nor the asset given up is reliably measurable. [FRS 102.17.14].

An exchange of assets with dissimilar values indicates that the transaction includes an equity contribution (unless the difference means that other goods and services are being provided, e.g., a management fee). When there is an equity contribution, the entity has the following accounting choice to recognise the transaction as an exchange of assets:

- At fair value with an equity transaction. Any difference between the fair value of the asset received and the fair value of the asset given up is an equity transaction (or capital contribution) while the difference between the carrying value of the asset given up and its fair value is recognised in OCI as it is not a realised profit.
- Or
- At fair value of the asset received. Any difference between the fair value of the asset received and the carrying value of the asset given up is recognised in OCI as it is not a realised profit.

When the first alternative is used, the difference is accounted by the subsidiary as a contribution or distribution of equity; and by the parent as an increase in the investment held in the subsidiary or a distribution received. As discussed at 4.4.1.C, a distribution received by the parent is recognised in OCI as it is not a realised profit. Consistent with the treatment of capital contributions discussed at 4.4.1.A and 4.4.1.B above, contributions and distributions of non-monetary assets between fellow subsidiaries are often made at the direction of the entities' common parent and are therefore also accounted for as equity transactions.

4.4.2.B Acquisition and sale of assets for shares

These transactions include the transfer of inventory, property, plant and equipment, intangible assets and investment property by one entity in return for the shares of the other entity. These transactions are usually between a parent and subsidiary where the subsidiary issues shares to the parent in exchange for the assets received. The requirements when the asset transferred in exchange for shares is an investment in subsidiary, jointly controlled entity or associate are discussed at 4.2.1.A above and are not repeated here.

Accounting treatment by the subsidiary

For the subsidiary, transactions that involve the transfer of inventory, property, plant and equipment, intangible assets and investment property in exchange for shares are usually within the scope of Section 26. Accordingly, the assets are recognised at fair value unless that fair value cannot be estimated reliably. In that case, the entity measures the assets' value, and the corresponding increase in equity, by reference to the fair value of the equity instruments granted. [FRS 102.26.7].

However, some subsidiaries that are wholly owned are entitled to group reconstruction relief on the shares issued (see 4.2.1.A above) and therefore the question arises as to whether the asset received can be recorded at a cost net of group reconstruction relief (usually the previous carrying amount of the transferor) rather than fair value (the usual approach for share-based payments), by applying s615 of the

Act. As explained at 4.2.1.A above, s615 is a determination of cost that is permitted when the asset transferred is an investment in subsidiary, jointly controlled entity or associate. The Appendix on Legal Requirements to FRS 102 refers to using group reconstruction relief only in terms of the 'cost' of investments in subsidiaries. [FRS 102.A3.24]. Although paragraph A3.24A refers to 'other consideration' for the issue of shares, this quotes the law and is not a clear reference to asset transfers of this nature.

How we see it

In our view, s615 cannot be applied to the initial measurement of the inventory, property, plant and equipment, intangible asset or investment property because:

- Section 26 requires measurement at fair value and s615 is a determination of cost
- And
- Application of s615 is not mandatory and hence there is no conflict with applying Section 26

Therefore, the subsidiary recognises the asset received at fair value. In equity, the entity recognises share capital at the nominal value of shares issued, share premium up to the minimum premium amount required, and any excess credit is taken either to share premium or to another reserve, usually a merger reserve, if group reconstruction relief is taken. Group reconstruction relief is explained further at 4.2.1.A above.

Accounting treatment by the parent

For the parent, based on 4.2.1 above, the cost of the new investment is recorded at the fair value of the consideration given (i.e., the fair value of the asset sold). However, if the transaction lacks substance for the parent, it recognises the additional cost of investment in the subsidiary at the carrying amount of the non-monetary asset given up. This accounting is generally appropriate if the subsidiary is a newly incorporated company or wholly owned. If the transaction has substance to the parent, it could recognise its additional investment in the subsidiary at the fair value of the consideration given, i.e., the fair value of the non-monetary asset given up. Any gain recognised would be unrealised and recognised in OCI, since the additional investment received in the subsidiary, an unquoted subsidiary, would not be regarded as qualifying consideration.

4.4.2.C Acquisition and sale of assets for cash (or equivalent)

These transactions include the transfer of inventory, property, plant and equipment, intangible assets, investment property and investments in subsidiaries, jointly controlled entities and associates by one entity in return for cash or an equivalent consideration such as an intercompany loan. The transactions can be between a parent and a subsidiary or between fellow subsidiaries. Often in these transactions the consideration received is not fair value but the carrying value of the transferred asset in the transferee entity.

How we see it

In our view, consistent with the guidance at 4.4.1.C above, the entity acquiring the asset has a choice to determine cost as either:

- The consideration agreed between the parties.
- Or
- Fair value, regardless of the agreed consideration, with the difference between the consideration and fair value recognised as an equity transaction (or capital contribution).

When fair value is used to determine cost, the difference is a contribution or distribution of equity for the subsidiary and an increase in the investment held in the subsidiary or a distribution received by the parent. As discussed at 4.4.1.D, a distribution received by the parent is recognised in OCI as it is not a realised profit. Consistent with the treatment of capital contributions discussed at 4.4.1.A and 4.4.1.B above, contributions and distributions of non-monetary assets between fellow subsidiaries are often made at the direction of the entities' common parent and are therefore also accounted for as equity transactions.

The consideration received (or paid) is likely to be a financial asset (or financial liability) that is recognised in accordance with the entity's accounting policy choice under Sections 11 or 12 - see 4.4.3 below.

4.4.3 Financial instruments within the scope of Sections 11 and 12

Section 11 requires the initial recognition of financial assets and financial liabilities to be transaction price unless the arrangement constitutes a financing arrangement when it is measured at the present value of future payments discounted at a market interest rate. [FRS 102.11.13].

A loan provided or received at zero (or a below market) rate of interest constitutes a financing transaction. For loans that are not repayable on demand, a difference arises between the amount of the cash received or advanced and the present value of the loan. This also occurs in relation to certain loans, such as public benefit entity concessionary loans and certain loans to small entities. [FRS 102.PBE34.88, FRS 102.11.13A]. This difference reflects the lower than market rate of interest, which is a benefit to the borrower. When the lender and the borrower are related parties because one owns the other or the lender and the borrower are owned by the same person, the difference arising on initial recognition of the loan is generally accounted for in equity as a distribution or capital contribution for a subsidiary (or fellow subsidiary) and an increase in the investment held in the subsidiary or a distribution received by the parent. The accounting for these transactions is discussed in Chapter 13 at 7.2.2 and Chapter 13 at 7.2.3.

When an entity has elected to apply IAS 39 and/or IFRS 9 to recognise and measure financial instruments (as permitted by Sections 11 and 12) the initial recognition is fair value. Any difference between the fair value and the terms of the agreement is recognised as an equity transaction (i.e., either as a distribution or a capital contribution) for a subsidiary (or fellow subsidiary) and an increase in the investment held or a distribution received by a parent. See Chapter 13 at 7.2.3.

4.4.4 Financial guarantee contracts - parent guarantee issued on behalf of subsidiary

Financial guarantee contracts are included in the scope of Section 21 *Provisions and Contingencies* unless: [FRS 102.21.1A]

- An entity has chosen to apply IAS 39 and/or IFRS 9 to its financial instruments.
- Or
- An entity has elected under FRS 103 *Insurance contracts* to continue the application of insurance contract accounting.

When an entity has elected to apply IAS 39 and/or IFRS 9 to its financial instruments, financial guarantees are initially recognised at fair value. Otherwise, they are recognised under Section 21 which means that a liability is not recognised if it is not probable.

When a financial guarantee is initially recognised at fair value, it is normally appropriate for a parent that gives a guarantee to treat the debit that arises on recognising the guarantee at fair value as an additional investment in its subsidiary. The same treatment applies to the debit entry when a guarantee is recognised in accordance with Section 21, when probable. The subsidiary or fellow subsidiary that is the beneficiary of the guarantee does not recognise the financial guarantee unless:

- It is provided to the lender separate and apart from the original borrowing.
- Does not form part of the overall terms of the loan.
- And
- It would not transfer with the loan if it were to be assigned by the lender to a third party.

This means that few guarantees will be reflected separately in the financial statements of the entities that benefit from the guarantees.

4.5 Intermediate payment arrangements

The requirements in respect of intermediate payment arrangements are, in substance, designed to 'consolidate' an employee benefit trust (EBT) or employee share option trust (ESOP) in individual or separate financial statements. It is explained in the Basis for conclusions that these requirements (derived from previous UK GAAP) have been added to Section 9 to avoid an entity that has no entities that it controls other than an intermediate payment arrangement from having to prepare consolidated financial statements. [FRS 102.BC.B9.5].

FRS 102 does not define intermediate payment arrangements. However, Section 9 explains that:
[FRS 102.9.33]

Extract from Section 9

9.13 Intermediate payment arrangement may take a variety of forms:

- (a) The intermediary is usually established by a sponsoring entity and constituted as a trust, although other arrangements are possible.
- (b) The relationship between the sponsoring entity and the intermediary may take different forms. For example, when the intermediary is constituted as a trust, the sponsoring entity will not have a right to direct the intermediary's activities. However, in these and other cases the sponsoring entity may give advice to the intermediary or may be relied on by the intermediary to provide the information it needs to carry out its activities. Sometimes, the way the intermediary has been set up gives it little discretion in the broad nature of its activities.
- (c) The arrangements are most commonly used to pay employees, although they are sometimes used to compensate suppliers of goods and services other than employee services. Sometimes, the sponsoring entity's employees and other suppliers are not the only beneficiaries of the arrangement. Other beneficiaries may include past employees and their dependants, and the intermediary may be entitled to make charitable donations.
- (d) The precise identity of the persons or entities that will receive payments from the intermediary, and the amounts that they will receive, are not usually agreed at the outset.
- (e) The sponsoring entity often has the right to appoint or veto the appointment of the intermediary's trustees (or its directors or the equivalent).
- (f) The payments made to the intermediary and the payments made by the intermediary are often cash payments but may involve other transfers of value.

Examples of intermediate payment arrangements are ESOPs and EBTs that are used to facilitate employee shareholders under remuneration schemes. In a typical employee trust arrangement for share-based payments, an entity makes payments to a trust or guarantees borrowing by the trust and the trust uses those funds to purchase shares to settle the employee's award under the remuneration scheme.

'Consolidation' of the intermediary in the separate financial statements of the sponsoring entity is appropriate because in many typical cases, the sponsoring entity has *de facto* control. I.e., although the trustees of an intermediary must act in accordance with the interests of the beneficiaries of the intermediary (e.g., employees in relation to an EBT), most intermediaries are specifically designed to serve the purposes of the sponsoring entity and minimise the risk of conflict between the duties of the trustees and the interest of the sponsoring entity. Therefore, in practice, the sponsoring entity's wishes are implemented. Where this is the case, the sponsoring entity has *de facto* control. [FRS 102.9.33].

It is possible for an entity to be owned by a trust established for the benefit of employees without the entity controlling the trust. Section 9 provides the example of a co-operative entity, owned by its employees, in which all of the shares are held in trust for the individual employees, but the shares never vest in individual employees. Dividends from the company are distributed to employees in accordance with the provisions of the trust deed. [FRS 102.9.33A].

4.5.1 Accounting for intermediate payment arrangements in the sponsoring entity

When a sponsoring entity makes payments (or transfers assets) to an intermediary, there is a rebuttable presumption that it has exchanged one asset for another and so the payment itself is not an immediate expense. To rebut this presumption at the time the payment is made, the entity must demonstrate that:
[FRS 102.9.34]

- It will not obtain future economic benefit from the amounts transferred.
- Or
- It does not have control of the right or other access to future economic benefit it is expected to receive.

When a payment to an intermediary is an exchange of one asset for another, any asset the intermediary acquires in a subsequent transaction will also be under the control of the entity. Accordingly, assets and liabilities of the intermediary are accounted for by the sponsoring entity as an extension of its own business and recognised in its own individual financial statements. An asset ceases to be recognised as an asset of

the sponsoring entity when, for example, the asset of the intermediary vests unconditionally with the beneficiaries of the intermediary. [FRS 102.9.35].

When a sponsoring entity has control, or *de facto* control, of the assets and liabilities of the intermediary and it distributes its own equity instruments, or other equity instruments to an intermediary, the sponsoring entity is, for all practical purposes, in the same position as if it had purchased the shares directly. [FRS 102.9.36].

When an intermediary holds the sponsoring entity's equity instruments, the sponsoring entity accounts for the assets and liabilities of the intermediary in its individual (or separate) financial statements as follows: [FRS 102.9.37]

- The consideration paid for the equity instruments of the sponsoring entity is deducted from equity until such time that the equity instruments vest unconditionally with employees (like a purchase of treasury shares).
- Consideration paid or received for the purchase or sale of the sponsoring entity's own equity instruments are shown as separate amounts in the statement of changes in equity.
- Other assets and liabilities of the intermediary are recognised as assets and liabilities of the sponsoring entity.
- No gain or loss is recognised in profit or loss or OCI on the purchase, sale, issue or cancellation of the entity's own equity instruments.
- Finance costs and any administration expenses are recognised on an accrual basis rather than as funding payments are made to the intermediary.
- Any dividend income arising on the sponsored entity's own equity instruments is excluded from profit or loss and deducted from the aggregate of dividends paid.

Illustration 4-4 below shows the application of these requirements.

Illustration 4-4: EBTs in individual or separate financial statements of sponsoring entity

A sponsoring entity lends its EBT £1,000,000 which the EBT uses to make a market purchase of 200,000 shares in the entity. Employees of the entity are beneficiaries of the trust and, a short while after purchase, the shares vest unconditionally with the identified beneficiaries in exchange for a payment of £200,000. During the period the EBT pays £100,000 of administration costs.

In the separate or individual financial statements of the entity, on the basis that the sponsoring entity accounts for the EBT as an extension of its own business the following accounting entries result:

	Dr	Cr
	£'000	£'000
Equity	1,000	
Cash (market purchase of shares)		1,000
Equity		200
Cash (Shares vest to employees)	200	
Profit or loss	100	
Cash (administration expenses)		100

No entries are made for the 'loan' between the sponsoring entity and the EBT as this is considered to be a transaction by the sponsoring entity with itself.

Any share-based payment charges incurred by the sponsoring employee in respect of the shares granted to the employees are accounted for separately under Section 26.

4.6 Disclosures in individual and separate financial statements

4.6.1 Disclosures required by Section 9 in separate financial statements

The following disclosures are required when a parent prepares separate financial statements:

- That the statements are separate financial statements.
- A description of the methods used to account for investments in subsidiaries, associates and jointly controlled entities. [FRS 102.9.27].
- A parent that uses one of the exemptions from presenting consolidated financial statements (described in 3.1 above) discloses the grounds on which the parent is exempt. [FRS 102.9.27A].

- When a parent adopts a policy of accounting for its subsidiaries, associates or jointly controlled entities at fair value with changes in fair value recognised in profit or loss, it must make the disclosures required by Section 11 (see Chapter 15 at 4.1.2.H) in order to comply with the requirements of paragraph 36(4) of Schedule 1 to the Regulations (and the equivalent paragraphs in Schedules 2 and 3). [FRS 102.9.27B]. These disclosures must be made even if the parent is a qualifying entity (see Chapter 1) since they are required by the Regulations.

4.6.2 Disclosures required by Section 9 in individual and separate financial statements in respect of intermediate payment arrangements

When a sponsoring entity recognises the assets and liabilities held by an intermediary, it discloses sufficient information in the notes to its financial statements to enable users to understand the significance of the intermediary and the arrangement in the context of the sponsoring entity's financial statements. This includes: [FRS 102.9.38]

- A description of the main features of the intermediary including the arrangements for making payments and for distributing equity instruments.
- Any restrictions relating to the assets and liabilities of the intermediary.
- The amount and nature of the assets and liabilities held by the intermediary which have not yet vested unconditionally with the beneficiaries of the arrangement.
- The amount that has been deducted from equity and the number of equity instruments held by the intermediary, which have not yet vested unconditionally with the beneficiaries of the arrangement.
- For entities that have their equity instruments listed or publicly traded on a stock exchange or market, the market value of the equity instruments held by the intermediary which have not yet vested unconditionally with employees.
- The extent to which the equity instruments are under options to employees, or have been conditionally gifted to them.

And

- The amount that has been deducted from the aggregate dividends paid by the sponsoring entity.

4.6.3 Additional disclosures in respect of investments in subsidiaries in separate financial statements required by the CA 2006 and the Regulations

The following disclosures are required by the CA 2006 and the Regulations in respect of subsidiaries, in separate financial statements:

- The name of each subsidiary undertaking and the address of the undertaking's registered office (whether in or outside the United Kingdom) and, if unincorporated, the address of its principal place of business. There is no relief available to limit this disclosure to those of the principal subsidiaries if it is of excessive length. This applies to both direct and indirect subsidiaries. [4 Sch 1].

- For each subsidiary not included in the consolidated accounts: [4 Sch 2]

- The aggregated amount of its capital and reserves as at the end of its relevant financial year

And

- Its profit or loss for that year

This information is not required if the subsidiary is included in the consolidated accounts under the equity method of accounting or if the subsidiary is not required by the CA 2006 to deliver a copy of its balance sheet for its relevant financial year and does not otherwise publish its balance sheet anywhere in the world and the company's holding is less than 50% of the nominal value of the shares (or if the information is not material).

- The number, description and amount of shares in the parent company held by or on behalf of subsidiary undertakings must be disclosed. [4 Sch 3].

If the company is not required to prepare group financial statements:

- The reasons why that is the case. [4 Sch 10(1)].
- If the reason is that all the subsidiaries fall within the exclusions provided in section 405 (see 3.1.1.E and 3.4 above), with respect to each subsidiary, which of the exclusions applies. [4 Sch 10(2)].
- For each subsidiary, the identity of each class of shares held and the proportion of the nominal value of that class of shares held, with shares held directly by the company itself distinguished from those attributed to the company held by subsidiaries. [4 Sch 11].

- When a subsidiary undertaking's financial year does not end with that of the company, the date on which the last financial year ended (last before the end of the company's financial year). *[4 Sch 12]*.
- If exempt by virtue of section 400 (see 3.1.1 and 3.1.1.A above) or section 401 (see 3.1.1 and 3.1.1.B above), the fact that it is exempt from the obligation to prepare and deliver group accounts and, in respect of the undertaking in whose consolidated financial statements it is included, the name, the address of the undertaking's registered office (whether in or outside the UK) and, if unincorporated, address of its principal place of business. *[s400(2Xc), s400(2Xd), s401(2Xd), s401(2Xe)]*.

Disclosures in respect of investments in associates and jointly controlled entities in separate financial statements are discussed in Chapter 17 at 4.2.5 and Chapter 18 at 3.10.3.B respectively.

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS are set out below.

	FRS 102	IFRS
Requirement to prepare consolidated financial statements	Required only if an entity is a parent at the reporting date.	Required if an entity was a parent at any time during the reporting period.
Exemptions from consolidation for parents	Companies subject to the small companies' regime are exempt provided they are not a member of a group which, at any time during the financial year, has an ineligible member. A UK entity that is an intermediate parent is exempt under section 400 (where it has a UK immediate parent) or section 401 (where it has a non-UK parent) of the Companies Act 2006 if included in the consolidated financial statements of a higher parent. There are several conditions that must be met including restrictions over which GAAP is used in the consolidated financial statements of the higher parent. There are other exemptions from preparing consolidated financial statements, including where all subsidiaries are required to be excluded from consolidation.	No exemption for small companies. Under IFRS 10, intermediate parents are exempt but only if included in consolidated financial statements of a parent prepared under IFRS that are available for public use (and subject to further conditions). However, despite IFRS 10, a UK intermediate parent subject to the Companies Act 2006 that prepares its accounts under UK-adopted international accounting standards (or EU-adopted IFRS) may still take advantage of the exemptions from preparing consolidated financial statements available under UK company law which allow the higher parent to prepare consolidated financial statements under additional GAAPs (so not restricted to IFRS). This exemption is not available to entities preparing IFRS as issued by the IASB. All subsidiaries are consolidated, except for certain subsidiaries held by an investment entity (see below). An investment entity parent that applies the exception to consolidation for all of its subsidiaries in the current and comparative periods presents separate financial statements as its only financial statements.
Definition of control	Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Limited application guidance.	An investor controls an investee if and only if: (a) It has power over the investee (existing rights that give it the current ability to direct the relevant activities) (b) it has exposure, or rights, to variable returns from its involvement with the investee, and (c) has the ability to affect those returns through its power over the investee (d) More detailed application guidance.

FRS 102		IFRS
Subsidiaries excluded from consolidation	Subsidiaries are excluded from consolidation if they operate under severe long-term restrictions or are held exclusively with a view to subsequent resale.	No similar concepts. However, a subsidiary which operates under severe long-term restrictions may fail to meet the IFRS definition of a subsidiary due to lack of control.
Investment entities	Subsidiaries held as part of an investment portfolio are not consolidated but recognised at fair value through profit or loss.	A parent that is an investment entity must measure all subsidiaries (other than those providing investment management services that are not investment entities) at fair value through profit or loss.
Special purpose entity/Structured entity	A special purpose entity is an entity created to establish a narrow objective. Control of a special purpose entity is a risks/reward model.	A structured entity is an entity designed so that voting or similar rights are not the dominant factor in deciding who controls it. Same control criteria as for other entities.
Initial measurement of NCI in a business combination	Measured at the NCI's share of the net amount of the identifiable assets, liabilities and contingent liabilities recognised.	Accounting policy choice for acquirer to recognise NCI (that are present ownership interests and entitle the holder to a proportionate share of net assets in the event of a liquidation) at either their share of net amount of identifiable assets or at fair value. Other NCI must be recognised at fair value.
Accounting for retained interest on loss of control of a subsidiary	Carrying amount of net assets (and goodwill) is cost on initial measurement of retained investment.	Retained investment must be recognised at fair value on date that control is lost.
Cumulative exchange differences on disposal of a foreign operation when control of a subsidiary is lost	Not recycled to profit or loss.	Recycled to profit or loss.
Cumulative exchange differences on partial disposal of a foreign operation without loss of control	No specific guidance on the accounting for amounts recognised in OCI (such as cumulative exchange differences) and whether they would be reattributed to NCI within equity. In our view, it is logical that such a reattribution would occur. But in any event, cumulative exchange differences are not reclassified on a subsequent loss of control (see above).	Recycled to NCI on a proportionate basis.
Exchanges of business or other non-monetary assets for an interest in a subsidiary in consolidated financial statements	FRS 102 recognises a gain only on the part of the business/non-monetary assets that is no longer owned by the reporting entity. Gains that are not realised are reported in OCI.	The accounting could differ from FRS 102, depending on the particular facts and circumstances and the requirements of IFRS. No distinction between realised and unrealised gains and all gains/losses reported in profit or loss.

FRS 102		IFRS
Investments in subsidiaries, associates and jointly controlled entities in individual and separate financial statements	Accounting policy choice for each class (subsidiaries which are held as part of an investment portfolio, subsidiaries that are not held as part of an investment portfolio, associates and jointly controlled entities) to measure at either cost, fair value through OCI or fair value through profit or loss. The equity method of accounting is not permitted.	Accounting policy choice for each category to measure at either cost, fair value through OCI, fair value through profit or loss or under the equity method of accounting.
Cost of investment in a subsidiary in separate financial statements	Merger relief and group reconstruction relief is available, in certain circumstances, that permits cost to be equal to the nominal value of shares issued (merger relief) or cost to the transferor (or if lower, the previous carrying amount of the investment) in the transferor's books (group reconstruction relief).	IAS 27 does not specifically define 'cost' except in certain circumstances. As detailed in the EY Publication, International GAAP®, we believe it is acceptable to measure the costs of the investment acquired in a share-for-share exchange based on the carrying amount of the investment in the subsidiary in the transferor entity's separate financial statements rather than the fair value of the shares given as consideration. A new parent must measure cost at the carrying amount of its share of the equity items of the original parent for certain group reconstructions.
Intermediate payment arrangements	Accounted for as an extension of the parent's own business in its separate financial statements.	No guidance. In practice, an entity could use either the parent extension method or treat as an investment in subsidiary.
Disclosures in consolidated financial statements (key differences)		
NCI that are material to the reporting entity	Summarised financial information is not required.	Summarised financial information is required for each subsidiary with material NCI.
Interests in consolidated special purpose or structured entities	No specific disclosures required for consolidated special purpose entities (would be included within the general disclosure requirements for subsidiaries).	Disclosures required in respect of contractual arrangements, obligations and intentions to provide financial support to consolidated structured entities.
Investments in unconsolidated special purpose/structured entities	Disclosure of the nature and extent of interests and the risks associated with those entities. Basis for conclusions refers to disclosure as 'principle based'. No additional guidance.	Disclosure of nature and extent of interests and nature of and changes in the risks associated with those entities. Extensive additional guidance and mandated disclosures (in addition to disclosures required by other IFRSs).
Significant restrictions and financial support provided to subsidiaries	Disclosure of significant restrictions on ability to transfer funds to parent.	As well as disclosure of significant restrictions, disclosures required of guarantees, provisions of financial support (contractual and non-contractual) and current tends to provide financial support.

FRS 102		IFRS
Changes in ownership interest of a subsidiary that do not result in loss of control	No separate schedule required.	Separate schedule required showing the effects on equity attributable to owners of the parent of any changes.
Unconsolidated subsidiaries	The Regulations require disclosure of the capital and reserves and profit and loss for each material subsidiary not included in the consolidated financial statements.	Separate disclosure required of significant restrictions and financial support. No requirement to disclose the capital and reserves and profit and loss for each material subsidiary not included in the consolidated financial statements.
Differences of accounting rules as between a parent's group and individual accounts	Disclosure required by the Regulations.	No disclosure requirement.
Disclosures in individual and separate financial statements (key differences)		
Investments in unconsolidated special purpose/structured entities	No specific disclosures required (in addition to those required by other sections of FRS 102).	Extensive disclosures required (in addition to disclosures required by other IFRSs).
Intermediate payment arrangements	Various disclosures required.	No specific disclosures required for intermediate payment arrangements (although these may be structured entities - see above).

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
control (of an entity)	The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
held as part of an investment portfolio	An interest is held as part of an investment portfolio if its value to the investor is through fair value as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out business. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments.
held exclusively with a view to subsequent resale	An interest: (a) for which a purchaser has been identified or is being sought, and which is reasonably expected to be disposed of within approximately one year of its date of acquisition; or (b) that was acquired as a result of the enforcement of a security, unless the interest has become part of the continuing activities of the group or the holder acts as if it intends the interest to become so; or (c) which is held as part of an investment portfolio.
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts' as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts' as set out in section 72A of the Building Societies Act 1986.
non-controlling interest	Separate financial statements are included in the meaning of this term. The equity in a subsidiary not attributable, directly or indirectly, to a parent.
parent	An entity that has one or more subsidiaries.
separate financial statements	Those presented by a parent in which the investments in subsidiaries, associates or jointly controlled entities are accounted for either at cost or fair value rather than on the basis of the reported results and net assets of the investees. Separate financial statements are included within the meaning of individual financial statements.
subsidiary	An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

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Chapter 9

Accounting policies, estimates and errors

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Overview

This chapter addresses the requirements of Section 10 *Accounting Policies, Estimates and Errors*. Section 10 provides guidance on how to develop accounting policies in a general and conceptual way; the section covers how to select and apply accounting policies used in preparing financial statements, whereas other individual sections within FRS 102 set out specific accounting requirements for the areas with which they deal. Section 10 sets out the difference between accounting policies and accounting estimates, how to address changes in accounting estimates, as well as explaining how errors are corrected. General principles on which accounting policies are based are addressed in Section 2 *Concepts and Pervasive Principles* (see Chapter 4).

What you need to know

Section 10 applies to:

- Selecting and applying accounting policies.
 - Accounting for changes in accounting policies which are usually accounted for retrospectively by way of a prior period adjustment.
 - Changes in accounting estimates which are accounted for prospectively in the current reporting period.
- And
- Corrections of prior period errors which are accounted for retrospectively by way of a prior period adjustment.

In the absence of specific requirements relating to a transaction, event or condition, Section 10 introduces a hierarchy of sources to consider when developing an accounting policy to address such items.

1 Introduction

Section 10 sets out the requirements for: (a) selecting and applying the accounting policies used in preparing financial statements; (b) accounting for changes in accounting estimates; and (c) accounting for corrections of errors in prior period financial statements. [FRS 102.10.1].

Overall, Section 10 is similar to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*: the definitions of 'accounting policy' and 'accounting estimate' respectively are identical, but IAS 1 *Presentation of Financial Statements* provides further guidance on how to implement the requirements.

For periods beginning on or after 1 January 2027, IAS 1 is replaced by IFRS 18 *Presentation and Disclosure in Financial Statements*. Some of the requirements from IAS 1 have been moved to IAS 8, which will be entitled IAS 8 *Basis of Preparation of Financial Statements*. Therefore, IAS 8 will contain requirements for additional topics compared to those covered in Section 10 - see 2.3 below. Where references are made to IAS 8 in this Chapter, references are relevant to both the existing standard and the revised standard.

2 Comparison between Section 10 and IFRS

The principal differences between Section 10 and IFRS are in respect of:

- The hierarchy established where the accounting for a transaction is not specifically addressed within the standard (see 2.1 below).
- Disclosure of the impact of accounting standards issued but not effective and not applied (see 2.2 below).

And

- Presentation of a third statement of financial position (see 2.3 below).

2.1 Hierarchy for selecting accounting policies

Where a section or standard does not specifically address a transaction, other event or condition, Section 10 permits but does not require an entity's management to refer to adopted IFRS in the hierarchy established to determine how judgement is used in developing and applying an accounting policy.

[FRS 102.10.6]. IAS 8's equivalent wording refers to any other standard setting body that uses a similar conceptual framework (to IFRS). [IAS 8.12]. This may result in different accounting policies being applied under FRS 102 for a particular transaction, event or condition compared to IFRS.

2.2 Disclosure of the impact of accounting standards issued but not effective and not applied

Section 10 does not require disclosure of the existence of, or possible impact on, the financial statements of future changes to FRS 102 that have been issued but are not yet effective and not applied. This would apply both to changes to individual sections of FRS 102 and changes to IFRS standards which are being applied by a reporting entity under paragraphs 1.4, 1.5 and 1.7 or 11.2(b) and 11.2(c) of FRS 102 (for example IAS 33 *Earnings per Share*).

IAS 8 requires disclosure of the existence of and known or reasonable estimable information of the possible impact of, a new IFRS which is not effective and not applied, on the reporting period of initial application.

[IAS 8.30].

2.3 Presentation of a third statement of financial position

Section 10 does not require a third statement of financial position as at the beginning of the preceding period to be presented whenever an accounting policy is applied retrospectively, or a retrospective restatement or reclassification is made in the financial statements.

IAS 1 (and subsequently IFRS 18) require a third statement of financial position in such circumstances.

[IAS 1.40A, IFRS 18.37].

2.4 Topics covered in IAS 8 which are not addressed in Section 10

As noted above, following the issuing of IFRS 18, certain topics have been moved from IAS 1 to IAS 8. As a result, the scope of the amended IAS 8 is wider than that of Section 10. The following topics are not addressed in Section 10, but are covered in other sections of FRS 102, marked below in brackets:

- Fair presentation ('true and fair') (Section 3 - see Chapter 6 at 3)
- Going concern (Section 3 - see Chapter 6)
- Accrual basis of accounting (Section 2 - see Chapter 4)
- Disclosure of material accounting policy information (Section 8 - See Chapter 6)
- Disclosure of judgements (Section 8 - see Chapter 6)

And

- Disclosure of sources of estimation uncertainty (Section 8 - see Chapter 6)

3 Requirements of Section 10 for accounting policies, estimates and errors

Section 10 sets out the requirements for selecting and applying accounting policies, as well as accounting for changes in accounting estimates and corrections of errors in prior period financial statements.

[FRS 102.10.1].

3.1 Selection and application of accounting policies

Accounting policies are defined as the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. [FRS 102 Appendix I, FRS 102.10.2]. This means that an accounting policy does not only address how to measure a transaction but also how to classify and present items in the financial statements. For example, an entity makes an accounting policy choice as to whether to adopt a single statement of comprehensive income or a two statement presentation. Similarly, an entity makes an accounting policy choice as to whether to present operating cash flows under the direct or indirect method.

The starting point of Section 10 is that if a section of FRS 102 specifically addresses a transaction, other event or condition, an entity must apply that section. However, the concept of materiality applies equally to accounting policies as to other areas of the financial statements and therefore a specific requirement need not be followed if the effect of doing so would not be material. [FRS 102.10.3]. See Chapter 4 at 3.3.1.B for a discussion of the concept of materiality.

There will be circumstances where a particular event, transaction or other condition is not specifically addressed by a section of the standard. When this is the case, Section 10 sets out a hierarchy of guidance to use in order to develop and apply an accounting policy. A policy developed applying the hierarchy will necessitate management to use judgement and resulting information must be: [FRS 102.10.4]

- Relevant to the economic decision-making needs of users
- Reliable, in that the financial statements:
 - Represent faithfully the financial position, financial performance and cash flows of the entity
 - Reflect the economic substance of transactions, other events and conditions, and not merely the legal form
 - Are neutral, i.e., free from bias
 - Are prudent
- And
- Are complete in all material respects

The hierarchy of guidance which must be considered, and guidance which may be considered, is set out below. Management is required to refer to and consider the applicability of the following sources in descending order of authority:

- The requirements and guidance in an FRS dealing with similar and related issues.
- Where an entity's financial statements are within the scope of a Statement of Recommended Practice (SORP), the requirements and guidance in that SORP dealing with similar and related issues.
- And
- The definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2. [FRS 102.10.5].

Management may also consider the requirements and guidance in adopted IFRS dealing with similar and related issues. Section 1 *Scope* requires certain entities to apply IAS 33 (as adopted in the relevant jurisdiction), IFRS 8 *Operating Segments* (as adopted in the relevant jurisdiction) or IFRS 6 *Exploration for and Evaluation of Mineral Resources* (as adopted in the relevant jurisdiction) and therefore, where applicable, the accounting policies required by those standards must be followed. [FRS 102.10.6].

Section 10 does not state that an entity may refer to any GAAP other than adopted IFRS.

How we see it

In our opinion, where FRS 102 does not specifically address a matter, an entity would not be prevented from continuing to apply an accounting policy for a transaction that was applied under a third party GAAP, or previously extant UK GAAP, provided the policy was consistent with the guidance, definitions, criteria and concepts contained in the sources referred to by the hierarchy above.

The hierarchy implies that it is not possible to apply an accounting policy for a transaction using the criteria in Section 2 where the accounting for that transaction is specifically addressed by FRS 102 or a relevant SORP (since Section 2 can only be consulted in the absence of specific guidance). However, Section 3 *Financial Statement Presentation* states that there may be special circumstances where management concludes that compliance with FRS 102 would be so misleading that it would conflict with the objective of financial statements of entities as set out in Section 2. In such circumstances, an entity can depart from the specific requirements of FRS 102 by using a true and fair override. [FRS 102.3.4]. See Chapter 6 at 8.2.2 for discussion of the use of the true and fair override.

The hierarchy in Section 10 does not refer to UK Company Law. The implication from Section 10 is that, where choice is available, an accounting policy must be selected on its merits based on the criteria in FRS 102 (relevance and reliability) rather than to comply with the law (for example, The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (the Regulations). Some accounting policy choices permitted or required by FRS 102, for example measuring certain financial liabilities at fair value through profit or loss, are not allowed by the Regulations. However, Section 3 requires an entity to make disclosures when it has departed from a requirement of applicable legislation. [FRS 102.3.5, FRS 102.3.6].

3.2 Consistency of accounting policies

FRS 102 sets out requirements which address the selection and application of accounting policies.

Extract from FRS 102

- 10.7** An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions unless an FRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an FRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category. [FRS 102.10.7].

There is no requirement in FRS 102 for each entity within a group to have consistent accounting policies in their separate or individual financial statements. Indeed, FRS 102 anticipates that this will not be the case by requiring consolidated financial statements to be adjusted where a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events. [FRS 102.9.17]. The Regulations also do not require each entity within a group to have consistent accounting policies. However, Section 10 requires an entity to select accounting policies that are both relevant to the economic decision-making needs of its users and reliable. [FRS 102.10.4]. Therefore, factors that one group entity takes into account in setting its accounting policies will normally also apply to other group entities.

3.3 Changes in accounting policies

Entities are only permitted to change an accounting policy in two specified circumstances:

Extract from FRS 102

- 10.8** An entity shall change an accounting policy only if the change:
- (a) is required by an FRS; or
 - (b) results in the financial statements providing reliable and more relevant information about effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. [FRS 102.10.8]

This means that a change in accounting policy cannot be made on an arbitrary basis.

Reliability is defined as the quality of information that makes it free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent. [FRS 102 Appendix I]. In previous versions of FRS 102, reliability constituted one of the qualitative characteristics of information in financial statements. However, since the alignment of the concepts in Section 10 with those in the IFRS Conceptual Framework, reliability is no longer identified as either a fundamental or enhancing qualitative characteristic and is only defined in the Appendix. Despite this omission as a characteristic, the definition of reliability is closely aligned to that of faithful representation and the term is still widely used throughout FRS 102. In Section 10, reliability remains a central concept in assessing whether a change in accounting policy is acceptable.

Relevant financial information is defined as information capable of making a difference in the decisions made by users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. [FRS 102.2.10].

If an FRS allows a choice of accounting treatment (including the measurement basis) for a specified transaction or other event or condition and an entity changes its previous choice, then that is a change in accounting policy. [FRS 102.10.10].

As noted at 3.1 above, an accounting policy is not restricted to the measurement of a transaction but also encompasses how items are classified and presented in the financial statements. Therefore, changes in presentation, such as a decision to change from a single statement of comprehensive income approach to a two statement approach is a change in accounting policy. [FRS 102.5.3].

The following are stated specifically not to be changes in accounting policies: [FRS 102.10.9]

- The application of an accounting policy for transactions, other events and conditions that differ in substance from those previously occurring.
- The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were not material.

And

- A change to the cost model when a reliable measure of fair value is no longer available (or vice versa) for an asset that an FRS would otherwise require or permit to be measured at fair value.

There are two exceptions to the usual application of the requirements for changes in accounting policies as follows:

- First time application of a policy to revalue assets (in accordance with Section 17 *Property, Plant and Equipment* or Section 18 *Intangible Assets other than Goodwill*) constitutes a change in accounting policy to be dealt with as a revaluation in accordance with those sections. [FRS 102.10.10A]. This means that the revaluation is accounted for prospectively using the fair value at the date of the revaluation. [FRS 102.17.15B, FRS 102.18.18B].
- A change in the measurement of a class of biological assets and its related agricultural produce from the cost model to the fair value model in accordance with Section 34 *Specialised Activities* is a change in accounting policy dealt with as a change in fair value less costs to sell in accordance with section 34. [FRS 102.10.10B].

Section 11 *Basic Financial Instruments* provides an accounting policy choice between applying the requirements of either sections 11 and 12, IAS 39 or IFRS 9 (see Chapter 11 at 4). However, once the accounting policy choice has been made, an entity can only change from either Section 11 or 12 or IFRS 9 *Financial Instruments* to IAS 39 *Financial Instruments: Recognition and Measurement* if the change is to make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which it is included. In other words, an entity does not have a free choice to change its accounting policy to IAS 39 to provide more reliable and relevant information and can only do so in the single circumstance specified above.

3.3.1 Applying changes in accounting policies

An entity must account for changes in accounting policies as follows:

- A change in an accounting policy resulting from a change in the requirements of an FRS are accounted for in accordance with the transitional provisions, if any, specified in that amendment.
- Where an entity has elected under paragraph 2 of Section 11 to follow IAS 39 and/or IFRS 9 and the requirements of IAS 39 and/or IFRS 9 change, the entity accounts for that change in accounting policy in accordance with the transitional provisions, if any, specified in the revised IAS 39 and/or IFRS 9.
- Where, under paragraphs 1.4, 1.5 or 34.11 of FRS 102, an entity is required or has elected to apply IAS 33, IFRS 8 or IFRS 6 and the requirements of those standards change, the entity accounts for the change in accordance with the transitional provisions, if any, specified in those standards as amended. And
- All other changes in accounting policy are accounted for retrospectively (see 3.3.2 below). [FRS 102.10.11].

When an entity applies an accounting policy based on an IFRS, other than the specific IFRSs referred to above (IFRS 6, IFRS 8, IFRS 9, IAS 33 and IAS 39), and that IFRS changes, the issue arises of whether the entity is obliged to change its accounting policy to align to the amended IFRS.

How we see it

We consider that when an entity applies an accounting policy based on an IFRS (other than IFRS 6, IFRS 8, IFRS 9, IAS 33 and IAS 39) and that IFRS changes, such a change is at the discretion of the entity, but is appropriate only if it satisfies the relevance and reliability criteria and is not otherwise inconsistent with the FRS 102 hierarchy (see 3.1 above).

All such accounting policy changes are accounted for retrospectively regardless of the specific transitional rules that may apply in the IFRS, because the change does not meet any of the exceptions from retrospective application listed above.

3.3.2 Retrospective application of accounting policy changes

When a change in accounting policy is applied retrospectively in accordance with 3.3.1 above, the entity applies the new accounting policy to comparative information for prior periods at the earliest date for which it is practicable, as if the new accounting policy had always been applied. [FRS 102.10.12].

The following Illustration shows how to apply retrospective accounting.

Illustration 3-1: Retrospective application of change in accounting policy (ignoring tax)

Entity A makes a voluntary change in its accounting policy for measuring its investment in an associate in its separate financial statements to change the measurement basis from cost less impairment to fair value through profit or loss. Fair value through profit and loss is considered by Entity A to be more relevant than cost less impairment. The change is made in Entity A's annual reporting period ending 31 December 20X5. The fair value of the investment was £9,500 at 31 December 20X5, £10,000 at 31 December 20X4 and £9,000 at 31 December 20X3, respectively. The cost less impairment of the investment in associate was £5,000 at 31 December 20X5, 31 December 20X4 and 31 December 20X3, respectively.

In its statement of changes in equity, Entity A restates its equity at 1 January 20X4 by £4,000 to account for the difference between fair value and cost less impairment of the investment in associate at that date. This difference is credited to retained earnings*.

Entity A restates its profit and loss account for the year-ended 31 December 20X4 to recognise the fair value gain of £1,000 on the investment in associate during the year**.

Entity A records a fair value loss of £500 in profit or loss for the year ended 31 December 20X5.

* If the unrealised fair value gain is not a distributable profit, Entity A may wish, instead of crediting retained earnings, to create a separate non-distributable reserve within equity.

** If the unrealised fair value gain is not a distributable profit, Entity A may wish to make a transfer of the unrealised gain in the statement of changes in equity from retained earnings to a separate non-distributable reserve within equity.

As discussed above, applying a new accounting policy retrospectively means applying it as if that policy had always been applied. This implies that hindsight must not be used when applying a new accounting policy, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. Hence, retrospectively applying a new accounting policy requires distinguishing information that provides evidence of circumstances that existed on the prior period date(s) from information which would have been available when the financial statements for that prior period(s) were authorised for issue.

In certain circumstances, it might be impracticable to restate the financial statements of prior years for a change in accounting policy. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. [FRS 102 Appendix I]. Impracticability could arise when the relevant information for the prior years, for example fair value that is not based on an observable price or input, is not available and the entity is unable to calculate the amount after making every reasonable effort.

When it is impracticable to determine the individual-period effects of a change in accounting policy on comparative information for one or more prior periods presented, the entity applies the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and makes a corresponding adjustment to the opening balance of each affected component of equity for that period. [FRS 102.10.12].

IAS 8 contains additional guidance on impracticability which is not included in Section 10 but which might be helpful to users and which could be applied via the hierarchy (see 3.1 above). This guidance states that it is impracticable to apply a change in accounting policy retrospectively or to correct an error retrospectively (see 3.5 below) if:

- The effects of the retrospective application or retrospective restatement are not determinable.
- The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.

Or

- The retrospective application or retrospective restatement requires significant estimates of amounts and that it is impossible to distinguish objectively information about those estimates that:
 - Provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed.

And

- Would have been available when the financial statements for that prior period were authorised for issue, from other information. [IAS 8.5].

3.4 Accounting estimates

FRS 102 observes that measurement uncertainty may arise when applying an accounting policy to certain items in financial statements. This happens in cases where the monetary amounts cannot be observed directly and are subject to estimate. In these cases, an entity develops an accounting estimate which will achieve the objective set out by the accounting policy. Developing accounting estimates involves the use of judgements or assumptions based on the latest available, reliable information. Section 10 provides the following examples of accounting estimates:

- The fair value of an asset or liability, applying Section 2A *Fair Value Measurement*.
 - The estimated selling price less costs to sell of an item of inventory, applying Section 13 *Inventories*.
 - The depreciation expense for an item of property, plant and equipment applying Section 17 *Property, Plant and Equipment*.
 - A provision for warranty obligations, applying Section 21 *Provisions and Contingencies*.
- And
- The recoverable amount of an item of property, plant and equipment, applying Section 27 *Impairment of Assets*. [FRS 102.10.14A].

In developing an accounting estimate, an entity uses measurement techniques and inputs which include estimation techniques and valuation techniques. [FRS 102.10.14B]. Section 10 clarifies that the term 'estimate' in FRS 102 sometimes refers to an estimate that is not an 'accounting estimate' as defined in Section 10, for example, an input used in developing an accounting estimate. [FRS 102.10.14C].

3.4.1 Changes in accounting estimates

Estimates will need revision as changes occur in the circumstances on which they are based or as a result of new information, new developments or more experience. [FRS 102.10.14D]. A change in an input or a change in a measurement technique impacting an accounting estimate are changes in accounting estimates, unless they result from the correction of prior period errors. Errors do not result from changes in circumstances or the availability of new information. See 3.5 below. [FRS 102.10.15].

However, a change in the measurement basis applied is a change in accounting policy and not a change in accounting estimate. [FRS 102.10.15]. There is one exception to this - if a reliable measure of fair value is no longer available for an asset which an FRS requires to be measured at fair value, a change to the cost model does not constitute a change in accounting policy. The reverse of this also applies; if a reliable fair value hitherto unavailable becomes available, the change from the cost model to the fair value model is similarly not a change in accounting policy.

The distinction between an accounting policy and an accounting estimate is important because a different accounting treatment is applied when there are changes in accounting policies or accounting estimates. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate. [FRS 102.10.15].

By its nature, a change in an accounting estimate is not caused by a prior period event. Consequently, the effect of a change in accounting estimate is required to be recognised prospectively in profit or loss by including it in:

- The period of the change, if the change affects that period only.

Or

- The period of the change and future periods, if the change affects both. [FRS 102.10.16].

An example of a change in estimate which would affect the current period only is a change in an estimate of the impairment charge relating to receivables recognised in the previous period. An example of a change which would affect both current and future periods is a change in the estimated useful life of a depreciable asset.

Some changes in accounting estimates will give rise to changes in assets and liabilities or relate to an item of equity. In those circumstances, the reporting entity adjusts the carrying amount of the related asset, liability or equity item in the period of the change. [FRS 102.10.17].

3.5 Corrections of prior period errors

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud. [FRS 102.10.20].

Extract from FRS 102

- 10.19** Prior period errors are omissions from, and misstatements in, an entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
- (a) was available when financial statements for those periods were authorised for issue; and
 - (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

[FRS 102.10.19]. When it is discovered that material prior period errors have occurred, Section 10 requires that they be corrected in the first set of financial statements prepared after the discovery. The correction is excluded from the statement of comprehensive income for the period in which the error is discovered. Rather, it is corrected retrospectively by adjusting prior periods. This is done by: [FRS 102.10.21]

- Restating the comparative amounts for the prior period(s) presented in which the error occurred.
- Or
- If the error occurred before the earliest period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

This process corrects the recognition, measurement and disclosure of amounts of elements of financial statements, as if a prior year error had never occurred.

The same caution on the use of hindsight in applying a new accounting policy (see 3.3.2 above) applies to correction of prior period errors. As is the case for the retrospective application of a change in accounting policy, retrospective restatement for the correction of prior period material errors is not required to the extent that it is impracticable to determine the period-specific effects on comparative information for one or more periods presented. In that case, the entity restates the opening balances of assets, liabilities and equity for the earliest period for which retrospective statement is practicable (which may be the current period). [FRS 102.10.22]. As discussed at 3.3.2 above, IAS 8 contains additional guidance on impracticability.

3.6 Disclosure of a change in accounting policy, a change in accounting estimate and prior period errors

3.6.1 Disclosure of a change in accounting policy

The disclosure requirements distinguish between a change in accounting policy that is mandatory (i.e., caused by a change to an FRS) and a change that is voluntary.

For changes in an accounting policy caused by an amendment to an FRS that have an effect on the current period, any prior period or which might have an effect on future periods, an entity must disclose:

- The nature of the change in accounting policy.

- For the current period and each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item presented.
 - The amount of the adjustment relating to periods before those presented, to the extent practicable.
- And
- An explanation if it is impracticable to determine the amounts to be disclosed above. [FRS 102.10.13].

Therefore, the nature of an accounting policy change that has been made and is expected to impact future periods must be disclosed but the financial impact of such a change need not be quantified.

Financial statements of subsequent periods need not repeat these disclosures.

When a voluntary change in accounting policy has an effect on the current period or any prior period, an entity discloses the following:

- The nature of the change in accounting policy
- The reasons why applying the new accounting policy provides reliable and more relevant information
- To the extent practicable, the amount of the adjustment for each financial statement line item affected, showing separately the amounts:
 - For the current period
 - For each prior period presented

And

 - In the aggregate for periods before those presented

And
- An explanation if it is impracticable to determine the amounts to be disclosed for each financial statement line item above. [FRS 102.10.14].

Financial statements of subsequent periods need not repeat these disclosures.

3.6.2 Disclosure of a change in accounting estimate

Disclosure is required of the nature of any change in an accounting estimate and the effect of the change on assets, liabilities, income and expense for the current period and, if practicable, the effect of the change on one or more future periods. [FRS 102.10.18].

This means that where a change in accounting estimate affects future periods, such as a change in the estimated useful life of a depreciable asset, the reporting entity must provide users of the accounts with information regarding the future impact of that change, if practicable.

In contrast to a change in accounting policy, there is no requirement to disclose the impact of a change in accounting estimate on each financial statement line item.

3.6.3 Disclosure of prior period errors

The following is required to be disclosed in respect of material prior period errors:

- The nature of the prior period error.
 - For each prior period presented, to the extent practicable, the amount of the correction for each financial statement line item affected.
 - To the extent practicable, the amount of the correction at the beginning of the earliest prior period presented.
- And
- An explanation if it is impracticable to determine the amounts to be disclosed above. [FRS 102.10.23].

Financial statements of subsequent periods need not repeat these disclosures.

These disclosures are similar to those required for a change in accounting policy. There is no exemption from disclosure of a prior period error on the grounds that such information might prejudice seriously the position of the reporting entity.

The following Illustration shows the disclosures required for a retrospective restatement of a prior period error.

Illustration 3-2: Retrospective restatement of prior period error

During 20X5, Beta Co discovered that some products that had been sold during 20X4 were incorrectly included in inventory at 31 December 20X4 at £6,500.

Beta's accounting records for 20X5 show sales of £104,000, cost of goods sold of £86,500 (including £6,500 for the error in opening inventory), and income taxes of £5,250.

In 20X4, Beta reported:

	£
Sales	73,500
Cost of goods sold	<u>(53,500)</u>
Profit before income taxes	20,000
Income taxes	<u>(6,000)</u>
Profit	<u>14,000</u>

The 20X4 opening retained earnings were £20,000 and closing retained earnings were £34,000.

Beta's income tax rate was 30% for 20X5 and 20X4. It had no other income or expenses.

Beta had £5,000 of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share.

Beta Co
Extract from the statement of comprehensive income

	(restated)	
	20X5	20X4
	£	£
Sales	104,000	73,500
Cost of goods sold	<u>(80,000)</u>	<u>(60,000)</u>
Profit before income taxes	24,000	13,500
Income taxes	<u>(7,200)</u>	<u>(4,050)</u>
Profit	<u>16,800</u>	<u>9,450</u>

Beta Co
Statement of Changes in Equity

	Share capital	Retained earnings	Total
	£	£	£
Balance at 1 January 20X4	5,000	20,000	25,000
Profit for the year ended 31 December 20X4 as restated	<u>-</u>	<u>9,450</u>	<u>9,450</u>
Balance at 31 December 20X4	5,000	29,450	34,450
Profit for the year ended 31 December 20X5	<u>-</u>	<u>16,800</u>	<u>16,800</u>
Balance at 31 December 20X5	<u>5,000</u>	<u>46,250</u>	<u>51,250</u>

Extracts from the Notes

- Some products that had been sold in 20X4 were incorrectly included in inventory at 31 December 20X4 at £6,500. The financial statements of 20X4 have been restated to correct this error. The effect of the restatement on each financial statement line item affected is shown below.

	Effect on 20X4
	£
Increase in cost of goods sold	(6,500)
Decrease in income tax expense	<u>1,950</u>
Decrease in profit	<u>(4,550)</u>
Decrease in inventory	(6,500)
Decrease in income tax payable	<u>1,950</u>
Decrease in equity	<u>(4,550)</u>

4 Company law matters

4.1 Corrections of prior period errors and defective accounts

If a company's previous annual report and accounts did not comply with the Companies Act 2006 (for example due to an error), s454 of the Act permits the directors to revise any such reports and accounts; this is often referred to as the Defective Accounts regime. If an entity corrects errors by way of a prior year adjustment in its latest financial statements, the directors might consider whether to revise the earlier financial statements, although it is common practice not to do so.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Hierarchy reference to other standard setters	May refer to adopted IFRS, but no reference to other standard setting bodies.	May refer to other standard setting bodies with similar conceptual framework.
Biological assets and its related agricultural produce: change from cost model to fair value model	If the measurement of a class of biological assets and its related agricultural produce is changed from the cost model to the fair value model, this change in accounting policy is to be dealt with as a change in fair value less costs to sell, rather than retrospectively as a change in accounting policy in accordance with Section 10.	There is a presumption in IAS 41 <i>Agriculture</i> that the fair value of all biological assets can be measured reliably. This presumption can only be rebutted on initial recognition for a biological asset (not agricultural produce). Once fair value becomes reliably measurable, the fair value model is applied from that date.
Impracticability	Relief for prior year restatements if impracticable.	Relief for prior year restatements if impracticable (more guidance compared to FRS 102).
Disclosures: IFRS issued but not effective	Disclose nature of changes to FRS 102 that are issued but not effective. Not required to disclose the impact on the financial statements of future periods or description and impact of transitional provisions.	Disclose both nature and impact of IFRS accounting standards issued but not effective and a description of the transitional provisions if applicable and whether those provisions might have an effect on future periods.
Disclosures: third balance sheet	Third balance sheet not required for prior period restatements.	Third balance sheet required for prior period restatements.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

accounting estimates	Monetary amounts in financial statements that are subject to measurement uncertainty
accounting policies	The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements
errors	Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (a) was available when financial statements for those periods were authorised for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
impracticable	Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.
reliability	The quality of information that makes it free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.

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Overview

This chapter deals with the requirements of Section 2A *Fair Value Measurement*.

What you need to know

- Section 2A is a new section added to FRS 102 as a result of the Periodic Review 2024 which replaces guidance contained previously in an Appendix to Section 2 *Concepts and Pervasive Principles*. The section addresses the measurement of fair value whilst the disclosures of fair value are covered by other applicable sections of FRS 102.
- Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” [FRS 102.2A.2]. This is an ‘exit’ price.
- Fair value is determined based on assumptions made by market participants, including considerations of the asset’s condition, location and any restrictions on its sale or use.
- Entities must identify the principal market for the asset or liability, and in some cases, the most advantageous market.
- For non-financial assets, fair value measurement considers the asset’s highest and best use.
- A fair value hierarchy is used in estimating fair value:
 - The best evidence of fair value is an unadjusted quoted price in an active market for the identical (or comparable asset) or liability.
 - When an unadjusted market price is not available, the price of a recent orderly transaction for the identical (or comparable) asset or liability is used.
 - Otherwise, if prices are unavailable, another valuation technique is used.
- If a reliable measure of fair value is not available, an entity is precluded from measuring the asset at fair value.

1 Introduction

Section 2A *Fair Value Measurement* applies when another section of FRS 102 requires or permits measurement or disclosure about fair value measurement. The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date. [FRS 102.2A.2].

- The Periodic Review 2024 introduced more detailed guidance compared to the 2022 version of FRS 102, achieving greater alignment with IFRS. The key changes are summarised as follows:
- The Appendix to Section 2 *Concepts and Pervasive Principles* was replaced and a new Section 2A *Fair Value Measurement* was added to FRS 102.
- The definition of fair value and the guidance on fair value measurement are aligned with IFRS 13. Fair value is now defined as “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” [FRS 102 Appendix I]. This is an exit price notion.
- Fair value is determined based on assumptions made by market participants, including considerations of the asset’s condition, location and any restrictions on its sale or use. Asset specific characteristics are considered rather than those that are transaction specific.
- Entities must identify the principal market for the asset or liability, and in some cases, the most advantageous market.
- For non-financial assets, fair value measurement considers the asset’s highest and best use.
- The fair value hierarchy remains unchanged and must be considered in estimating fair value.
- Valuation techniques comprise a market, cost or income approach and are applied consistently from period to period (in general).
- As a practical expedient, mid-market pricing for fair value measurements within a bid-ask spread is permitted.
- If a reliable measure of fair value is not available, the entity is precluded from measuring the asset at fair value and this is aligned with the previous version of the standard.
- The fair value of a liability must reflect non-performance risk.
- The fair value of financial liabilities due on demand is now addressed by Section 2A rather than Section 12 *Other Financial Instruments Issues*.

2 Comparison between Section 2A and IFRS

The comparable IFRS accounting standard is IFRS 13 *Fair Value Measurement*. The main differences between FRS 102 and IFRS are discussed below. Following the Periodic Review 2024, there are fewer differences to IFRS than previously.

2.1 Definition

The definition of fair value and the methodology for measuring fair value are aligned with IFRS, however, IFRS 13 provides significantly more guidance. This could give rise to divergence in practice as some entities may adopt the detailed guidance in IFRS as part of an accounting policy choice (see 4.10.1 below for discussion of one of these potential differences).

2.2 Measurement

Section 2A contains limited guidance on fair valuing liabilities whilst IFRS 13 contains extensive guidance and additionally includes guidance on fair valuing an entity's own equity. The Section 2A requirements for fair valuing liabilities are discussed in 4.9 below.

2.3 The portfolio exception

IFRS 13 contains an exception to measuring fair value of a group of financial assets and liabilities with offsetting risk exposures, referred to as 'the portfolio exception'. A reporting entity that manages a group of financial assets and financial liabilities with offsetting risks on the basis of its net exposure to market or credit risks is allowed to measure the group based on the price that would be received to sell its net long position, or paid to transfer its net short position, for a particular risk. The objective of the valuation is to determine the price that market participants would pay (or receive) in a single transaction for the entire net risk exposure. There is no similar exception in Section 2A.

2.4 Reliable measurement

Section 2A precludes an entity from measuring items at fair value if fair value cannot be reliably measured. In contrast IFRS 13 provides no such exemption, requiring entities to prioritise observable data and where necessary, apply valuation techniques to measure fair value.

2.5 Disclosure

Section 2A does not include disclosures about fair value. These disclosures are included in the relevant section of FRS 102 that requires measurement at fair value. For instance, Section 34 *Specialised Activities* requires financial institutions to disclose the fair value of financial instruments. Furthermore, the Companies Act 2006 imposes additional disclosure requirements related to fair value measurement. Overall, FRS 102's disclosure requirements are less extensive than those in IFRS 13, which includes enhanced disclosures for level 3 instruments (instruments valued using significant unobservable inputs).

3 The requirements of Section 2A

Prior to the Periodic Review 2024, fair value was defined as “the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm’s length transaction”. [FRS 102(2022) Appendix I]. This was an ‘entry’ price notion and different to IFRS 13’s ‘exit’ price.

Following the post-implementation review of IFRS 13 in 2018 affirming that the standard was functioning as intended and considering the time that had passed since IFRS 13 was first introduced, the FRC incorporated amendments into FRS 102 as part of the Periodic Review 2024. These changes bring the definition of fair value and the associated measurement guidance in line with IFRS 13 effective from 1 January 2026. [FRS 102.B2A.2].

3.1 Scope

Section 2A contains scope exceptions which are largely consistent with those in IFRS 9 *Financial Instruments*, IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Presentation*. The guidance in Section 2A is applied whenever another section of FRS 102 requires or permits fair value measurements or disclosures about fair value measurements, except: [FRS 102.2A.1]

- Share-based payment transactions within the scope of Section 26 *Share-based Payment*.

And

- Leasing transactions within the scope of Section 20 *Leases*.

The section prescribes ‘how’ to measure fair value but not ‘what’ must be measured at fair value, ‘when’, or the accounting for subsequent changes in fair value. An entity must consider other relevant sections of FRS 102 for each of these requirements.

There are two other special circumstances:

- Some sections of FRS 102 require or permit measurements based on fair value, such as fair value less costs to sell. This includes, for example, where the recoverable amount for an asset or cash-generating unit determined in accordance with Section 27 *Impairment of Assets*, is its fair value less costs to sell.
- Biological assets and agricultural produce at the point of harvest are measured at fair value less costs to sell in accordance with Section 34 *Specialised Activities - Agricultural Activities* (see Chapter 36 at 2)

In each of these situations, the fair value component is measured in accordance with Section 2A. Costs to sell or costs of disposal are determined in accordance with the applicable section of FRS 102. Adjustments made to determine a measurement based on fair value excludes factors that have already been considered when determining that fair value. For example, transportation costs taken into account when measuring fair value are not to be adjusted for again when measuring fair value less costs to sell. [FRS 102.2A.24].

3.1.1 Share-based payments

The extant definition of fair value has been retained for Section 26 in order to avoid unintended consequences. This approach is consistent with the approach taken in IFRS 2, upon which Section 26 is based. [FRS 102.B26.13]. For example, Section 26 requires certain share-based payments to be measured at grant date fair value (see Chapter 28). However, the objective of a Section 26 fair value measurement is not entirely consistent with Section 2A. The grant date fair value of such share-based payments is, therefore, measured and disclosed in accordance with Section 26, not Section 2A.

3.1.2 Lease transactions

Section 2A does not apply to any leasing transactions accounted for in accordance with Section 20. The fair value measurement and disclosure requirements in Section 20 apply instead (see Chapter 23).

4 Measurement

4.1 Objective

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date. [FRS 102.2A.2].

A fair value measurement does not consider management's intent to hold an asset or to settle or otherwise hold a liability at the measurement date. Instead, it represents a market-based measurement that contemplates a hypothetical transaction between market participants at the measurement date. It is measured using the assumptions that market participants would use when pricing the asset or liability and therefore, is a market-based measurement rather than being specific to the entity (these concepts are discussed further below). [FRS 102.2A.3].

4.2 Unit of account

The identification of exactly what asset or liability is being measured is fundamental to determining its fair value. Fair value may need to be measured for either:

- A stand-alone asset or liability (e.g., a financial instrument or an operating asset).
- Or
- A group of assets, a group of liabilities, or a group of assets and liabilities (e.g., a cash-generating unit (CGU) or a business).

The unit of account defines what is being measured for financial reporting purposes. It is an accounting concept that determines the level at which an asset or liability is aggregated or disaggregated for the purpose of applying Section 2A, as well as other sections. [FRS 102.2.45, FRS 102.2.46]. The appropriate unit of account is determined by the applicable section of FRS 102 that permits or requires the fair value measurement or disclosure, rather than by Section 2A.

4.2.1 The valuation premise

In valuing non-financial assets, the concepts of 'unit of account' and 'valuation premise' are distinct, even though both concepts deal with determining the appropriate level of aggregation (or disaggregation) for assets and liabilities. The unit of account identifies what is being measured for financial reporting and drives the level of aggregation (or disaggregation) for presentation and disclosure purposes. Valuation premise is a valuation concept that addresses how a non-financial asset derives its maximum value to market participants, either on a stand-alone basis or through its use in combination with other assets and liabilities.

Since financial instruments do not have alternative uses and their fair values typically do not depend on their use within a group of other assets or liabilities, the concepts of highest and best use and valuation premise are not relevant for financial instruments. As a result, the fair value for financial instruments is largely based on the unit of account prescribed by the section that requires (or permits) the fair value measurement.

The distinction between these two concepts becomes clear when the unit of account of a non-financial asset differs from its valuation premise. Consider an asset (e.g., customised machinery) that was acquired other than by way of a business combination, along with other assets as part of an operating line. Although the unit of account for the customised machinery may be as a stand-alone asset (i.e., it is presented for financial reporting purposes at the individual asset level in accordance with Section 17 *Property, Plant and Equipment*), the determination of the fair value of the machinery may be derived from its use with other assets in the operating line (see 4.8.1 below).

4.3 Characteristics of the asset or liability

When measuring fair value, Section 2A requires an entity to consider the characteristics of the asset or liability. Examples of such characteristics include: [FRS 102.2A.4]

- The condition and location of an asset.
- Or
- Restrictions, if any, on the sale or use of an asset.

The fair value of the asset or liability must take into account those characteristics that market participants would take into consideration when pricing the asset or liability at the measurement date. [FRS 102.2A.4]. For example, when valuing individual shares in an unlisted company, market participants might consider factors such as the nature of the company's operations; its performance to date and forecast future performance; and how the business is funded, including whether it is highly leveraged.

4.3.1 Condition and location

An asset may not be in the condition or location that market participants would require for its sale at an observable market price. In order to determine the fair value of the asset as it currently exists, the market price needs to be adjusted to the price market participants would be prepared to pay for the asset in its current condition and location. This includes deducting the cost of transporting the asset to the market if location is a characteristic of the asset being measured, and may include deducting the costs of converting or transforming the asset, as well as a normal profit margin.

For non-financial assets, condition and location considerations may influence, or be dependent on, the highest and best use of an asset (see 4.8.1 below). That is, an asset's highest and best use may require an asset to be in a different condition. However, the objective of a fair value measurement is to determine the price for the asset in its current form. Therefore, if no market exists for an asset in its current form, but there is a market for the converted or transformed asset, an entity could adjust this market price for the costs a market participant would incur to re-condition the asset (after acquiring the asset in its current condition) and the compensation they would expect for the effort.

Illustration 4-1 below provides an example of how costs to convert or transform an asset might be considered in determining fair value based on the current use of the asset.

Illustration 4-1: Adjusting fair value for condition and location

An entity owns a pine forest. The pine trees take approximately 25 years to mature, after which they can be cut down and sold. The average age of the trees in the forest is 14 years at the end of the reporting period. The current use of the forest is presumed to be its highest and best use.

There is no market for the trees in their current form. However, there is a market for the harvested timber from trees aged 25 years or older. To measure the fair value of the forest, the entity uses an income approach and uses the price for 25-year-old, harvested timber in the market today as an input. However, since the trees are not yet ready for harvest, the cash flows must be adjusted for the costs a market participant would incur. Therefore, the estimated cash flows include costs to manage the forest (including silviculture activities, such as fertilising and pruning the trees) until the trees reach maturity; costs to harvest the trees; and costs to transport the harvested logs to the market. The entity estimates these costs using market participant assumptions. The entity also adjusts the value for a normal profit margin because a market participant acquiring the forest today would expect to be compensated for the cost and effort of managing the forest for the period (i.e., 11 years) before the trees will be harvested and the timber is sold (i.e., this would include compensation for costs incurred and a normal profit margin for the effort of managing the forest).

4.3.2 Restrictions on assets or liabilities

Section 2A requires that the effect on fair value of a restriction on the sale or use of an asset is incorporated within the fair value if a market participant would consider the effect. [FRS 102.2A.4]. A restriction that would transfer with the asset in a sale would generally be deemed a characteristic of the asset and, therefore, would likely be considered by market participants when pricing the asset. Conversely, a restriction that is specific to the entity holding the asset would not transfer with the asset in an assumed sale and, therefore, would not be considered when measuring fair value. Determining whether a restriction is a characteristic of the asset or of the entity holding the asset may be contractual in some cases. In other cases, this determination may require judgement based on the specific facts and circumstances.

IFRS 13 has different treatments for restrictions on assets and those over liabilities. A liability may be subject to restrictions that prevent the transfer of the item. When measuring the fair value of a liability in most instances, IFRS 13 does not allow an entity to include a separate input (or an adjustment to other inputs) for such restrictions because the effect of the restriction is either implicitly or explicitly included in other inputs to the fair value measurement. This is not addressed in Section 2A, however, the usual principles of fair value measurement remain applicable. Specifically, any restriction is reflected in the fair value measurement if it would be taken into account by a market participant and has not already been reflected in the transaction price.

How we see it

If an entity is aware that a restriction on transfer of a liability is not already reflected in the price (or in the other inputs used in the measurement), it would adjust the price or inputs to reflect the existence of the restriction. However, in our view this would be rare because nearly all liabilities include a restriction and, when measuring fair value, market participants are assumed to be sufficiently knowledgeable about the liability to be transferred.

4.4 The principal (or most advantageous) market

A fair value measurement contemplates an orderly transaction to sell the asset or transfer the liability in either: *[FRS 102.2A.5]*

- The principal market for the asset or liability.

Or

- In the absence of a principal market, the most advantageous market for the asset or liability.

If there is a principal market for the asset or liability, the fair value measurement represents the price in that market at the measurement date even if the price in a different market is potentially more advantageous. *[FRS 102.2A.5]*.

4.4.1 The principal market

The principal market is the market that has the greatest volume or level of activity for the asset or liability. *[FRS 102 Appendix I]*. There is a general presumption that the principal market is the one in which the entity would normally enter into a transaction to sell the asset or transfer the liability, unless there is evidence to the contrary. *[FRS 102.2A.6]*.

Management is not required to perform an exhaustive search of all possible markets to identify the principal (or most advantageous) market; however, it cannot ignore evidence that is reasonably available when considering which market has the greatest volume and level of activity. *[FRS 102.2A.6]*.

The entity must be able to access the principal market (or the most advantageous market) to transact at the measurement date, even in a hypothetical transaction. If there is no such market to which the entity has access at the measurement date, entities must assume that a transaction takes place at the measurement date as a basis for determining fair value. *[FRS 102.2A.7]*.

In practice, an entity would first consider the markets it can access. Then it would determine which of those markets has the greatest volume and liquidity in relation to the particular asset or liability to decide what the principal market is. Management's intent to transact in a particular market is not a factor in this determination.

4.4.2 The most advantageous market

The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs. *[FRS 102 Appendix I]*.

If there is a principal market for the asset or liability being measured, fair value is determined using the price in that market even if the price in a different market is more advantageous at the measurement date. Only in situations where there is no principal market for the asset or liability being measured, can an entity consider the most advantageous market. *[FRS 102.2A.5]*.

When determining the most advantageous market, an entity must take into consideration the transaction costs and transportation costs it would incur to sell the asset or transfer the liability. The market that would yield the highest price after deducting these costs is the most advantageous market. However, it must be noted that whilst transaction costs and transport costs are considered in determining the most advantageous market, fair value is only adjusted for transportation costs (see 4.7.2 below). *[FRS 102.2A.8]*.

4.5 Market participants

When measuring fair value, an entity is required to use the assumptions that market participants would use when pricing the asset or liability. However, Section 2A does not require an entity to identify specific market participants. Instead, an entity must identify the characteristics of market participants that would generally transact for the asset or liability being measured and this may require judgement.

FRS 102 defines market participants as “buyers and sellers in the principal (or most advantageous) market for the asset or liability”. [FRS 102 Appendix I].

FRS 102 assumes that market participants have all of the following characteristics: [FRS 102 Appendix I]

- They are independent of each other, that is, they are not related parties, as defined in Section 33 *Related Party Disclosures* (see Chapter 35).
- They are knowledgeable, having a reasonable understanding about the asset or liability using all available information.
- They are able to enter into a transaction for the asset or liability.

And

- They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Since market participants are independent of each other, the hypothetical transaction is assumed to take place between market participants at the measurement date, not between the reporting entity and another market participant. [FRS 102.2A.2].

Market participants in the principal (or most advantageous) market are assumed to have sufficient knowledge about the asset or liability for which they are transacting. The appropriate level of knowledge does not necessarily need to come from publicly available information, but could be obtained in the course of a normal due diligence process.

When determining potential market participants, the legal capability and the operating and financial capacity of the market participant to purchase the asset or assume the liability are considered. Market participants must have both the willingness and the ability to transact for the item being measured.

Fair value is not the value specific to the reporting entity and it is not the specific value to one market participant whose risk assessment or specific synergies may differ from other market participants. The reporting entity needs to consider those factors that market participants, in general, would consider. Fair value is not measured based on a single market participant's assumptions or their specific intent or use of the asset or liability. For example, assume a single market participant, Market Participant A, is willing to pay a higher price for an asset than the remaining market participants, due to specific synergies that only Market Participant A could achieve. In such a situation, fair value would not be the price that Market Participant A would be willing to pay for the asset. Instead, fair value would be the price that typical market participants would pay for the asset.

4.6 The transaction

As at the measurement date, the transaction to sell an asset or transfer a liability is, by definition, a hypothetical transaction for the particular asset or liability being measured at fair value.

Section 2A assumes this hypothetical transaction will take place in the principal (or most advantageous) market (see 4.4 above) and will: [FRS 102.2A.2]

- Be orderly in nature.
- Take place between market participants that are independent of each other, but knowledgeable about the asset or liability (see 4.5 above for additional discussion on market participants).

And

- Occur on the measurement date.

These assumptions are important in ensuring that the estimated exit price in the hypothetical transaction is consistent with the objective of a fair value measurement. For example, the concept of an orderly transaction is intended to distinguish a fair value measurement from the exit price in a distressed sale or forced liquidation. Unlike a forced liquidation, an orderly transaction assumes that the asset or liability is exposed to the market prior to the measurement date for a period that is usual and customary to allow for information dissemination and marketing. That is, the hypothetical transaction assumes that market participants have sufficient knowledge and awareness of the asset or liability, including that which would be obtained through customary due diligence even if this process may not have begun yet (or may never occur at all, if the entity does not sell the asset or transfer the liability).

The hypothetical transaction between market participants does not consider whether management actually intends to sell the asset or transfer the liability at the measurement date; nor does it consider the reporting entity's ability to enter into the transaction on the measurement date. [FRS 102.2A.3].

A fair value measurement considers market conditions as they exist at the measurement date and is intended to represent the current value of the asset or liability, not the potential value of the asset or liability at some future date. The transaction is therefore assumed to take place on the measurement date and the entity assumes that the marketing activities and due diligence activities have already been performed.

4.7 The price

FRS 102 defines fair value as "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." [FRS 102 Appendix I].

IFRS 13 requires the entity to estimate fair value based on the price that would be received to sell the asset or transfer the liability being measured (i.e., an exit price). While the determination of this price may be straightforward in some cases (e.g., when the identical instrument trades in an active market), in others it will require significant judgement. Section 2A makes it clear that the price used to measure fair value must not be adjusted for transaction costs, but would consider transportation costs. [FRS 102.2A.8].

4.7.1 Transaction costs

Transaction costs are defined as the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of an asset or the transfer of the liability. In addition, these costs must be incremental, i.e., they would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made and must be necessary for and result directly from the transaction. [FRS 102 Appendix I]. Examples of transaction costs include commissions or certain due diligence costs. Transaction costs do not include transportation costs.

Fair value is not adjusted for transaction costs because transaction costs are not a characteristic of an asset or a liability; they are a characteristic of the transaction. While not deducted from fair value, an entity considers transaction costs in the context of determining the most advantageous market in the absence of a principal market (see 4.4.2 above) because in this instance the entity is seeking to determine the market that would maximise the net amount that would be received for the asset.

4.7.2 Transport costs

Transport costs represent those that would be incurred to transport an asset or liability to (or from) the principal (or most advantageous) market. [FRS 102.2A.8]. If location is a characteristic of the asset or liability being measured (e.g., as might be the case with a commodity), the price in the principal (or most advantageous) market is adjusted for transportation costs.

Illustration 4-2: Transport costs

Entity A holds a physical commodity measured at fair value in its warehouse in Europe. For this commodity, the London exchange is determined to be the principal market as it represents the market with the greatest volume and level of activity for the asset that the entity can reasonably access.

The exchange price for the asset is £25. However, the contracts traded on the exchange for this commodity require physical delivery to London. Entity A determines that it would cost £5 to transport the physical commodity to London and the broker's commission would be £3 to transact on the London exchange.

Since location is a characteristic of the asset and transportation to the principal market is required, the fair value of the physical commodity would be £20 - the price in the principal market for the asset of £25, less transportation costs of £5. The £3 broker commission represents a transaction cost that would not adjust the price in the principal market.

4.8 Application to non-financial assets

4.8.1 Highest and best use

The fair value measurement of non-financial assets must reflect the highest and best use of the asset from a market participant's perspective. Highest and best use is a valuation concept that considers how market participants would use a non-financial asset to generate and maximise the economic benefits or sell to another market participant who would use the asset in its highest and best use. [FRS 102.2A.9]. The maximum value of a non-financial asset to market participants may come from its use: [FRS 102.2A.12]

- In combination with other assets or with other assets and liabilities.
- Or
- On a stand-alone basis

This is the valuation premise and might be its current use or some alternative use. However, there is a presumption that an entity's current use is the highest and best use unless there are factors that suggest a different use by market participants would maximise the value of that asset. [FRS 102.2A.11]. For example, market participants may maximise the value of land, currently used as a site for a manufacturing facility, by using it for residential housing instead.

The concepts of highest and best use and valuation premise are only relevant for non-financial assets and not financial assets and liabilities. This is explained in the basis for conclusions for IFRS 13 in paragraph 63.

In determining the highest and best use of a non-financial asset, Section 2A indicates that uses that are physically possible, legally permissible and financially feasible are to be considered. [FRS 102.2A.10]. As such, when assessing alternative uses, entities must consider the physical characteristics of the asset, any legal restrictions on its use and whether the value generated provides an adequate investment return for market participants.

How we see it

In our view, an entity would need to have sufficient evidence to support its assumption about the potential for an alternative use, particularly in light of Section 2A's presumption that the highest and best use is an asset's current use. Provided there is sufficient evidence to support these assertions, alternative uses that would enable market participants to maximise value are considered.

If there are multiple types of market participants who would use the asset differently, these alternative scenarios must be considered before concluding on the asset's highest and best use.

A careful assessment is particularly important when the highest and best use of a non-financial asset is in combination with other assets and liabilities as a group. In this case, the fair value of the non-financial asset is determined assuming that a market participant already holds the complementary assets and associated liabilities. Assets and liabilities within a group are all valued using the same valuation premise.

[FRS 102.2A.12]. For example, if the fair value of a piece of machinery on a manufacturing line is measured assuming its highest and best use is in conjunction with other equipment in the manufacturing line, those other non-financial assets in the asset group (i.e., the other equipment on the manufacturing line) would also be valued using the same premise, regardless of whether any individual asset within the group would have a higher fair value on a stand-alone basis.

4.9 Application to liabilities

Section 2A applies to liabilities, both financial and non-financial, whenever another section of FRS 102 requires those liabilities to be measured at fair value.

4.9.1 Fair value of a liability

The fair value measurement of a liability contemplates the transfer of the liability to a market participant at the measurement date. [FRS 102.2A.2]. This applies, even if in practice, the entity has no intention of transferring the liability or if there are restrictions in place that prevent its transfer. [FRS 102.2A.3]. The liability is assumed to continue (i.e., it is not settled or extinguished), and the market participant to whom the liability is transferred would be required to fulfil the obligation.

4.9.2 Non-performance risk

The fair value of a liability must reflect the effect of non-performance risk. [FRS 102.2A.13]. Non-performance risk is the risk that an obligation will not be fulfilled. This risk includes, but may not be limited to, the entity's own credit risk, for example, settlement risk. [FRS 102 Appendix I]. In the case of non-financial instruments, such as commodity contracts, non-performance risk could represent the risk associated with physically extracting and transferring an asset to the point of delivery.

Non-performance risk remains unchanged before and after the transfer implying that the liability is hypothetically transferred to a market participant of equal credit standing. [FRS 102.2A.13]. As explained in IFRS 13, one reason for this is because a market participant taking on the obligation would not enter into the transaction without reflecting a difference in credit risk in the price. [IFRS 13.BC94].

No further guidance is provided in FRS 102 on how the requirement is to be applied in practice. For example, when valuing a derivative contract, an entity would need to consider the effect of its own credit risk, often referred to as a debit valuation adjustment (DVA). The concept and valuation methods are discussed further in the most recent version of the EY publication, International GAAP®.

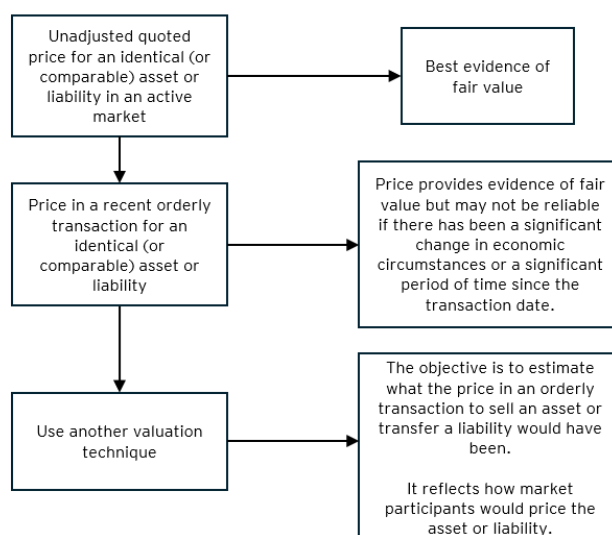
4.9.3 Financial liability with a demand feature

The fair value of a financial liability that is due on demand is deemed to be not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. [FRS 102.2A.14]. The logic is that a rational lender would demand repayment if the fair value were ever less than the net present value of the amount repayable, even though in practice many people do not withdraw their demand deposits in such circumstances. No guidance is provided in this context as to the appropriate discount rate, however, discount rates generally reflect the time value of money and risks specific to the liability. [FRS 102.21.7, FRS 102.27.20]. This requirement is identical to that in IFRS 13.47; hence, further information can be found in the most recent version of the EY publication, International GAAP®.

4.10 The fair value hierarchy

Section 2A contains a hierarchy of inputs to be used when determining a fair value for which the best evidence of fair value is a quoted price in an active market. [FRS 102.2A.15(a)]. Figure 4-1 below shows the fair value hierarchy to be used. [FRS 102.2A.15].

Figure 4-1: Fair value hierarchy



FRS 102 is explicit that the best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market. Only when an unadjusted quoted price is unavailable, does an entity use the price of a recent orderly transaction for an identical or comparable asset or liability and failing both of those techniques, an estimation using another valuation technique. [FRS 102.2A.15]. Section 34 refers to a fair value hierarchy for disclosure purposes and categorises the measurement into three levels: Level 1, 2 and 3 (see Chapter 15). Whilst Section 2A does not label the hierarchy in this manner, the approach is similar in that application of the hierarchy in both sections requires an entity to prioritise observable inputs over those that are unobservable when measuring fair value.

4.10.1 Unadjusted quoted price in an active market

When determining fair value, entities are required to maximise the use of inputs determined by reference to a market price in an 'active market'. [FRS 102.2A.15]. 'Active market' is defined as "A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis." [FRS 102 Appendix I].

Section 2A states that the best evidence of fair value is an unadjusted quoted price in an active market for the identical or comparable asset or liability. [FRS 102.2A.15]. If a quoted price in an active market is available, an entity must use this price to measure fair value without adjustment.

Adjustments may be necessary in some limited instances, for example, when a quoted price in an active market does not represent fair value at the measurement date. This may be the case if significant events (e.g., transactions in a principal-to-principal market, trades in a brokered market or announcements), take place after the close of a market, but before the measurement date. An entity must establish and consistently apply a policy for identifying those events that might affect fair value measurements.

Based on the above definition of an active market, most equities and bonds that are listed on an exchange for which there is a liquid secondary market in terms of regular trading will be considered to be traded in an active market. In addition, instruments that are frequently traded in over-the-counter markets (i.e., instruments that are not listed on an exchange), such as interest rate swaps and options, foreign exchange derivatives and credit default swaps, and for which there are available quotes may also be traded in an active market if closing prices are published.

How we see it

The requirement that the best evidence of fair value is a quoted price for an identical asset in an active market is similar to that in IFRS 13. However, FRS 102 does not reproduce the additional guidance contained in IFRS 13 that the fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price, known as 'p times q'. P times q means that an entity which has a very large holding of an actively traded financial instruments is unable to adjust the quoted price to reflect any discount or premium that might arise if the holding were to be unloaded onto the market. Given that p times q guidance is not contained in FRS 102, in our view it is not required unless an entity uses the requirements and guidance of adopted IFRS in setting an accounting policy as permitted by paragraph 10.6 of FRS 102.

4.10.2 Price of a recent transaction

When an unadjusted quoted price is not available, a recent orderly transaction is considered. The term 'orderly' is not defined in FRS 102 but is understood to refer to transactions that are not forced, for example, a liquidation or distress sale. Further guidance can be found in the most recent version of the EY publication, International GAAP®.

How we see it

When a market has undergone a significant decrease in volume, there may be increased instances of transactions that are not orderly. However, it is not appropriate to assume that all transactions that occur in a market during a period of dislocation are distressed or forced. This determination is made at the individual transaction level and requires the use of judgement based on the specific facts and circumstances.

The use of the price of a recent transaction for an identical instrument is a simple valuation technique. However, judgement is required in determining whether that price is a reliable estimate of fair value. In addition to the use of the price of a recent transaction for an identical instrument, other valuation techniques could include reference to the current fair value of another instrument that is comparable or substantially the same as the instrument being measured. However, if there has been a significant change in economic circumstances or a significant lapse in time between the transaction and the measurement date, the price may not be a reliable fair value, in which case, another valuation technique is used.

[FRS 102.2A.15(b)].

FRS 102 requires that for an asset or a liability that has a bid price and an ask price (e.g., an input from a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances is used to measure fair value. The use of bid prices to measure assets and ask prices to measure liabilities is permitted, but not required. [FRS 102.2A.18]. Therefore, an inception loss could be experienced by an entity due to a difference in the price within the bid-ask spread that the entity could hypothetically exit the instrument and the price within the bid-ask spread that the entity actually transacted.

As a practical expedient, FRS 102 allows the use of mid-market pricing or other pricing conventions that are used by market participants when measuring fair value within the bid-ask spread. [FRS 102.2A.18]. Use of a mid-market pricing convention results in a valuation of an asset or liability at the mid-point of the bid-ask spread.

4.10.3 Other valuation techniques

In circumstances where unadjusted quoted prices or recent orderly transactions are unavailable or unreliable, another valuation technique is used to estimate fair value. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an orderly transaction between market participants. [FRS 102.2A.15(c)].

Many entities applying FRS 102 will not enter into instruments that are required to be recorded at fair value through profit or loss and for which a quoted price in active markets is not available. However if they do invest in, or issue complex instruments that must be fair valued but do not have quoted prices in active markets, they may have to draw upon the larger body of guidance within IFRS 13 in making judgements regarding how to measure fair value, especially regarding the use of valuation techniques. Further information regarding IFRS 13 can be found in the most recent version of the EY publication, International GAAP®.

4.11 Valuation techniques

Section 2A recognises the following three valuation approaches to measure fair value: [FRS 102.2A.16]

- Market approach: based on market transactions involving identical or similar assets or liabilities.
 - Cost approach: based on the amount required to replace the service capacity of an asset (frequently referred to as current replacement cost).
- Or
- Income approach: based on expectations of future performance (e.g., cash flows or income and expenses).

An entity uses valuation techniques that are consistent with one or more of the above valuation approaches. [FRS 102.2A.16]. Selecting a single valuation technique may be appropriate in some circumstances, for example, when measuring a financial asset or liability using a quoted price in an active market. However, in other situations, more than one valuation technique may be deemed appropriate and multiple approaches would be applied, producing a range of values. For example, it may be appropriate to use multiple valuation techniques when measuring fair value less costs of disposal for a CGU to test for impairment. However, determining the point in a range of values that is most representative of fair value can be subjective and requires management to exercise judgement, considering both qualitative and quantitative factors relevant to the measurement. [FRS 102.2A.20].

On the other hand, financial assets that frequently trade in active markets are often valued using only a market approach given the availability and relevance of observable data.

Even when the entity uses a single technique, entities need to be aware of changing circumstances that could indicate using a different or multiple approaches may be more appropriate if the change results in a measurement that is equally or more representative of fair value. For example, this might be the case if new markets develop or new information becomes available. Observable transactions that once formed the basis for the fair value estimate may cease to exist altogether or may not be determinative of fair value and, therefore, require an adjustment to the fair value measurement (this is discussed further in 4.10.1 above). As such, the use of a different or multiple valuation techniques may be more appropriate. FRS 102 notes that any change in these circumstances is a change in an accounting estimate, although the disclosures required by paragraph 18 of Section 10 *Accounting Policies, Estimates and Errors* for changes in accounting estimates do not need to be provided (see Chapter 9). [FRS 102.2A.17].

There is not a hierarchy of valuation techniques because one valuation technique might be more appropriate in some circumstances than in others. Instead the standard prioritises the inputs used in the application of these techniques (see 4.11 below). [FRS 102.2A.15].

4.11.1 Market approach

Section 2A describes the market approach as: [FRS 102.2A.16(a)]

Extract from FRS 102

2A.16(a) The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business.

The market approach uses prices that market participants would pay or receive for the transaction, for example, a quoted market price. The market price may be adjusted to reflect the characteristics of the item being measured, such as its current condition and location, and could result in a range of possible fair values.

Valuation techniques consistent with the market approach use prices and other market data derived from observed transactions for the same or similar assets, for example, revenue, or EBITDA multiples.

Another example of a market approach is matrix pricing. Matrix pricing is a mathematical technique used principally to value certain types of financial instruments, such as debt securities, where specific instruments (e.g., CUSIPs) may not trade frequently. The method derives an estimated price of an instrument using transaction prices and other relevant market information for benchmark instruments with similar features (e.g., coupon, maturity or credit rating).

4.11.2 Cost approach

The cost approach is used typically to measure the fair value of tangible assets, such as plant or equipment. FRS 102 states: [FRS 102.2A.16(b)]

Extract from FRS 102

2A.16(b) The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

From the perspective of a market participant seller, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical deterioration, functional (technological) obsolescence and economic (external) obsolescence. The adjustment for obsolescence ensures that the asset's value is based on its present condition including factors such as the level of wear and tear.

4.11.3 Income approach

IFRS 13 states the following about the income approach: [FRS 102.2A.16(c)]

Extract from FRS 102

2A.16(c) The income approach reflects expectations of future performance (eg cash flows or income and expenses). Valuation techniques using the income approach include present value techniques, option pricing models, and the multi-period excess earnings method.

Option pricing models include the Black-Scholes-Merton formula or a binomial model (i.e., a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option into the valuation. These models convert expected future amounts to a single present amount. That is, a present value technique uses the projected future cash flows of an asset or liability and discounts those cash flows at a rate of return commensurate with the risk(s) associated with those cash flows. Present value techniques, such as discounted cash flow analyses, are frequently used to estimate the fair value of business entities, non-financial assets and non-financial liabilities, but are also useful for valuing financial instruments that do not trade in active markets. Further details and examples of applying the present value technique can be found in the latest version of the EY publication, International GAAP®.

The multi-period excess earnings method is often used to value intangible assets that generate cash independently. The method isolates the contribution of the asset being valued by deducting the cash flows that can be attributed to complementary assets, ensuring that only the excess earnings attributable to the intangible asset are considered. The excess cash flows are then discounted to calculate a present value.

4.11.4 Broker quotes and pricing services

When quoted prices from brokers or pricing services are used to measure fair value, it is the entity's responsibility to understand the source and nature of this information to accurately assess its relevance. When there has been a significant decrease in the volume or level of activity for the asset or liability, management need to evaluate whether the prices received from brokers or pricing services are based on current information from orderly transactions or valuation techniques that appropriately reflect market participant assumptions regarding risk. This will determine the weight to place on these data points, compared to other value indications.

4.11.5 Reliable measure of fair value

For instruments that do not have a quoted market price in an active market, a valuation technique is considered to produce a reliable measure of fair value if it appropriately reflects how the market would likely price the asset and if its inputs reasonably represent market expectations and the risk return factors inherent in the asset. [FRS 102.2A.19].

Valuation techniques, including the use of multiple techniques often result in a range of reasonable valuations. Determining the most appropriate fair value within this range requires professional judgement, considering both quantitative and qualitative factors relevant to the measurement. [FRS 102.2A.20]. A fair value selected from within a range is deemed reliable if the range of reasonable fair value estimates is not significant or the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. [FRS 102.2A.21]. There are many situations in which the range of reasonable fair value estimates of assets that do not have a quoted market price is unlikely to be significant. Normally it is possible to estimate the fair value of an asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant, and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the asset at fair value.

[FRS 102.2A.22].

How we see it

No further guidance is provided to assess significance or probabilities in this context. Therefore, entities will need to exercise judgement. However, we believe that the bar for determining that a fair value measurement is not reliably measurable is relatively high and is limited to investments such as equity holdings in private companies, for which the investee has no comparable peers.

If, initially, fair value can be reliably measured, but such measurement ceases to be reliable at a subsequent date, an asset's carrying amount at the last date it was reliably measurable becomes its new cost. Going forward, the instrument is measured at its new cost less impairment until a reliable measure of fair value becomes available again. [FRS 102.2A.23].

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Definition of fair value	The definition is aligned with IFRS but limited guidance is provided.	Extensive guidance is provided on each aspect of the definition.
Measurement	The methodology for estimating fair value is aligned with IFRS although less detail is provided compared with IFRS. Section 2A includes limited guidance on application to liabilities.	Extensive guidance is provided on applying the measurement principles. IFRS 13 contains detailed guidance on each aspect of measurement including the application to liabilities and an entity's own equity instruments, dealing with restrictions and 'orderly' transactions.
Portfolio exception	Not addressed.	Contains an exception to measuring fair value of a group of financial assets and liabilities with offsetting risk exposures (the portfolio exception). An entity can measure the group on the basis of the net exposure.
Reliable measure of fair value	If fair value cannot be measured reliably, an entity is precluded from measuring the item at fair value.	No exceptions to measuring at fair value under IFRS 13. The approach is to use observable data in the first instance, valuation techniques and to provide disclosure (enhanced disclosures for significant unobservable inputs). Other standards provide exceptions in some instances.
Disclosures	Disclosures about fair value are contained within the relevant Sections of FRS 102 that requires the fair value measurement. Fair value levelling disclosures are contained within section 34 of FRS 102 and apply only to financial institutions. These disclosures are less extensive than those required by IFRS.	Extensive disclosures contained within both IFRS 7 and IFRS 13. Fair value levelling disclosures in IFRS 13 apply to all entities and are more extensive than those in Section 34 of FRS 102.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value
market participant	Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics: (a) they are independent of each other, that is they are not related parties; (b) they are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information; (c) they are able to enter into a transaction for the asset or liability; and (d) they are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so
most advantageous market	The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.
non-performance risk	The risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.
principal market	The market with the greatest volume and level of activity for the asset or liability
transaction costs (fair value measurement)	The costs to sell an asset or transfer a liability in the principal market (or most advantageous market) for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria: (a) they result directly from and are essential to that transaction; and (b) they would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made

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Chapter 11

Financial instruments: Definitions and Scope

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Overview

The sections which address financial instruments under FRS 102 are Section 11 *Basic Financial Instruments*, Section 12 *Other Financial Instruments Issues* and Section 22 *Liabilities and Equity*. Section 11 applies to basic financial instruments and is relevant to all entities, while Section 12 applies to other, more complex financial instruments and transactions. Section 22 sets out the classification and accounting requirements for liabilities and equity. This chapter deals with the definitions and scope requirements of these sections. The chapter also introduces the accounting policy choices that are available under FRS 102 for the recognition and measurement of an entity's financial instruments. Instead of applying the recognition and measurement requirements of Section 11 and 12, FRS 102 reporters have the choice of applying the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* (as adopted in the relevant jurisdiction) or IFRS 9 *Financial Instruments* (as adopted in the relevant jurisdiction) (see 4 below). The accounting policy choices are not discussed in detail in this chapter, for further details see Chapter 13 at 3. In addition, this chapter compares the scope and definitions of Sections 11, 12 and 22, with those of IFRS.

In many cases it will be clear whether an asset, liability, equity instrument, or other similar instrument must be accounted for in accordance with one or more of these sections. However, at the margins, determining whether these sections must be applied may not be always easy. Firstly, one needs to determine whether the definition of a financial instrument is met; secondly, not all financial instruments are within the scope of each of these sections - some are within the scope of other sections or standards (for instance insurance contracts are within the scope of FRS 103 *Insurance Contracts*), and some are not within the scope of any standard; and finally, certain contracts that do not meet the definition of a financial instrument are within the scope of some of these sections.

What you need to know

This chapter addresses the definition and scope of financial instruments and covers the following areas:

- Comparison between the scope of FRS 102 and IFRS (see 2 below).
- The definitions used in FRS 102 relevant to understanding financial instruments (see Appendix A).
- Scope exceptions of Sections 11, 12 and 22 of FRS 102 (see 3.1 below).
- Introduction to the accounting policy choices available under FRS 102 (See 4 below).

1 Introduction

Section 11, Section 12 and Section 22 contain the accounting and disclosure requirements for financial instruments.

Section 34 *Specialised Activities* contains additional disclosure requirements for financial instruments that apply to financial institutions. Public benefit entities and other members of a public benefit entity group that make or receive public benefit entity concessionary loans must refer to the relevant paragraphs of Section 34 for the accounting requirements for such loans, irrespective of the accounting policy choice made concerning applying Sections 11 and 12 or the recognition and measurement provisions of IAS 39 or IFRS 9. See 4 below for further details on the accounting policy choices.

Section 11 deals with what are termed 'basic' financial instruments, which are certain non-complex debt instruments and equity securities. It sets out the criteria for basic financial instruments and how they are measured, along with the impairment requirements. It also includes the derecognition requirements for financial instruments, and various disclosure provisions for all financial instruments. This section has been structured to provide all the financial instrument accounting requirements for many entities, who do not enter into more complex transactions. [FRS 102.11.1].

Section 12 applies to all other financial instruments, which need to be measured at fair value through profit or loss, and addresses hedge accounting requirements. It also contains associated disclosure requirements. [FRS 102.12.1].

Section 22's requirements for classifying issued instruments as either liabilities or equity are closely modelled on those in IAS 32 *Financial Instruments: Presentation*, but without the detailed guidance. The requirements also cover the issue of equity instruments, distributions to individuals or other parties acting in their capacity as investors in equity instruments (i.e., in their capacity as owners) and the accounting for purchases of own equity.

The classification and measurement requirements in Sections 11 and 12 are simpler and less stringent compared to IFRS 9, where instruments are classified as either basic or other, and measurement is at amortised cost, cost or fair value.

The impairment requirements in Section 11 have been drawn from IAS 39's incurred loss model. The FRC has delayed amending FRS 102 to adopt an expected loss impairment approach similar to that of IFRS 9.

The FRS 102 hedge accounting requirements are similar to those in IFRS 9, but with some simplifications and without the detailed guidance of IFRS 9. Also, FRS 102 incorporates a more principles-based approach to hedge accounting compared to IAS 39.

The FRC issued an updated version of FRS 102 in September 2024, following the issue in March 2024 of the Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland - Periodic Review 2024* ('the Periodic Review 2024'). The Periodic Review 2024 includes amendments to Sections 11, 12 and 22 of FRS 102 as issued in January 2022. These amendments are mandatory for accounting periods beginning on or after 1 January 2026.

The main amendments relevant to the definitions and scope of Sections 11, 12 and 22 are as follows:

- The amendments now include within the scope exceptions to Sections 11 and 12 rights and obligations that within the scope of Section 23 *Revenue from Contracts with Customers* which are financial instruments, except for receivables and impairment of contract assets. [FRS 102.11.7(j), FRS 102.12.3(m)].
- The definition of fair value was also amended to align with that in IFRS 13. Under the previous version of FRS 102, fair value was defined as "the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction". The new definition states that "fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". [FRS 102 Appendix I].
- In addition, the definition of an active market has also been amended and is now aligned with IFRS 13. Under the previous version of FRS 102, an active market was defined as "a market in which all the following conditions exist:
 - The items traded in the market are homogeneous.
 - Willing buyers and sellers can normally be found at any time.
 And
 - Prices are available to the public.
- The new definition, which states that an "active market is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis" is aligned with IFRS 13. [FRS 102 Appendix I].

2 Comparison between Sections 11, 12, 22 and IFRS

The comparable extant IFRSs are IAS 32, IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*. The main differences between FRS 102 and IFRS, from a definitions and scope perspective are discussed below.

2.1 Comparison between Sections 11, 12, 22 and IFRS (scope differences only)

2.1.1 Comparison between Sections 11, 12, 22 and IFRS - Scope

The differences in the scope of FRS 102 compared to that of IFRS are:

- Certain loan commitments are scoped out of IFRS 9 and scoped into IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* while, under FRS 102, all loan commitments are within the scope of either Section 11 or 12. When applying IFRS 9, loan commitments that are otherwise out of the scope of this standard are still subject to the impairment requirements of IFRS 9. We do not expect this scope difference to have a significant impact in practice. [FRS 102.11.5(g), FRS 102.11.6(d)].
- Financial guarantee contracts are scoped out of Sections 11, 12 and 22 and are accounted for under Section 21 *Provisions and Contingencies*. Under IFRS, financial guarantee contracts are accounted for in accordance with IFRS 9 and are generally measured at fair value on initial recognition (subject to certain exemptions), regardless of whether or not it is considered probable that the guarantee will be called. This is unless the entity has previously asserted explicitly that it regards such contracts as insurance contracts and has elected, under IFRS 17 *Insurance Contracts*, to continue the application of insurance contract accounting. [FRS 102.11.7(i), FRS 102.12.3(l), FRS 102.22.2(g)]
- Contracts for contingent consideration in a business combination (acquirer only). Unlike IFRS, where such contracts can be within the scope of IFRS 9, contracts for contingent consideration in a business combination are scoped out of Sections 11, 12 and 22 of FRS 102, and instead accounted for under Section 19 *Business Combinations and Goodwill*. [FRS 102. 12.3(g), FRS 102.22.2(c)]
- Certain leases such as those that could as a result of non-typical contractual terms, result in a loss to the lessor or the lessee are scoped in under Section 12 of FRS 102. [FRS 102.12.3(f)]. However, leases are generally scoped out of IFRS 9, except for the related receivables and lease liabilities which are within scope under both IFRS 9 and Section 11 of FRS 102. [FRS 102.11.7(c), FRS 102. 12.3(f)]

See 3.2 below for further details of the scope of FRS 102.

3 Scope of Sections 11, 12 and 22

3.1 Scope

Sections 11, 12 and 22 contain scope exceptions which are largely consistent with those in IFRS 9 and IAS 32. The guidance in Sections 11, 12 and 22 must be applied to all financial instruments except for the following:

- Investments in subsidiaries, associates and joint ventures, (see Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures* respectively).
- Employers' rights and obligations under employee benefit plans, to which Section 28 *Employee Benefits* applies, except for the determination of the fair value of plan assets.
- Insurance contracts (including reinsurance contracts) that the entity issues and reinsurance contracts that the entity holds, which are subject to FRS 103.
- Leases (see Section 20 *Leases*), except for certain aspects such as derecognition of related receivables and lease liabilities and impairment of finance lease receivables, or if the lease could, as a result of non-typical contractual terms, result in a loss to the lessor or the lessee (see Chapter 23 at 3.1.1).
- Contracts for contingent consideration in a business combination to which Section 19 applies. This exemption applies only to the acquirer.
- Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date. The terms of the forward contract must not exceed a reasonable period normally necessary to obtain the required approval and to complete the transaction.
- Financial instruments, contracts and obligations to which Section 26 *Share-based Payment* applies, except that the classification requirements discussed in Chapter 12 must be applied to treasury shares issued, purchased, sold, transferred or cancelled in connection with share-based payment arrangements.
- Financial instruments issued by an entity with a discretionary participation feature (see Chapter 38).
- Reimbursement assets (see Chapter 24).
- Financial guarantee contracts to which Section 21 applies. [FRS 102.11.7(i), FRS 102.12.3(l), FRS 102.22.2(g)].
- Rights and obligations within the scope of Section 23 are financial instruments, except for receivables and the impairment of contract assets which are scoped into Sections 11 and 12.
- Contracts to buy or sell non-financial items such as commodities, inventory or property, plant and equipment are excluded from the scope of Section 12 (as they are not financial instruments), unless:
 - The contract imposes risks on the buyer/seller that are not typical of such contracts. For example, Section 12 may apply when the buyer/seller is required to absorb losses unrelated to price movements of the underlying non-financial items, to default by one of the counterparties or to fluctuations in foreign exchange rates. [FRS 102.12.4].
 - Or
 - The contract can be settled net in cash or another financial instrument and it does not meet the 'own use' exception. That is, Section 12 does apply to contracts for non-financial instruments that can be net settled and that were not entered into for, and continue to be held without, the purpose of the receipt or delivery of a non-financial item in accordance with an entity's expected purchase, sale or usage requirements. [FRS 102.12.5].

4 Recognition and measurement: accounting policy choice

As discussed at 1 above, entities can choose for recognition and measurement to apply either:

- Sections 11 or 12.
Or
- IAS 39 (as adopted in the relevant jurisdiction) as the standard applies prior to the application of IFRS 9. An entity must apply the version of IAS 39 that applied immediately prior to IFRS 9 superseding IAS 39. Entities must also apply what is commonly referred to as 'EU carve-out of IAS 39', which amended paragraph 81A and related Application Guidance in IAS 39, with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities.
Or
- IFRS 9 (as adopted in the relevant jurisdiction), and IAS 39 (as amended following the publication of IFRS 9) as far as it remains applicable once IFRS 9 is applied. [FRS 102.11.2, FRS 102.12.2]. On application of IFRS 9 entities are permitted to continue to apply the IAS 39 hedge accounting requirements with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities. Hence, following the publication of IFRS 9, IAS 39 was amended to include only the guidance necessary to continue to apply such a hedge relationship. [IFRS 9.6.1.3].

The above choice of guidance represents an 'accounting policy choice' that only applies for 'recognition and measurement' of financial instruments. [FRS 102.11.2, FRS 102.12.2]. See Chapter 13 for further details.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS 9/IAS 32
Financial guarantee contracts	Excluded from the scope of Section 11, 12 and 22 of FRS 102.	Scoped in under IFRS 9 except where accounted for under IFRS 17.
Accounting policy choices	Option to apply the recognition and measurement requirements of Sections 11 or 12, IAS 39 or IFRS 9. No matter the option chosen, entities must apply disclosure requirements of Sections 11 and 12.	Option to apply hedge accounting requirements of IAS 39 in full.
Loan commitments	Loan commitments are scoped in under both Section 11 and 12 of FRS 102.	IFRS 9 generally excludes loan commitments other than: ▪ Loan commitments that an entity designates as financial liabilities at fair value through profit and loss. ▪ Loan commitments that can be settled net in cash or by delivering or issuing another financial Instrument. Or ▪ Commitments to provide a loan at a below-market interest rate cost.
Contracts for contingent consideration in a business combination (acquirer only)	Contracts for contingent consideration in a business combination are scoped out of Sections 11, 12 and 22 of FRS 102, and instead accounted for under Section 19.	Within the scope of IFRS 9/IAS 32.
Leases that could as a result of non-typical contractual terms result in a loss to the lessor or the lessee	Scoped in under Section 12 of FRS 102.	Leases are generally scoped out of IFRS 9, except for the related receivables and lease liabilities.

Appendix A - Defined terms

Extracts from FRS 102

Appendix I Glossary

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
amortised cost (of a financial asset or financial liability)	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
compound financial instrument	A financial instrument that, from the issuer's perspective, contains both a liability and an equity element.
credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
derecognition	The removal of all or part of a previously recognised asset or liability from an entity's statement of financial position.
derivative	A financial instrument or other contract with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the carrying amount of the financial asset or financial liability.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of FRS 102, the guidance in Section 2A Fair Value Measurement shall be used in determining fair value.

financial asset	Any asset that is: (a) cash; (b) an equity instrument of another entity; (c) a contractual right: (i) to receive cash or another financial asset from another entity, or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
financial instrument	A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
financial liability	Any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
financial risk	The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
firm commitment	Binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
forecast transaction	An uncommitted but anticipated future transaction.
hedging gain or loss	Change in fair value of a hedged item that is attributable to the hedged risk.

highly probable	Significantly more likely than probable.
liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. Interest rate risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Currency risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Other price risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
most advantageous market	The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.
non-controlling interest	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
ordinary share	An equity instrument that is subordinate to all other classes of equity instrument.
prevailing market rate	The rate of interest that would apply to the entity in an open market for a similar financial instrument.
principal market	The market with the greatest volume and level of activity for the asset or liability.
probable	More likely than not.
publicly traded (debt or equity instruments)	Traded, or in process of being issued for trading, in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
transaction costs (financial instruments)	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, or the issue or reacquisition of an entity's own equity instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.
treasury shares	An entity's own equity instruments, held by that entity or other members of the consolidated group.

Chapter 12 Financial Instruments: Financial liabilities and equity

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Overview

This chapter addresses the requirements for classifying issued instruments as either liabilities or equity. The distinction between equity and liability, from the perspective of an issuer can be complex. Some instruments, while being legally equity can have the characteristics that are in substance those of a financial liability, while other instruments can have a number of different features of both debt and equity.

To provide consistent classification of such instruments, Section 22 *Liabilities and Equity* lays out principles for presenting financial instruments as liabilities or equities from the perspective of the issuer. These principles are closely modelled on those used within IAS 32 *Financial Instruments: Presentation*, but without the detailed guidance in IAS 32. The overriding principle being that if the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the instrument will be a liability for the issuer. However, exceptions can apply, such as when a transaction will be settled in the issuer's own shares, where the classification will generally depend on whether the number of shares to be delivered is fixed or variable. In other cases, instruments may have some features which meet the definition of equity and others which meet the definition of a liability. Section 22 sets out the principles for the classification and measurement of such 'compound' instruments.

Section 22 also discusses the definition, initial recognition and subsequent measurement of an entity's own equity instruments and the accounting for treasury shares.

What you need to know

- Section 22 establishes the principles for classifying financial instruments as liabilities or equity from the perspective of the issuer.
- Classification principles are based on the contractual terms of the instrument.
- Some complex financial instruments contain features of both financial liabilities and equity, and therefore determining the classification can require considerable analysis and judgement.
- Where financial instruments contain both liability and equity components, Section 22 sets out the principles for splitting the instrument between equity and liability.
- Section 22 also provides guidance on the accounting treatment of treasury shares.

1 Introduction

Section 22 contains the requirements for classifying issued financial instruments as either liabilities or equity. Financial instruments are contracts that give rise to a financial asset of one entity and a financial liability or equity of another entity. Section 22 sets out the requirements for:

- Classifying financial instruments as either liabilities or equity and the accounting for compound financial instruments.
- The issue of equity instruments, distributions to individuals or other parties acting in their capacity as investors in equity instruments (i.e., in their capacity as owners) and the accounting for purchases of own equity.

And

- Section 22 states that the accounting for non-controlling interests in consolidated financial statements is in the scope of this Section, however that is now no longer the case as the relevant paragraph has been moved to Section 9 *Consolidated and Separate Financial Statements*. [FRS 102.22.1]. We consider this a drafting error that does not have an impact on the accounting treatment for non-controlling interest. Entities should apply the paragraph in Section 9 instead.

The FRC issued an updated version of FRS 102 in September 2024, following the issue of the Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs- Periodic Review* ('the Periodic Review 2024'). The Periodic Review 2024 includes amendments to Section 22 of FRS 102. These amendments are mandatory for accounting periods beginning on or after 1 January 2026, when an entity first applies the Periodic Review 2024 amendments below and retrospective application is required. [FRS 102.1.19].

The main amendments are as follows:

- Adding the definition of a liability, for the purposes of section 22, as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- Amending and removing paragraph 19, concerning the accounting for non-controlling interests in a subsidiary and moving this to section 9 (see Chapter 8 at 3.7).

2 Comparison between Sections 22 and IFRS

The comparable extant IFRS is IAS 32. The main differences between FRS 102 and IAS 32 are discussed below.

2.1 Differences between Section 22 and IAS 32

A contractual obligation or even a potential obligation for an entity to purchase its own equity instruments for cash or another financial asset is generally treated as a derivative within the scope of Section 12 and measured at fair value through profit or loss. In contrast, IAS 32 requires measurement at the present value of the financial liability's (gross) redemption amount. This is further discussed at 2.1.1 below.

Another potential difference arises in relation to the classification of contracts that will or may be settled by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. The IFRS Interpretations Committee concluded that any obligation denominated in a foreign currency represents a variable amount of cash and, consequently, a contract settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency must be classified as a liability. There is no similar explicit interpretation under FRS 102, and therefore, a judgement must be made on whether a fixed amount of foreign currency represents a fixed amount of cash or not, which in turn will affect the conclusion on the classification of such instrument (see 2.1.2 below).

FRS 102 contains explicit accounting requirements for the initial measurement of equity instruments issued to settle a financial liability in particular circumstances that are excluded from the scope of IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* leading to the potential for divergence in the accounting (see 2.1.3 below).

2.1.1 Obligation to repurchase own equity

Under IAS 32, contracts that contain an obligation or even a potential obligation for an entity to pay cash, or another financial asset, to purchase its own equity instruments will give rise to a liability for the present value of the redemption amount (e.g., the present value of the forward repurchase price or option exercise price). [IAS 32.23]. Section 22 does not contain this requirement and in such cases, the obligation/potential obligation meets the definition of a derivative that must be measured at fair value through profit or loss under Section 12. This could result in a potentially significant measurement difference. There is an exception to derivative accounting for put options over NCI in certain circumstances, see Chapter 8 at 3.7.2.B.

For example, if a listed entity grants a written put option to a counterparty to sell the entity's own shares back to the entity for a fixed price at some point in the future, under IAS 32, the listed entity measures that potential obligation at the present value of that fixed price, with a corresponding reduction in equity. This is regardless of whether that option is likely to be exercised by the counterparty. In contrast, under FRS 102, the option would be treated as a derivative, measured at fair value through profit or loss, with no reduction in equity.

2.1.2 Derivatives contracts to acquire a fixed number of own equity instruments

Other potential differences arise in relation to the classification of contracts that will or may be settled by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. The potential differences are as follows:

- In April 2005, the IFRS Interpretations Committee considered whether the reference to 'fixed amount of cash' included a fixed amount of foreign currency. The Interpretations Committee noted that although this matter was not directly addressed in IAS 32, it was clear that, when the question is considered in conjunction with guidance in other international accounting standards at the time, particularly IAS 39, any obligation denominated in a foreign currency represents a variable amount of cash. Consequently, the Interpretations Committee concluded that a contract settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency must be classified as a liability. Even though this conclusion was reached based on the guidance in IAS 39, we believe the same answer applies when considering IFRS 9. There is no similar explicit interpretation under FRS 102, and therefore, a judgement could be made on whether a fixed amount of foreign currency represents a fixed amount of cash or not, which in turn will affect the conclusion on the classification of such instrument.

How we see it

In our view, this judgement needs to be treated as an accounting policy choice which must be applied consistently in the assessment of instruments with this feature.

- Amending and removing paragraph 19, concerning the accounting for non-controlling interests in a subsidiary IAS 32 further clarifies that rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of 'any currency' are equity instruments if the entity offers those instruments 'pro rata' to all of its existing owners of the same class of its own non-derivative equity instruments. [IAS 32.22]. This clarification is only relevant when a fixed amount of foreign currency is not considered to be a fixed amount of cash, as such contracts must otherwise be classified as a liability. FRS 102 does not explicitly address this point due to the fact that it is also silent on the treatment of contracts involving a fixed amount of foreign currency as discussed above; hence an FRS 102 reporting entity could reach the same result by interpreting that a fixed amount of foreign currency represents a fixed amount of cash.

2.1.3 Settlement of a financial liability with equity instruments

Section 22 has explicit accounting requirements for the initial measurement of equity instruments issued to settle a financial liability in particular circumstances [FRS 102.22.8A]. The circumstances covered by this paragraph in Section 22, are specifically excluded from the scope of IFRIC 19. This leads to a situation where FRS 102 mandates a specific accounting outcome for circumstances where under IFRS there is no equivalent guidance and therefore an accounting policy choice. This could lead to a potential GAAP difference on the initial measurement of the equity issued. We further discuss this issue at 4.4.2.B below.

3 Scope of Section 22

This section covers the scope of Sections 22.

3.1 Scope

Section 22 contains scope exceptions which are largely consistent with those in IAS 32. The guidance in Section 22 must be applied to all financial instruments except for the following: [FRS 102.12.2]

- Investments in subsidiaries, associates and joint ventures, (see Section 9, Section 14 *Investments in Associates* and Section 15 *Investments in Joint Ventures* respectively).
- Employers' rights and obligations under employee benefit plans, to which Section 28 *Employee Benefits* applies.
- Insurance contracts (including reinsurance contracts) that the entity issues and reinsurance contracts that the entity holds, which are subject to FRS 103 *Insurance Contracts*.
- Contracts for contingent consideration in a business combination to which Section 19 *Business Combinations and Goodwill* applies. This exemption applies only to the acquirer.
- Financial instruments, contracts and obligations to which Section 26 *Share-based Payment* applies, except that the classification requirements discussed at 5 below must be applied to treasury shares issued, purchased, sold, transferred or cancelled in connection with share-based payment arrangements.
- Financial instruments issued by an entity with a discretionary participation feature (see FRS 103).
- Financial guarantee contracts to which Section 21 applies.

4 Financial liabilities and equity

4.1 Introduction

The classification of issued instruments as either debt or equity is within the scope of Section 22 which contains the principles for classifying an instrument, or its components, as a liability or equity by the issuer. Unlike Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues*, there is no accounting policy choice available to apply IAS 32. Section 22 must be applied regardless of the choice in relation to recognition and measurement of financial instruments.

The overriding principle in Section 22 is that those instruments, or components of an instrument, with terms such that the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation represent a financial liability. Classification between liability and equity is a complex matter and requires identifying and assessing the components of the instrument and their terms.

In addition, Section 22 discusses the initial recognition and subsequent measurement requirements for an entity's own equity instruments. The initial recognition and subsequent measurement from the point of view of the holder of the instrument is covered by Sections 11 and 12 and are further discussed in Chapter 13.

4.2 Scope and definitions

Equity is defined as the residual interest in the assets of an entity after deducting all its liabilities. This is identical to the definition in IAS 32, but Section 22 elaborates further by stating that "equity includes investments by the owners of an entity plus retained profits, or minus losses and distributions to owners". [FRS 102.22.3].

A liability, for the purposes of Section 22, is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A financial liability is any liability that is:

- A contractual obligation:
 - To deliver cash or another financial asset to another entity.
 - Or
 - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- Or
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments.
 - Or
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. [FRS 102.22.3].

The basic premise of FRS 102 is similar to IAS 32 in the sense that an instrument can only be classified as equity under FRS 102 if the issuer has an unconditional right to avoid delivering cash or another financial instrument, or, if it is settled through own equity instruments, it is an exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments. In all other cases, it would be classified as a financial liability.

FRS 102 provides some examples of instruments that are classified as financial liabilities as there is a contractual obligation to make payments and the issuer has no discretion to avoid them:

- Instruments that oblige the issuer to make payments to the holder before liquidation (e.g., a mandatory dividend). [FRS 102.22.5(c)].
- And
- Preference shares that provide for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or the holder has the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount. [FRS 102.22.5(e)].

Although in many cases the classification of an instrument as equity or liability will be straightforward, certain instruments may contain terms that can be more problematic. We further discuss these issues at 4.3 to 4.6 below.

4.3 Contingent settlement provisions

Some financial instruments contain contingent settlement provisions whereby settlement is dependent on the occurrence or non-occurrence of uncertain future events beyond the control of both the issuer and the holder, and the issuer does not have the unconditional right to avoid settling in cash or by delivery of another financial asset when such an event happens. This could be the case where settlement is dependent on events such as amendments to tax legislation, regulatory requirements or changes in interest rates or price indices, or even changes in the credit rating of the issuer. These are events which the issuer and the holder cannot prevent from happening; consequently, such instruments must be classified as financial liabilities unless they are included in the following exclusions: [FRS 102.22.3A, FRS 102.22.4]

- (i) The part of the contingent settlement provision that could require settlement in cash or another financial asset is not 'genuine'.
Or
- (ii) The issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer.
Or
- (iii) The instrument can be put by the holder back to the issuer and meets the criteria described at 4.3.3 below.
Or
- (iv) The instrument contains obligations arising only on liquidation and meets the criteria described at 4.3.2 below.

4.3.1 Contingencies that are 'not genuine'

FRS 102 does not contain any guidance as to what constitutes a contingent settlement provision that is 'not genuine'. The guidance within IAS 32 states that 'not genuine' refers to the occurrence of an event that is extremely rare, highly abnormal or very unlikely to occur. [IAS 32.AG28]. Terms that are contained within a contract are normally intended to have a commercial effect, thus, a high hurdle must apply to demonstrate that a specific term is not genuine. Nevertheless, individual facts and circumstances would need to be evaluated on a case-by-case basis.

4.3.2 Instruments that contain obligations only on liquidation

In respect of (ii) at 4.3 above, a contingent settlement provision that is only effective on liquidation of the issuer may be ignored and the instrument would be treated as an equity instrument, as different rights and obligations apply in the event of liquidation. However, if the instrument provides for settlement on the occurrence of events that could lead to liquidation such as insolvency, the exclusion does not apply, and the instrument would be a financial liability.

The exclusion noted in (iv) at 4.3 above, is only applicable to financial instruments, or components of instruments, that are subordinate to all other classes of instruments; when such instruments impose on the entity an obligation to deliver to another party a 'pro rata' share of the net assets of the entity, only on liquidation, they are classified as equity. [FRS 102.22.4(b)]. It could be interpreted that these instruments are equity based purely on the exclusion in (ii) discussed in the preceding paragraph. Hence, at first sight, the additional exclusion in (iv) for these instruments appears irrelevant.

IAS 32 includes guidance that clarifies that the equivalent exclusion in (ii) does not apply to circumstances where the obligation arises because liquidation is either certain to occur and beyond the control of the entity (e.g., a limited life entity) or is not certain to occur but the holder of the instrument has the option to enforce liquidation. [IAS 32.16C, IAS 32.16D].

How we see it

Although not explicitly included within the guidance in FRS 102, we believe that the FRC wrote exclusions (ii) and (iv) with the IAS 32 guidance in mind. We therefore consider that in the circumstances described (i.e., when liquidation is either certain to occur and beyond the control of the entity, or is not certain to occur but the holder of the instrument has the option to enforce liquidation), the financial instruments, or its components, would be classified as a liability unless they meet the criteria of being the most subordinate class of instrument and the obligation is to deliver a 'pro rata' share of the net assets in accordance with the exclusion in (iv). This assertion is supported by the example of preference shares that provide for mandatory redemption at 4.2 above.

Another example of the application of the requirements of the exclusion in (iv) is given in FRS 102. If on liquidation the holders of an instrument receive a 'pro rata' share of the net assets, but this amount is subject to a maximum amount (a ceiling) and the excess net assets are distributed to a charity organisation, the instrument would be classified as a financial liability. [FRS 102.22.5(a)]. This is because such terms have the effect of fixing or restricting the residual return, which is not in line with the definition of equity. This example highlights the importance of meeting the exact criteria given in the standard.

4.3.3 Puttable instruments

'Puttable instruments' are defined as financial instruments that give the holder the right to sell that instrument back to the issuer for cash or another financial asset or are automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. [FRS 102.22.4(a)]. In most cases, puttable instruments would meet the definition of a financial liability, such as a corporate bond that provides the holder with the option to require the issuer to redeem the instrument for cash or another financial asset at a future date. The option held by the holder means that the issuer does not have an unconditional right to avoid delivering cash, thus, the puttable instrument meets the definition of a financial liability. However, if a puttable instrument meets all the five criteria stated below, it will, as an exception, be classified as an equity instrument:

- The instrument entitles the holder to a pro rata share of an entity's net assets on liquidation (i.e., those assets that remain after deducting all other claims on assets).
- The instrument is in the class of instruments that is most subordinate to all other classes of instruments (i.e., it is the most junior class of instrument in the hierarchy to be applied if the entity were to be liquidated).
- All puttable instruments in the most subordinate class have identical features.
- Apart from the put feature, the instrument does not contain any other liability features and is not a contract that will or may be settled in the entity's own equity instruments, as set out at 4.2 above.
- The total expected cash flows attributable to the instrument over the instrument's life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the instrument's life (excluding any effects of the instrument). [FRS 102.22.4(a)].

If all the criteria mentioned above are met, a puttable instrument will be classified by exception as an equity instrument. These criteria are intended to prevent an inappropriate classification of such instruments in the financial statements of entities such as some open-ended mutual funds, unit trusts, limited life entities, partnerships and co-operative entities. FRS 102 provides the following examples of application of this classification requirement:

- A puttable instrument is classified as equity if, when the put option is exercised, the holder receives a pro rata share of the net assets of the entity, determined by dividing the entity's net assets on liquidation into units of equal amounts and multiplying the resulting amount by the number of the units held by the financial instrument holder. However, if the holder is entitled to an amount measured on some other basis the instrument is classified as a liability. [FRS 102.22.5(b)].
- A puttable instrument classified as equity in a subsidiary's financial statements is classified as a liability in the consolidated financial statements of its parent, as they will not be the most subordinate instrument issued by the consolidated group. [FRS 102.22.5(d)].
- Members' shares in co-operative entities are classified as equity if the entity has an unconditional right to refuse redemption of the members' shares or the redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. [FRS 102.22.6].

We would not expect many FRS 102 adopters to have issued puttable instruments. Thus, we do not elaborate upon them any further in this book, but further information can be found in the EY publication, International GAAP®.

4.4 Recognition and measurement of issued equity instruments

FRS 102 contains accounting recognition criteria for equity instruments, including options and warrants over equity instruments, unlike IAS 32 which only addresses the treatment of transaction costs. At 4.4.1 to 4.4.3 below we address the recognition requirements for equity instruments issued by the reporting entity. The initial recognition and measurement requirements for the holder of investments in equity instruments and for financial liabilities are discussed in Chapter 13.

4.4.1 Initial recognition

Section 22 states that an entity must recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the entity in exchange for those instruments:

- If the entity receives cash before the equity instruments are issued and it cannot be required to repay the cash, the entity must recognise an increase in equity for the consideration received.
- If the equity instruments are subscribed for, but have not been issued or called up, and the entity has not yet received the cash or other resources, the entity cannot recognise an increase in equity.

[FRS 102.22.7].

4.4.2 Initial measurement

The general rule is that equity instruments must initially be measured at the fair value of the cash or other resources received or receivable, net of transaction costs. Any income tax related to those transaction costs must be accounted for in accordance with Section 29 *Income Tax* (see Chapter 31). If payment is deferred and the time value of money is material, the initial measurement must be on a present value basis. [FRS 102.22.8, FRS 102.22.9]. No guidance is provided in this context as to the appropriate discount rate, although the guidance on financing transactions set out in Chapter 13 would be appropriate. This would require the use of a market rate of interest for the amount receivable.

There are two exceptions to this general rule. These are discussed below at 4.4.2.A and 4.4.2.B.

4.4.2.A Merger relief or group reconstructions relief under the Companies Act

The general rule at 4.4.2 does not apply when merger relief or group reconstruction relief under the Companies Act 2006 are applied. [FRS 102.22.8]. Merger relief and group reconstruction relief have an impact on the accounting considerations for capital and reserves of the issuer for certain group reconstructions. The requirements for these reliefs and the considerations for the related accounting are further discussed in Chapter 22 at 5.5.1 for consolidated financial statements and in Chapter 8 at 4.2.1A for separate financial statements.

As the use of these reliefs affects the accounting for capital and reserves of the issuer, they have an impact on the overall initial measurement of the equity instruments issued. The Companies Act indicates that when the reliefs are applied, the amount that is not required to be included in share premium can be disregarded in determining the value of the assets received as consideration provided for the shares issued. [s615]. Therefore, depending on whether acquisition accounting or merger accounting is applied, the point of reference to determine the value of the consideration received will vary, and so will the measurement of the equity instruments issued.

4.4.2.B Settlement of financial liability with equity instrument

The general rule at 4.4.2 above must not be applied to transactions in which a financial liability is extinguished (partially or in full) by the issue of equity instruments in any of the following circumstances:

- The creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder.
- Or
- The creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.
- Or

- The extinguishment is in accordance with the original terms of the financial liability. [FRS 102.22.8A]. In these circumstances there is no gain or loss recognised in profit or loss as the result of such a transaction. [FRS 102.22.8A].

This exception is consistent with the scope exclusions in IFRIC 19. However, FRS 102 addresses the accounting for those circumstances excluded from the scope of IFRIC 19, where no equivalent IFRS guidance exists. This could lead to a potential GAAP difference on the initial measurement of the equity issued.

4.4.3 Presentation

Exactly how the increase in equity arising on the issue of shares or other equity instruments is presented is determined by applicable laws. For instance, the nominal value of the shares may need to be presented separately from any premium received. [FRS 102.22.10].

4.5 Other topics

Section 22 also includes provisions that deal with the accounting for certain instruments and transactions involving equity instruments issued by the reporting entity. These are described at 4.5.1 to 4.5.6 below. The FRS 102 accounting requirements in respect of compound instruments, treasury shares and distributions to owners are based on the explicit guidance included in IAS 32. The other topics are not explicitly addressed by IAS 32 but are consistent with practice under IFRS.

4.5.1 Exercise of options, right and warrants

Equity issued by means of exercise of options, rights, warrants and similar equity instruments must be accounted for according to the principles discussed at 4.4 above. [FRS 102.22.11].

4.5.2 Bonus issues and share splits

Capitalisation or bonus issues of shares (sometimes referred to as stock dividend) entail the issue of new shares to shareholders in proportion to their existing holdings. For example, an entity might give its shareholders one bonus share for every four shares held.

Another common transaction is a share or stock split, which involves dividing an entity's existing shares into multiple shares. For example, in a share split, shareholders may receive five additional shares for each share held and, in certain cases, the previously outstanding shares may be cancelled and replaced by the new shares.

Bonus issues and stock splits do not change total equity; however, an entity must reclassify amounts within equity as required by applicable laws. [FRS 102.22.12]. These transactions must be permitted by an entity's articles of association as well as comply with provisions of the applicable laws. For instance, for a bonus issue the entity may utilise one of its existing reserves such as the share premium account, retained earnings or capital redemption reserve to issue the bonus shares. The relevant reserve is debited with the nominal value of the shares issued while issued share capital is credited with an equivalent amount, if the bonus shares meet the criteria to be accounted for as equity. [s610(4), s628(3), s733(6)].

4.5.3 Compound instruments

Some issued financial instruments cannot be classified in their entirety as either an equity instrument or a financial liability. These instruments subject to a single contract that contain both a liability and equity component are known as compound instruments.

A typical example is a convertible bond, whereby the issuer is obligated to pay principal and interest, but the holder also has an option to convert their holding into a fixed number of equity shares of the issuer. Consequently, from the issuer's perspective, the bond contains two components, a financial liability represented by the obligation to deliver cash payments and an equity element, represented by the obligation to deliver a fixed number of equity shares (see discussion at 4.2 above).

However, not all convertible debt instruments are considered to be compound financial instruments. For example, a convertible bond that allows for conversion into a variable number of shares: since the obligation on conversion is to deliver a variable number of shares, there is no equity element. Thus, the entire liability would be recorded at fair value through profit or loss, as it would not be a basic debt instrument (see Chapter 13 at 4).

4.5.3.A Initial recognition and measurement

The proceeds from issuing a compound instrument must be allocated between the two components. To perform that allocation, the issuer must:

- First calculate the liability component by computing the fair value of a similar bond that does not have the conversion option. In essence, the entity would need to work out the fair value of the bond assuming it had issued it without the option to convert to its own equity. See Chapter 10 for further information on how to calculate fair value.
 - Calculate the equity element as the residual amount (i.e., the difference between the proceeds received and the fair value of the liability).
- And
- Transaction costs arising from the instrument's issue are allocated to the liability and equity components on the basis of their relative fair values.

This allocation must not be revised subsequently. *[FRS 102.22.13, FRS 102.22.14].*

4.5.3.B Subsequent measurement

The subsequent measurement of the liability component of a compound instrument will depend on whether it meets the criteria to be accounted for as a basic financial instrument (i.e., at amortised cost). If not, it has to be subsequently measured at fair value through profit or loss. *[FRS 102.22.15]*. Subsequent measurement of financial liabilities is further discussed at Chapter 13 at 6.

After initial recognition, the equity component is not re-measured.

4.5.4 Treasury shares

Treasury shares are equity instruments of an entity that have been issued and subsequently reacquired by the entity. When acquiring treasury shares, the entity must deduct from equity the fair value of the consideration given. No gain or loss can be recognised in profit or loss arising from the purchase, sale, transfer or cancellation of treasury shares. *[FRS 102.22.16]*.

4.5.5 Distributions to owners

Distributions to owners (i.e., holders of an entity's equity instruments) are accounted for as a reduction in equity. *[FRS 102.22.17]*.

An entity must disclose the fair value of any non-cash assets that have been distributed to its owners during the reporting period, except when the non-cash assets are ultimately controlled by the same parties both before and after the distributions. *[FRS 102.22.18]*.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Obligations to repurchase own equity	Similar principle to IFRS but less guidance. A contractual obligation to purchase own equity instruments for cash or another financial asset is considered to be a derivative.	IAS 32 requires a contractual obligation to purchase own equity instruments for cash or another financial asset to be measured at the present value of the gross redemption amount.
Derivative contracts to acquire a fixed number of own equity instruments	Contracts to exchange a fixed amount of equity instrument for a fixed amount of foreign currency could be classified as a liability or equity depending on interpretation.	Contracts to exchange a fixed amount of equity instrument for a fixed amount of foreign currency are classified as a liability.
Settlement of a financial liability with equity instruments	Contains guidance when a financial liability is extinguished by the issue of equity instruments in specific circumstances that are excluded from the scope of IFRIC 19.	Under IFRS there is no equivalent guidance and therefore an accounting policy choice.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

Active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
Amortised cost (of a financial asset or financial liability)	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
Compound financial instrument	A financial instrument that, from the issuer's perspective, contains both a liability and an equity element.
Contract	An agreement between two or more parties that create enforceable rights and obligations
Derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position.
Derivative	A financial instrument or other contract with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
Effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
Equity	The residual interest in the assets of the entity after deducting all its liabilities.
Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A - <i>Fair Value Measurement</i> shall be used in determining fair value.
Financial asset	Any asset that is: (a) cash; (b) an equity instrument of another entity; (c) a contractual right: (i) to receive cash or another financial asset from another entity, or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

	(d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
Financial instrument	A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
Financial liability	Any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
Non-controlling interest	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
Publicly traded (debt or equity instruments)	Traded, or in process of being issued for trading, in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
Transaction costs (financial instruments)	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, or the issue or reacquisition of an entity's own equity instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.
Treasury shares	An entity's own equity instruments, held by that entity or other members of the consolidated group.

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Overview

This chapter deals with the recognition, derecognition and measurement requirements of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* of FRS 102.

What you need to know

- Entities can make an accounting policy choice for recognition and measurement to apply either:
 - Sections 11 and 12 of FRS 102
 - Or
 - IAS 39 *Financial Instruments: Recognition and Measurement* (as adopted in the relevant jurisdiction) as the standard applied immediately prior to IFRS 9 *Financial Instruments* superseding IAS 39
 - Or
 - IFRS 9 (as adopted in the relevant jurisdiction), and IAS 39 (as amended following the publication of IFRS 9) as far as it remains applicable when IFRS 9 is applied [FRS 102.11.2, FRS 102.12.2]
- Although an entity can continue with an existing accounting policy of applying IAS 39, an entity must not change its accounting policy from either Sections 11 and 12 or IFRS 9 to IAS 39 except to make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included.
- This chapter discusses Sections 11 and 12 of FRS 102. IFRS 9 and IAS 39 are discussed in the EY publication, International GAAP®.
- Sections 11 and 12 distinguish between 'basic' and 'non-basic' financial instruments. In general, basic financial instruments are usually measured at amortised cost or cost and non-basic financial instruments are measured at fair value through profit or loss. Unlike IFRS, Sections 11 and 12 do not contain an option to present fair value gains and losses on financial instruments in other comprehensive income.
- To qualify as a basic debt instrument under Section 11, certain conditions need to be met. If one of the conditions is not satisfied, a debt instrument may still meet the definition of 'basic' if it is consistent with the principle-based description of a 'basic' financial instrument. Debt instruments that are not 'basic' are accounted for under Section 12 at fair value through profit or loss with limited exceptions.
- Equity instruments are usually measured at fair value through profit or loss under Section 12 although there are some exceptions for investments in related parties.
- Under section 11, at the end of each reporting period, if there is objective evidence of impairment of any financial assets that are measured at cost or amortised cost, then an impairment loss is recognised.
- Whilst largely aligned with IFRS 9 and IAS 39, the derecognition guidance for financial assets is less comprehensive under FRS 102, as it is less likely that complex transactions will be entered into by FRS 102 reporters. The guidance for derecognition of financial liabilities is more aligned with IFRS 9 and IAS 39. However, the May 2024 Amendments to IFRS 9 clarify the settlement date for financial liabilities and introduce an accounting policy choice where financial liabilities are deemed to be discharged before the settlement date if initiated using an electronic payment system (if specific conditions are met), which are changes that impact IFRS reporters only.

1 Introduction

Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* contain the recognition and measurement requirements for financial instruments when an entity has applied the accounting policy choice to use those sections instead of applying the requirements of IFRS 9 or IAS 39. Additional information on scoping is included in Chapter 11 at 3.1. [FRS 102.11.7].

Section 11 deals with what are termed 'basic' financial instruments, which are certain non-complex debt instruments and equity securities. It sets out the criteria for basic financial instruments and how they are measured, along with the impairment requirements. It also includes the derecognition requirements for financial instruments, and various disclosure provisions. Section 11 has been structured to provide all the financial instrument accounting requirements for many entities who do not enter into more complex transactions.

Section 12 applies to all other financial instruments, which need to be measured at fair value through profit or loss, and addresses the hedge accounting requirements. It also contains associated disclosure provisions.

The classification and measurement requirements in Sections 11 and 12 are simpler and less stringent compared to IAS 39 and IFRS 9: instruments are classified as either basic or other, and measurement is at amortised cost, cost or fair value.

The impairment requirements in Section 11 have been drawn from IAS 39's incurred loss model. As part of the FRC's Periodic Review 2024, the FRC did not make any amendments to incorporate the expected credit loss model into FRS 102 (see 6.5.1 below).

The FRC issued an updated version of FRS 102 in September 2024, following the issue of the Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland - Periodic Review 2024* - issued in March 2024 ('the Periodic Review 2024'). These amendments are mandatory for accounting periods beginning on or after 1 January 2026.

The main amendment made by the Periodic Review 2024 is that entities can only change their accounting policy for recognition and measurement from applying Section 11 and Section 12 or a combination of IFRS 9 and IAS 39, to solely applying IAS 39 if it makes their policies consistent with the consolidated financial statements in which the entity is included. [FRS 102.11.2].

2 Comparison between Sections 11, 12 and IFRS

The comparable extant IFRS accounting standards are IAS 39 and IFRS 9. The main differences between FRS 102 and IFRS 9 are discussed below. The discussion also includes a comparison to IAS 39 which is relevant for those entities that choose the option to apply IAS 39 for the purposes of recognition and measurement.

2.1 Classification and measurement

FRS 102 has a three-tiered measurement model: amortised cost, cost or fair value through profit or loss. That is, debt instruments must be measured at amortised cost if they meet the criteria or, if they do not, at fair value through profit or loss, while equities (and certain derivatives on equities) must be measured at fair value through profit or loss and only at cost in limited circumstances. Hence, entities which prefer to recognise debt or equity securities at fair value through other comprehensive income may choose to opt to apply IAS 39 or IFRS 9.

Section 11 and 12		IAS 39	IFRS 9
Financial assets			
Debt instrument	Amortised cost if the conditions in Section 11 are met, otherwise fair value through profit or loss.	Amortised cost, unless: (a) Held for trading. (b) Designated at FVTPL upon initial recognition both categories leading to measurement at fair value through profit or loss. (c) Available for sale, leading to measurement at fair value through other comprehensive income.	Depending on the business model and contractual cash flow characteristics of the asset (SPPI test) debt instruments can be at amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss.
Equity instrument	Fair value through profit or loss, unless fair value cannot be measured reliably then cost.	Fair value through profit or loss, unless designated as available for sale, leading to measurement at fair value through other comprehensive income.	Fair value through profit or loss unless designated irrevocably upon initial recognition at FVOCI (without recycling of fair value movements).
Financial liabilities			
All instruments	Under FRS 102 there is no difference between assets and liabilities in terms of subsequent measurement. However, entities must consider legal requirements.	Amortised cost, unless it is: (a) Held for trading. (b) Designated at FVTPL upon initial recognition. (c) A financial liability that arises when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. (d) A financial guarantee contract.	Same as IAS 39.

Section 11 and 12		IAS 39	IFRS 9
		(e) A below-market loan commitment. (f) Designated as a hedged item in a qualifying hedging relationship. (g) Contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies.	
Embedded derivatives			
Embedded derivatives	No separation of embedded derivatives	Separation of embedded derivatives within financial assets and financial liabilities is required unless: (i) The embedded derivative is considered to be closely related to the host contract. (ii) The embedded derivative does not meet the definition of a derivative on its own. And (iii) The host contract and embedded derivative are together accounted for as a hybrid instrument, measured at fair value through profit or loss.	Separation of embedded derivatives within financial liabilities is required unless: (i) The embedded derivative is considered to be closely related to the host contract. (ii) The embedded derivative does not meet the definition of a derivative on its own. And (iii) The host contract and embedded derivative are together accounted for as a hybrid instrument, measured at fair value through profit or loss. Embedded derivatives within financial assets are not separated but affect the classification of the instrument as they may not meet the definition of a basic lending arrangement.

For basic debt securities, the criteria to recognise them at amortised cost under FRS 102 are less stringent than under IFRS 9, as explained at 2.3.1 below. Unlike under IFRS, there is no concept in FRS 102 of 'held for trading'. Basic debt instruments that are held for trading purposes are not automatically required to be recorded at fair value, and entities will need to elect to use the 'fair value option', as explained at 6.4 below, if they wish to record these instruments at fair value rather than at amortised cost.

In the case of investments in equity instruments, FRS 102 requires measurement at fair value through profit or loss (unless fair value cannot be measured reliably, in which case they must be measured at cost less impairment). Unless such investments are held for trading, IFRS provides the option to designate these investment as: a) at fair value through other comprehensive income under IFRS 9, in which case changes in fair value are recognised in other comprehensive income with no impact on profit or loss; or b) available for sale under IAS 39, in which case changes in fair value are recognised in other comprehensive income, with recycling to profit or loss in case of impairment or de-recognition.

The complex embedded derivative separation rules in paragraph 11 of IAS 39 (both assets and liabilities) and IFRS 9 (liabilities only) do not exist in FRS 102 and many financial instruments containing embedded derivatives, including financial liabilities, will need to be measured at fair value through profit or loss under FRS 102.

2.2. Impairment

Section 11 uses the same principles and criteria as the incurred loss model under IAS 39 with one major difference: under FRS 102, assets which have been individually assessed for impairment and found not to be impaired, are not subsequently required to be included in a collective assessment of impairment.

By contrast, the IFRS 9 expected credit loss model is complex. Entities are required to recognise either 12-month or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk since initial recognition. The measurement of expected credit losses reflects:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes.
 - The time value of money.
- And
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. [IFRS 9.5.5.17].

2.3 Subsequent measurement

The requirements for subsequent measurement are fundamentally different between IAS 39 and IFRS 9, and are therefore treated in two different sections.

2.3.1 Subsequent measurement: IFRS 9

The classification of financial assets and liabilities under FRS 102 is generally symmetrical, that is, instruments classified as basic financial assets by the holder are usually classified as basic financial liabilities by the issuer.

By contrast, IFRS 9 requires two different approaches for the classification of financial assets and financial liabilities. Under IFRS 9, the classification of financial assets is based on two tests:

- (a) The contractual characteristics test

And

- (b) The business model test

Only those debt instruments that both pass the contractual characteristics test and are held within a business model with the objective to collect contractual cash flows can be carried at amortised cost. Under FRS 102, debt instruments that qualify as basic under Section 11 should also pass the IFRS 9 contractual characteristics test; however, FRS 102 has no business model test and therefore, regardless of whether they are held for trading or for purposes other than collecting cash flows, basic debt instruments are not prevented from being carried at amortised cost.

In addition, under IFRS 9 there are two categories of financial assets carried at fair value through other comprehensive income, for which there are no equivalent categories available under FRS 102:

- (a) Debt instruments that pass the contractual characteristics test and are held within a business model for which the purpose is collecting contractual cash flows and selling, in which case, gains or losses recognised in other comprehensive income are recycled into profit or loss upon impairment or derecognition.

And

- (a) Equity instruments that are not held for trading can be designated irrevocably at initial recognition at fair value through other comprehensive income, in which case gains or losses recognised in other comprehensive income are never recycled into profit or loss.

Under IFRS 9, the classification of financial liabilities prescribes the use of amortised cost, unless the fair value option is applied (which is explained in 6.4 below) or they are designated at fair value through profit or loss. Under FRS 102, the classification of financial liabilities follows the same criteria as for financial assets, and any instrument for which the terms are not consistent with the principle-based description of a basic debt instrument would be classified as an 'other' financial instrument in accordance with Section 12 of FRS 102 and carried at fair value through profit or loss.

Furthermore, in the case of financial liabilities with embedded derivatives, under IFRS 9 there is a requirement to separate certain embedded derivatives and carry the host financial liability at amortised cost, while under FRS 102 such an instrument must be treated as a single financial liability and carried at fair value through profit or loss.

There are two main differences for the fair value option under FRS 102 and IFRS 9:

- Under IFRS 9, a financial liability that contains an embedded derivative that requires separation as discussed in the preceding paragraph can be instead designated at fair value through profit or loss. When this designation occurs, the accounting will be consistent with FRS 102.
- Under FRS 102, financial assets can be designated at fair value if they are managed and their performance is evaluated on a fair value basis. Under IFRS 9, no fair value option is necessary since financial assets managed on a fair value basis would fail the business model test for amortised cost accounting and must be measured at fair value through profit or loss.

Under IFRS 9, when financial liabilities are designated at fair value through profit or loss, the effect of changes in own credit risk on its fair value must be recognised in other comprehensive income. This requirement does not exist in Sections 11 and 12 of FRS 102.

In May 2024, the IASB issued amendments to IFRS 9 that address, among other topics, two areas relevant to subsequent measurement. These are only applicable to FRS 102 preparers that apply IFRS 9 as an accounting policy choice: [FRS 102.11.2(c)]

- (a) **SPPI Test for Contingent Features (including ESG-linked loans):** The amendments provide guidance on the application of the SPPI test to financial assets with contingent features, such as ESG-linked loans. In contrast, FRS 102 does not include specific guidance in this area, therefore the requirements in paragraphs 9 and 9A of Section 11 of FRS 102 should be followed when accounting for both financial assets and financial liabilities. See 4.1.2.C below.
- (b) **Non-recourse Features and Contractually Linked Instruments:** The amendments also introduce additional guidance for financial assets with non-recourse features and for contractually linked instruments, which are a subset of such assets. FRS 102 does not provide specific requirements for these instruments; therefore, entities should refer to paragraphs 9 and 9A of Section 11 of FRS 102. See 4.1.2.D below.

Further guidance on the treatment under IFRS 9 on this topic is provided in the most recent version of the EY publication, International GAAP®.

2.3.2 Subsequent measurement: IAS 39

Section 11 contains less stringent conditions for a debt instrument to be measured at amortised cost than IAS 39. Under IAS 39, only financial assets that are classified as loans and receivables or held to maturity can be subsequently measured at amortised cost. For the former category, the financial asset must not be quoted in an active market and must contain fixed or determinable payments while for the latter category, in addition to the financial asset having fixed or determinable payments, the entity must have the positive intention and ability to hold it to maturity. [IAS 39.9]. This means that, for example, most quoted debt securities, which could not be classified as a loan and receivable under IAS 39, will probably qualify for measurement at amortised cost under Section 11. Furthermore, under Section 11 entities are not required to hold debt securities to maturity to achieve amortised cost accounting.

Another difference is that FRS 102 does not have the concept of the 'trading book' contained in IAS 39, so all basic debt instruments will be recorded at amortised cost, irrespective of the reason they were acquired or the purpose for which they are held, unless the entity makes use of the 'fair value option' (see 6.4 below).

2.4 Derecognition

The FRS 102 derecognition principles for financial assets are broadly similar to those in IFRS 9 and IAS 39 but they have been simplified and do not contain the full body of guidance that can be found in IFRS 9 and IAS 39. In below paragraphs we address three differences between IFRS and FRS 102.

2.4.1 What is a transfer?

Section 11 provides no guidance on what is meant by a 'transfer of risks and rewards' within paragraph 33(b) of Section 11 of the standard. Nor does it define the meaning of the word 'transfer'. Whereas, under IFRS, an entity transfers all or a part of a financial asset (the transferred financial asset) if, and only if, it either: *[IFRS 9.3.2.4, IAS 39.18]*

(a) Transfers the contractual rights to receive the cash flows of that financial asset.

Or

(b) Retains the contractual rights to receive the cash flows of that financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement (pass through arrangements).

IFRS 9 and IAS 39 also address in some detail many complex arrangements that do not qualify for derecognition because they do not meet their transfer criteria. In particular, IFRS 9 and IAS 39 have additional guidance on the treatment of pass-through arrangements. *[IAS 39.19, IFRS 9.3.2.5]*. FRS 102 does not contain guidance for any of these complex arrangements; therefore, a preparer has to develop an appropriate accounting policy if it deals with such transactions, *[FRS 102.10.4]*, and may want to look at IFRS. *[FRS 102.10.6]*.

Further guidance on the treatment under IFRS on this topic is provided in the most recent version of the EY publication, International GAAP®.

2.4.2 Continuing involvement

Situations in which the transferor has retained some, but not substantially all, risks and rewards of ownership and has retained control over the asset give rise to another difference from the IFRS derecognition requirements.

Under IFRS the assets would only be recognised to the extent of the transferor's 'continuing involvement', that is, the extent that the transferor is exposed to changes in the value of the transferred asset.

[IFRS 9.3.2.16, IAS 39.30]. Under FRS 102, derecognition would not be appropriate and the asset continues to be recognised, as it only allows for derecognition if control has been transferred. *[FRS 102.11.33(c)]*.

2.4.3 Derecognition date of financial assets and liabilities

In May 2024, the IASB issued amendments to IFRS 7 *Financial Instruments: Disclosures* and IFRS 9, which clarify that financial assets are derecognised when the entity's rights to the contractual cash flows expire or are transferred. Financial liabilities are derecognised when the obligations specified in the contract are discharged, cancelled or expire, or the liability otherwise qualifies for derecognition, which is the settlement date. *[IFRS 9.B3.1.2A]*. The amendments also introduce an accounting policy choice where financial liabilities are deemed to be discharged before the settlement date if initiated using an electronic payment system (if specific conditions are met). *[IFRS 9.B3.3.8]*. These amendments are not reflected in FRS 102.

Further information regarding the impact of these amendments in IFRS 9 can be found in the most recent version of the EY publication, International GAAP®.

3 Recognition and measurement: accounting policy choice

As discussed at 2 above, entities can choose for recognition and measurement to apply either:

- (i) Sections 11 and 12

Or

- (ii) IAS 39 (as adopted in the relevant jurisdiction) as the standard applies prior to the application of IFRS 9

An entity must apply the version of IAS 39 that applied immediately prior to IFRS 9 superseding IAS 39. This means that, for UK and Irish entities, the so-called 'EU carve-out of IAS 39' must be applied. The EU carve-out of IAS 39 amended paragraph 81A and related Application Guidance in IAS 39, with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities.

Once the Periodic Review 2024 changes are adopted, an entity is not permitted to choose IAS 39 as a new accounting policy unless the change makes its policies consistent with the consolidated financial statements in which the entity is included. See 3.2.2 below. Entities are permitted to continue applying IAS 39.

Or

- (iii) IFRS 9 (as adopted in the relevant jurisdiction), and IAS 39 (as amended following the publication of IFRS 9) as far as it remains applicable when IFRS 9 is applied. [FRS 102.11.2, FRS 102.12.2].

On application of IFRS 9 entities are permitted to continue to apply the IAS 39 hedge accounting requirements with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities. Hence, following the publication of IFRS 9, IAS 39 was amended to include only the guidance necessary to continue to apply such a hedge relationship. [IFRS 9.6.1.3].

The above choice of guidance represents an accounting policy choice that only applies for recognition and measurement of financial instruments. [FRS 102.11.2, FRS 102.12.2]. The disclosure requirements of paragraph 38A in Section 11 and presentation requirements of paragraph 25W in Section 12 of the standard for offsetting on the statement of financial position are still applicable regardless of the accounting policy choice above.

3.1 Impact of the accounting policy choice

In applying this accounting policy choice, preparers of financial statements have to bear in mind the consequences implied in choosing the application of IAS 39 or IFRS 9. Below there is a list of the most significant ones:

- a. **Applicability:** The choice must be made for all financial instruments, [FRS 102.11.2, FRS 102.12.2], and be applied for classification and measurement, impairment and hedge accounting. Entities cannot decide to elect to use IAS 39 or IFRS 9 with IAS 39 to the extent it remains applicable only for certain items.
- b. **Scope:** When an entity chooses to apply IAS 39 or IFRS 9, it applies the scope of the relevant standard to its financial statements. [FRS 102.11.2, FRS 102.12.2]. Therefore, there could be situations where instruments that are out of the scope of Sections 11 and 12 could be within the scope of IAS 39 or IFRS 9; examples of this are embedded derivatives in non-financial contracts (which are discussed at 4.1.4 below) and financial guarantees (which are discussed in Chapter 24 at 2.1). Furthermore, entities have to bear in mind that IAS 39 and IFRS 9 have their own exclusions from the scope; in such cases, the references to other IFRSs should be interpreted as to the relevant sections of FRS 102.
- c. **Definitions:** IAS 39 and IFRS 9 have their own definitions which in some cases differ from those in FRS 102, including the definition of fair value (see 6.4 below) and derecognition date of financial assets and liabilities (see 2.4.3 above).
- d. **Disclosure requirements:** As mentioned at 4 above, the disclosure requirements of Sections 11 and 12 are applicable regardless of the accounting policy choice for recognition and measurement. However, such disclosure requirements are written based on the definitions and scope of FRS 102. Entities that apply IAS 39 and IFRS 9 refer to the corresponding definitions provided in IFRS when interpreting the disclosure requirements in FRS 102.

Disclosure requirements under FRS 102 are less onerous than those in IFRS 7. Entities applying IAS 39 and IFRS 9 are not required to comply with the additional disclosures of IFRS 7 although they should consider whether any additional disclosures are to be made to enable users of the financial statements to evaluate the significance of financial instruments for their financial position and performance.

[FRS 102.11.42].

The recognition and measurement requirements of Sections 11 and 12 are discussed in the rest of this chapter.

3.2 Changes in accounting policy choice for recognition and measurement of financial instruments

Section 10 *Accounting Policies, Estimates and Errors* contains the requirements for determining when a change in accounting policy is appropriate, how such a change should be accounted for and what information should be disclosed. Chapter 9 discusses in detail the requirements of Section 10. Below we discuss the relevant aspects resulting from the application of the accounting policy choice described at 3.1 above. [FRS 102.11.2, FRS 102.12.2].

3.2.1 Mandatory changes in accounting policy

When an entity has elected to apply the recognition and measurement provisions of IFRS 9 and the requirements of IFRS 9 change, the entity must account for that change in accounting policy in accordance with the transitional provisions, if any, specified in the revised IFRS 9. [FRS 102.10.11(b)].

The accounting policy choice described at 3 above allows the use of IAS 39 (as adopted in the relevant jurisdiction). Even though IFRS 9 has superseded IAS 39, the FRC decided to maintain the option of continuing to apply IAS 39 (in the form applicable immediately prior to the effective date of IFRS 9). Hence there is no requirement for entities to change to IFRS 9 from IAS 39 for classification and measurement of financial instruments.

3.2.2 Voluntary changes

An entity can voluntarily change its accounting policy only if the change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. [FRS 102.10.8(b)].

In the case of a change from IAS 39 to IFRS 9, it would appear logical to apply the transition provisions of IFRS 9. A change from IAS 39 or IFRS 9 to Sections 11 and 12 is not discussed in FRS 102, hence as there are no specific transitional provisions any change must be applied retrospectively. [FRS 102.10.11(d)]. The transition rules of Section 35 *Transition to this FRS* will not apply in these circumstances as they apply only upon first-time adoption of FRS 102. Following the FRC's Periodic Review 2024, entities can only change their accounting policy for recognition and measurement from applying full Section 11 and Section 12 or a combination of IFRS 9 and IAS 39, to applying IAS 39 if it makes their policies consistent with consolidated financial statements in which the entity is included. [FRS 102.11.2].

4 Classification

Section 11 provides a definition of a financial instrument as follows: a financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. [FRS 102.11.3]. This is identical to the definition in IAS 32 *Financial Instruments: Presentation*.

FRS 102 introduces two categories of financial instruments:

(i) Basic financial instruments

And

(ii) Other financial instruments

All financial instruments within the scope of Sections 11 and 12 (see Chapter 11 at 3.2) must be categorised as either a 'basic' or 'other' financial instrument. This categorisation will drive whether the accounting guidance in Section 11 or 12, respectively, must be applied.

The category of basic financial instruments is not defined. Instead, a list of conditions that basic instruments would ordinarily satisfy, and examples of instrument types that normally satisfy those conditions is provided. 'Other' or non-basic financial instruments are defined as a default category of all financial instruments that fail to meet the conditions to be a basic financial instrument.

4.1 'Basic' financial instruments

Section 11 deals with the classification and accounting for basic financial instruments. It introduces the term 'basic financial instrument' by providing a list of financial instruments that must be accounted for as basic financial instruments. [FRS 102.11.8].

Extract from Section 11

- 11.8** An entity shall account for the following financial instruments as basic financial instruments in accordance with this section:
- (a) cash;
 - (b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9 and is not a derivative financial instrument;
 - (bA) a debt instrument that, whilst not meeting the conditions in paragraph 11.9, nevertheless is consistent with the description in paragraph 11.9A, and is not a derivative financial instrument;
 - (c) commitments to receive or make a loan to another entity that:
 - (i) cannot be settled net in cash; and
 - (ii) when the commitment is executed, are expected to meet the conditions in paragraph 11.9 or be consistent with the description in paragraph 11.9A;
 and
 - (d) an investment in a non-derivative financial instrument that is equity of the issuer (eg most ordinary shares and certain preference shares).

FRS 102 additionally provides a list of examples that normally satisfy the conditions of paragraph 11.8 above, these are shown below: [FRS 102.11.5]

Extract from Section 11

- 11.5** Basic financial instruments within the scope of Section 11 are those that satisfy the conditions in paragraph 11.8. Examples of financial instruments that normally satisfy those conditions include:
- (a) cash;
 - (b) demand and fixed-term deposits when the entity is the depositor, eg bank accounts;
 - (c) commercial paper and commercial bills held;
 - (d) accounts, notes and loans receivable and payable;
 - (e) bonds and similar debt instruments;
 - (f) investments in non-derivative financial instruments that are equity of the issuer (eg most ordinary shares and certain preference shares); and
 - (g) commitments to receive a loan and commitments to make a loan to another entity that meet the conditions of paragraph 11.8(c).

4.1.1 Basic equity instruments

Section 11 includes as 'basic', investments in non-derivative financial instruments that are equity of the issuer. [FRS 102.11.8(d)]. Defining basic equity instruments in this fashion ensures consistency in the treatment from the point of view of the issuer and the holder.

Investments in subsidiaries, associates and joint ventures that are accounted for in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Investments in Joint Ventures* are outside the scope of Sections 11 and 12 and therefore are not considered basic equity instruments.

4.1.2 Basic debt instruments

The term 'debt instrument' is not defined in FRS 102. Instead, examples of debt instruments are given of an account, note or loan receivable or payable. [FRS 102.11.8(b)]. A debt instrument can be a financial asset or a financial liability, depending on whether the entity is the debtor or creditor in the instrument. However, the assessment must first be made as to whether the issued instrument is a liability or equity from the point of view of the issuer (see Chapter 12).

FRS 102 sets out six conditions a debt instrument must satisfy in order to be classified as 'basic'. If one of the conditions is not satisfied, it will still meet the definition of 'basic' if it is consistent with the principle-based description of a 'basic' financial instrument. The description requires a 'basic' debt instrument to give rise to cash flows on specified dates that constitute reasonable compensation for the time value of money, credit risk and other basic lending risks and costs (e.g., liquidity risk, administrative costs associated with holding the instrument and lender's profit margin). Such reasonable compensation is dependent on the prevailing economic conditions and monetary policies in operation. [FRS 102.11.9A, FRS 102.BC.B11.11, FRS 102.BC.11.12].

Most 'plain vanilla' debt instruments will satisfy either the six conditions or the principle-based description of a 'basic' debt instrument and can therefore be accounted for at amortised cost. These include, *inter alia*:

- (a) Trade accounts and notes receivable/payable, and loans from banks or third parties [FRS 102.11.10(a)]
- (b) Accounts payable in a foreign currency (however, any change in the amount payable because of a change in the exchange rate is recognised in profit or loss) [FRS 102.11.10(b)]
- (c) Loans to or from subsidiaries or associates that are due on demand [FRS 102.11.10(c)]
- (d) A debt instrument that would become immediately receivable if the issuer defaults on an interest or principal payment [FRS 102.11.10(d)]
- (e) Commercial paper and commercial bills [FRS 102.11.5(c)]

And

- (f) Bonds and similar instruments [FRS 102.11.5(e)]

Contractual terms that introduce exposure to unrelated risks or volatility (e.g., changes in equity prices or commodity prices) are inconsistent with the principle-based description of a 'basic' debt instrument.

[FRS 102.11.9A], and therefore debt instruments with such terms would be within the scope of Section 12. These instruments include, *inter alia*, derivatives (such as options, rights, warrants, future contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument) and investments in convertible debt. [FRS 102.11.6(b), FRS 102.11.11].

The six conditions for and the description of, a basic financial instrument and how these interact in assessing classification is discussed at 4.1.2.A to 4.1.2.F below.

Condition	Paragraph
Condition 1 - Contractual return to the holder	4.1.2.A
Condition 2 - Link to inflation	4.1.2.B
Condition 3 - Variation of the return	4.1.2.C
Condition 4 - Loss of principal or interest	4.1.2.D
Condition 5 - Prepayment options	4.1.2.E
Condition 6 - Extension options	4.1.2.F

4.1.2.A Condition 1 - Contractual return to the holder

In order for a debt instrument to be classified as 'basic', the contractual return to the holder, assessed in the currency in which the debt instrument is denominated, must be:

- (i) A fixed amount
- (ii) A positive fixed rate or a positive variable rate
- Or
- (iii) A combination of a positive variable rate and a positive or a negative fixed rate (e.g., SONIA plus 200 basis points or SONIA less 50 basis points, but not 500 basis points less SONIA) [FRS 102.11.9(a)]

A variable rate is defined for this purpose as a rate which varies over time and is linked to a single observable interest rate, or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated - see Condition 2 below - provided such links are not leveraged. [FRS 102.11.9fn46].

FRS 102 does not provide a definition of leverage. However, FRS 102 gives the example of interest on a loan that is referenced to 2 times the bank's standard variable rate and explains that such a leveraged instrument should be measured in accordance with Section 12.

Illustration 4-1: Interest on a loan is referenced to 2 times the bank's standard variable rate

A bank's standard variable rate is an observable rate and meets the definition of a variable rate, but the rate in this example is 2 times the bank's standard variable rate and therefore the link to the observable interest rate is leveraged. As a result of the leverage, the rate in this example is not a variable rate as described in paragraph 11.9(a).

A leveraged link to an observable interest rate is also inconsistent with the description in paragraph 11.9A because it increases the variability of cash flows so that they do not represent reasonable compensation for the time value of money, credit risk or other basic lending risks and costs. The instrument is measured at fair value in accordance with Section 12. [FRS 102.11.9A.E5].

The contractual return must be assessed in the currency in which the debt instrument is denominated. [FRS 102.11.9fn46]. We believe this clarification is included to avoid concluding that a return would not be determinable (as required by Condition 3 below) when subject to foreign currency fluctuations. When a debt instrument is denominated in a currency other than the functional currency, the impact of the changes in the exchange rate are accounted for as required by Section 30 *Foreign Currency Translation* (see Chapter 32).

The following contractual returns meet Condition 1:

- (a) A fixed amount: FRS 102 provides the example of a zero-coupon loan.

Illustration 4-2: A zero-coupon loan

For a zero-coupon loan, the holder's return is the difference between the nominal value of the loan and the issue price. The holder (lender) receives a fixed amount when the loan matures and the issuer (borrower) repays the loan. The return to the holder meets the condition in paragraph 11.9(a)(i). [FRS 102.11.9A.E1].

- (b) A positive fixed rate or a positive variable rate: This is the case when a single interest rate is specified in the debt instrument.

How we see it

In our view, examples of variable rates would be a bank's standard variable rate ('SVR'), IBOR, SONIA, Euribor and the Bank of England base rate, but this is not an exhaustive list.

- (c) A negative variable rate: This is the case when that variable rate reflects prevailing economic conditions and monetary policies.

Illustration 4-3: A loan with interest payable at the bank's standard variable rate plus 1% throughout the life of the loan - the bank's standard variable rate is negative

The combination of a positive bank's standard variable rate plus a fixed interest rate of 1% meets the condition in paragraph 11.9(a)(iv). However, the conditions in paragraph 11.9(a) do not explicitly address the case when the bank's standard variable rate is negative and such a rate may not meet the conditions. The interest rate is consistent with the description in paragraph 11.9A provided the bank's standard variable rate reflects prevailing economic conditions and monetary policies. In this case the negative interest rate represents reasonable compensation for basic lending risks. [FRS 102.11.9A.E3A].

How we see it

In our view, even though the example refers to a negative variable rate, the same considerations and conclusion would apply to a fixed negative rate that reflects the prevailing conditions in the market.

- (d) A combination of a positive variable rate and a positive or a negative fixed rate: FRS 102 provides the example of a loan with interest payable at the bank's SVR plus 1% throughout the life of the loan.

Illustration 4-4: A loan with interest payable at the bank's standard variable rate plus 1% throughout the life of the loan

As discussed in Example 2 above, a bank's standard variable rate is a permitted variable rate in accordance with the definition of variable rate. The combination of a positive fixed rate (i.e., plus 1%) and a positive variable rate is a permitted return under paragraph 11.9(a)(iv). The combination of a bank's standard variable rate plus a fixed interest rate of 1% therefore meets the condition in paragraph 11.9(a)(iv). [FRS 102.11.9A.E3].

FRS 102 also provides an example of an 'inverse floater' and explains that such an instrument must be measured in accordance with Section 12.

Illustration 4-5: Interest on a loan is charged at 10% less 6-month interbank offered rate (IBOR) over the life of the loan

The effect of deducting a variable rate from a positive fixed rate is that the interest on the loan increases as and when the variable rate decreases and vice versa (so called inverse floating interest).

In accordance with paragraph 11.9(a)(iv) the combination of positive or negative fixed rate and positive variable rate is a permitted return. The variable rate (6-month IBOR) meets the definition of a variable rate, as the rate is a quoted interest rate. However, since the variable rate is negative (minus 6-month IBOR), the rate is in breach of the condition in paragraph 11.9(a)(iv).

The inverse floating interest rate is also inconsistent with the description in paragraph 11.9A because the interest charged increases when reasonable compensation for the time value of money, credit risk or other basic lending risks and costs would decrease, and vice versa. The instrument is measured at fair value in accordance with Section 12. [FRS 102.11.9A.E6].

4.1.2.B Condition 2 - Link to inflation

The contract may provide for repayments of the principal or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged. [FRS 102.11.9(aA)].

The three main aspects of this condition are:

- (i) The link to inflation can be for either the repayment of principal or the return of the holder but should not be such that the inflation adjusted interest rate is applied to the inflation adjusted principal, as this would imply leverage.
- (ii) The inflation index must be a single relevant observable index of general price inflation and must be denominated in the currency of the debt instrument. Common examples would be the Retail Price Index (RPI) and the Consumer Price Index (CPI) in the UK. Other indexes that do not measure general price inflation of goods and services would not be acceptable.

FRS 102 provides the example of interest on a Sterling denominated mortgage that is linked to the UK Land Registry House Price Index (HPI) plus 3% and explains that such an instrument should be measured in accordance with Section 12.

Illustration 4-6: Interest on a GBP denominated mortgage is linked to the UK Land Registry House Price Index (HPI) plus 3%

In accordance with paragraph 11.9(aA) the holder's return may be linked to an index of general price inflation of the currency of the debt instrument. The mortgage is denominated in GBP and a permitted inflation index would be an index that measures general price inflation of goods and services denominated in GBP.

As the HPI measures inflation for residential properties in the UK and is not a measure of general price inflation, the return to the holder breaches the condition in paragraph 11.9(aA).

The mortgage is also inconsistent with the description in paragraph 11.9A because the linkage to the HPI introduces exposure to a risk that is not consistent with a basic lending arrangement. The instrument is measured at fair value in accordance with Section 12. [FRS 102.11.9A.E7].

- (iii) The link to inflation must not be leveraged. Similar to the condition discussed at 4.1.2.A above, a term that amplifies the inflation impact on the return is likely to make the instrument fail the 'basic' definition.

4.1.2.C Condition 3 - Variation of the return

The contract may provide for a determinable variation of the return to the holder during the life of the instrument, provided that:

- (i) The new rate satisfies Condition 1 and the variation is not contingent on future events other than:
- (a) A change of a contractual variable rate.
 - (b) To protect the holder against credit deterioration of the issuer.
 - (c) Changes in levies applied by a central bank or arising from changes in relevant taxation or law.
- Or

- (ii) The new rate is a market rate of interest and satisfies Condition 1. [FRS 102.11.9(aB)].

The crux of Condition 3 is that variations in the rate after initial recognition are permitted provided that:

- The variations are not contingent on future events, except in the limited scenarios mentioned above. These limited scenarios are designed to allow variations in the return driven by changes in the credit risk of the borrower and costs of lending, both of which are inherent to the determination of interest rates. Increasing the interest rate due to a decline in the borrower's credit worthiness would be acceptable. For example, if a borrower breaches a debt covenant that was stipulated in the loan agreement, the bank would be entitled to increase the interest rate to ensure that its return from the loan mitigates its increased credit risk. Finally, if a rate change is required due to changes in levies or legislation or regulations, this would be permitted.
- Variations in the rate other than those discussed above are only allowed when the new rate is a market rate of interest.

Contractual terms that give the lender the unilateral option to change the terms of the contract are not 'determinable' for this purpose. [FRS 102.11.9(aB)].

How we see it

In our view, when the lender has the unilateral option to change the terms of the contract without stipulating which rate it can change to, it would fail to meet the conditions of a basic instrument. In this respect, we do not believe that the unilateral right of a bank to change its SVR represents a change in the terms of the contract. If the option to change the terms was restricted to a market rate of interest, then the terms would also pass this condition.

FRS 102 does not include guidance on how to deal with the issue of financial assets with ESG-linked contractual features. Therefore, provided the accounting policy choice to apply IFRS 9 or IAS 39 has not been made, the guidance in paragraphs 9 and 9A of Section 11 of FRS 102 should be followed when dealing with both financial assets and liabilities.

Further guidance on the treatment under IFRS on this topic is provided in the most recent version of the EY publication, International GAAP®.

How we see it

The existence of a contractually specified variation of interest depending on whether a carbon emission target is met, is not dealt with in paragraph 9(aB)(i) of Section 11. In our view, a preparer therefore needs to consider whether the new rate is a market rate of interest and therefore satisfies paragraph 9(aB)(ii) of Section 11 or whether it can be considered a basic financial instrument under paragraph 9A of Section 11. In the case of non-basic financial liabilities, a preparer will also need to consider the impact of the Regulations in determining the measurement basis, which has been discussed at 4.4.2.A below.

Some examples of the application of condition 3 are provided below:

Illustration 4-7: A fixed interest rate loan with an initial tie-in period which reverts to the bank's standard variable interest rate after the tie-in period

The initial fixed rate is a return permitted by paragraph 11.9(a)(ii). A bank's standard variable interest rate is an observable interest rate and, in accordance with the definition of a variable rate, is a permissible link and so meets the condition in paragraph 11.9(a)(ii).

The variation of the interest rate after the tie-in period is non-contingent and, since the new rate (i.e., the bank's standard variable rate) meets the conditions in paragraph 11.9(a), the conditions in paragraph 11.9(aB)(i) are met. [FRS 102.11.9A.E2].

Illustration 4-8: A loan with interest payable at the bank's standard variable rate less 1% throughout the life of the loan, with the condition that the interest rate can never fall below 2%

Paragraph 11.9(aB)(i)(1) permits variation of a return to a holder (lender) that is contingent on a change of a contractual variable rate. In this example the contractual variable rate is the bank's standard variable rate. The variation of the return to the holder is between the bank's standard variable rate less 1% and 2%, depending on the bank's standard variable rate. For example, if the bank's standard variable rate is less than 3%, the return to the holder is fixed at 2%; if the bank's standard variable rate is higher than 3%, the return to the holder is the bank's standard variable rate less 1%. The contractual variation meets the condition in paragraph 11.9(aB)(i)(1).

The holder is protected against the risk of losing the principal amount of the loan via the interest rate floor of 2%. The condition in paragraph 11.9(b) is therefore also met. [FRS 102.11.9A.E4].

Illustration 4-9: A loan with a condition that the interest rate is reset to a higher rate if a set number of payments is missed.

In this case the change in interest rate is contingent on a set number of payments being missed. The missed payments are an indicator of credit deterioration of the issuer. The interest rate reset condition therefore meets the condition in paragraph 11.9(aB)(i)(2) (provided the new rate meets the conditions in paragraph 11.9(a)), and the interest rate reset condition would not result in the loan being measured at fair value in accordance with Section 12. [FRS 102.11.9A.E4A].

Another situation related to credit exists in the case of an instrument with a variable interest rate that changes based on variations in the credit rating of the issuer, i.e., if the credit rating deteriorates, the rate increases, and if it improves, the rate decreases.

The change in interest rate is contingent on a future event. Condition (3)(i)(b) allows changes contingent on future events to protect against credit deterioration of the issuer, but it does not mention changes based on credit improvement.

How we see it

We believe the fact that the rate could decrease when the credit rating improves does not contradict the principle that variations in the return caused by contingent future events should only occur to protect against the deterioration of credit risk. This is because variations in the return driven by credit risk are considered to be consistent with a basic lending arrangement and therefore with the principle-based description of a 'basic' debt instrument (see 4.1.2 above). Therefore, provided that the variable interest rate satisfies Condition 1, we believe this arrangement also satisfies Condition 3(i)(b) above.

FRS 102 does not include guidance on how to deal with the issue of financial assets with ESG-linked contractual features.

4.1.2.D Condition 4 - Loss of principal or interest

The focus of this condition is the possibility of losing principal or interest for the holder as a result of a contractual provision. Subordination of the debt instrument to other debt instruments does not affect the contractual right of the holder to the principal repayment. [FRS 102.11.9(b)]. Furthermore, the possibility of the issuer not repaying the amounts because of financial difficulties is not a contractual provision of the instrument and therefore should not be considered in assessing this condition.

FRS 102 provides an example of applying this condition in practice [FRS 102.11.9A.E4]. In that example, which is discussed at 4.1.2.C above, it is determined that the existence of the floor protects the holder against the risk of losing the principal amount of loan in circumstances where the negative fixed spread exceeds the positive variable rate. Without the floor, Condition 4 may not be met. [FRS 102.11.9.E4]. This could be interpreted as an indication that any negative market interest rate would fail this condition. However, as discussed at 4.1.2.A above, a negative rate would be consistent with the principle-based description of a basic debt instrument, when that variable rate reflects prevailing economic conditions and monetary policies, and would therefore not prevent the instrument from being classified as 'basic'. [FRS 102.11.9.E3A].

In assessing Condition 4, an entity must differentiate between debt instruments with terms that are contractually linked to the performance of an underlying asset or basket of assets without any other sources of repayment, (e.g., a securitisation or a non-recourse loan) and other debt instruments where the assets of the borrower are merely concentrated in one asset or a limited group of assets.

Where the cash flows of a debt instrument are contractually limited to the cash flows generated by an underlying asset or basket of assets, the risk of loss of principal due to losses on the underlying assets derives from a contractual term; therefore, the instrument would generally fail Condition 4 and be classified as non-basic, unless it is considered a basic financial instrument per paragraph 9A of Section 11 of the standard. However, the assessment is more complicated when there are several tranches of debt linked to the performance of the underlying asset or basket of assets through a 'waterfall' mechanism.

How we see it

Depending on their subordination in the waterfall, the resulting contractual risk of losing principal or interest will affect the assessment of the instrument's classification as a basic debt instrument. In our view, all tranches in the structure would fail Condition 4. However senior tranches in the structure are more likely to still be considered a basic debt instrument depending on the assessment of paragraph 9A of Section 11 as, on initial recognition, they may be expected to never experience losses of principal or interest. As more junior tranches are designed to absorb the first credit losses in the underlying portfolio, we would not expect such tranches to be considered basic debt instruments.

In the case of the concentration of assets of the borrower, there may be a similar economic effect without the contractual linkage, i.e., there is credit risk associated with whether the concentrated assets will be able to generate enough cash flows to service the debt instrument payments. For example, if an entity issues two loans, one more senior than the other and has no assets and liabilities other than a property, the question arises whether both or either of the loans in substance fail Condition 4.

How we see it

In our view, the more senior loan does not fail Condition 4 provided it is likely that the lower ranking loan is sufficient to absorb the expected losses on the property. In our view, even though the subordinated loan is not contractually linked, it is in substance constructed to absorb the first losses on the underlying assets in a similar manner to a contractually linked loan, in which case it fails Condition 4. Consequently, debt instruments where the borrower has a concentration of assets may not be consistent with a basic lending arrangement and judgement will be required to conclude on their classification.

4.1.2.E Condition 5 - Prepayment options

Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument, or permit the holder (the lender) to put it back to the issuer before maturity, must not be contingent on future events, other than to protect:

- (i) The holder against the credit deterioration of the issuer (for instance, as a consequence of defaults, credit downgrades or loan covenant breaches), or a change in control of the issuer.
- Or
- (ii) The holder or the issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that as a result of the early termination require reasonable compensation from either the holder or the issuer for the early termination does not constitute, in itself, a breach of Condition 5. [FRS 102.11.9(c)].

How we see it

In our view, even though FRS 102 refers to contractual provisions that permit prepayment, automatic prepayment provisions (i.e., those provisions that require, rather than permit, prepayment) must also be assessed on the same basis. Therefore, automatic prepayment provisions that would trigger prepayment in circumstances other than those listed above would cause the debt instrument to fail to meet this condition.

The following paragraphs discuss the key terms necessary to understand this Condition.

Contingent event considerations

Determining what is considered to be a contingent future event and whether the event meets the conditions above, particularly in relation to events under the control of the parties to the contract is a matter of judgement.

How we see it

If the lender has the right to require prepayment upon an event under the control of the borrower, such a provision would not be considered to be contingent on future events, as it represents a choice of the borrower, and hence would not contravene Condition 5. This is consistent with the approach for contingent settlement provisions applied to the classification of equities and liabilities (see Chapter 12 at 4.3).

In this regard, FRS 102 provides the following example:

Illustration 4-10: Early repayment on subordinated debt contingent on repayment of senior debt

Bank A lends CU10 million to Entity S. Entity S has an option to repay this loan at any time. Entity S's parent, Entity P, also lends it CU10 million. The loans have the same maturity date but the loan from Bank A is senior to the loan from Entity P. Entity S has the right to repay the loan to Entity P at par plus accrued interest at any time after the loan from Bank A has been repaid.

Early repayment terms that are within the control of the issuer are not contingent on future events. Therefore if early repayment of both loans is within Entity S's control then the prepayment option in the loan from Entity P is not considered to be contingent, does not breach the condition in paragraph 11.9(c) and does not therefore cause the loan from Entity P to be measured at fair value in accordance with Section 12.

If the terms were such that early repayment of the loan from Bank A was not within the control of Entity S, then the prepayment option in the loan from Entity P would be contingent on a future event other than those listed in paragraph 11.9(c). The nature of the contingent event may be an indicator when assessing whether a debt instrument is consistent with the description in paragraph 11.9A, but is not in itself a determinative factor. The restriction on the prepayment feature in the loan from Entity P would be consistent with the description in paragraph 11.9A because it exists simply to enforce its subordination relative to another debt instrument. The restriction on Entity S's ability to exercise the prepayment option in the loan from Entity P would not therefore cause the loan from Entity P to be measured at fair value in accordance with Section 12 by Entity S.

Reasonable compensation

Compensation in the event of prepayment may be payable by either party that chooses to exercise the early termination option. However, no guidance is provided as to what would be considered a reasonable amount of compensation. In this regard, we believe that entities will have a fair degree of discretion and that judgement will need to be exercised.

How we see it

In our view, if the amount of the prepayment compensation to the lender substantially represents the fair value of the instrument at that point, the compensation would normally be considered reasonable. That is, the prepayment amount represents the present value of the remaining contractual interest and principal payments at the point of prepayment, discounted by the current market interest rate for the remaining tenure.

For example, if a six-year bond is prepaid at the end of the third year, the prepayment amount will be approximately the sum of the contractual interest and principal amounts due over the remaining three years, discounted using the current market interest rate for a bond with similar characteristics.

A penalty on prepayment that is contractually pre-determined would not automatically fail to meet this condition but should be assessed in order to conclude whether such compensation in essence represents a reasonable amount of compensation or not. An example would be a mortgage loan with a prepayment penalty clause where the amount is intended to represent present value of lost interest, even if calculated in a different manner.

Examples of payments that would not be considered reasonable compensation for early termination could include penalty payments that are something other than lost interest, e.g., when it is linked to an index other than a general inflation index.

4.1.2.F Condition 6 - Extension options

Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy Conditions 1 to 5. *[FRS 102.11.9(e)]*.

In assessing compliance with this condition, entities must consider the fact that the extension option is a contingent event and its exercise will most likely cause a variation of return. In such a case, Condition 3(ii) would be applicable since the contingent event does not correspond to the three circumstances allowed under Condition 3(i); in order for the instrument to be considered as 'basic', the rate of interest for the extended period would need to be a prevailing market rate of interest at the time of exercising the option.

How we see it

In our view, extension options for which the rate applicable to the extended period are based on an agreed fixed rate or fixed amount would be consistent with the principle-based description of a 'basic' debt instrument, and hence the instrument could be classified as 'basic'.

4.1.3 Basic loan commitments

Loan commitments are not defined in FRS 102 but they are essentially firm commitments to provide credit under pre-specified terms and conditions, as defined in IFRS 9 and IAS 39. *[IFRS 9.BC22.2, IAS 39.BC15]*. Accordingly, loan commitments are financial instruments and therefore within the scope of Section 11 (see 3.1 above). *[FRS 102.11.8(c)]*. Examples would include a mortgage offer to an individual or a committed borrowing facility granted to a company. Within the terms of the loan commitment, the borrower could have the option or the obligation to borrow from the lender.

For a loan commitment to qualify as basic debt instrument, the following two conditions must be met:

- (i) The commitment cannot be settled net in cash.
- And
- (ii) The loan to be received/paid when the commitment is executed, is expected to be a basic financial instrument under Section 11 (see discussion at 4.1.2 above). *[FRS 102.11.8(c)]*.

4.1.4 Embedded derivatives

Unlike IAS 39 and IFRS 9, Sections 11 and 12 do not contain the concept of separating embedded derivatives. An embedded derivative is a component of a hybrid (combined instrument) that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative. *[IAS 39.10, IFRS 9.4.3.1]*. As the rules for separating embedded derivatives have not been included in Sections 11 and 12, it is likely that many financial instruments that contain embedded derivatives that are not closely related to the host instrument will not meet the conditions for basic financial instruments. Hence the whole instrument will be considered in the scope of Section 12. This is different from IFRS which requires an embedded derivative that is not closely related to the host instrument to be separated and measured at fair value through profit or loss, while the host instrument can be measured at amortised cost:

- (i) Only by the issuer in the case of IFRS 9
- Or
- (ii) By both the issuer and the holder in the case of IAS 39

4.2 Other financial instruments

All financial instruments that are not 'basic' are dealt with in Section 12. Examples of financial instruments that do not normally meet the conditions for classification as basic, and are therefore within the scope of Section 12, include:

Extract from Section 11

- 11.6** Examples of financial instruments that do not normally meet the conditions for classification as basic, and are therefore within the scope of Section 12, include:
- (a) asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables;
 - (b) derivatives (eg options, rights, warrants, futures contracts, forward contracts and interest rate swaps);
 - (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12; and
 - (d) commitments to make a loan to another entity and commitments to receive a loan, if the commitment can be settled net in cash. [FRS 102.11.6].

Even though FRS 102 mentions repurchase agreements as an example of financial instruments that would usually fail the conditions to be classified as basic, in practice most such contracts would fail to meet the de-recognition criteria and would be accounted for as basic collateralised loans.

Other financial instruments are mostly required to be measured at fair value through profit or loss. Their accounting treatment is discussed further at 5.2 and 6.1 below.

4.3 Reclassifications

FRS 102 states that the initial classification assessment of a financial instrument should take into account the relevant contractual terms dealing with the returns and any subsequent contractual variations relating to returns, prepayments and extensions of terms, etc. Once the classification of a financial instrument is determined at initial recognition, re-assessment is only required at subsequent dates if there is a modification of the contractual terms that is relevant to an assessment of the classification [FRS 102.11.6A].

4.4 Financial instruments not permitted to be measured at fair value through profit or loss by UK Company Law

4.4.1 Legal requirements

Notwithstanding whether they are basic or non-basic, financial instruments must be measured at amortised cost if they are not permitted by law to be measured at fair value through profit or loss. [FRS 102.12.8(c), 1 Sch 36 (SC), 1 Sch 36, 2 Sch 44, 3 Sch 30, 1 Sch 36 (LLP SC), 1 Sch 36 (LLP)].

The financial instruments in the list below may be included in the financial statements at fair value through profit or loss only if fair value is permitted in accordance with UK-adopted IFRS:

- (i) Financial liabilities, unless they are held as part of a trading portfolio or are derivatives (see definition of derivatives in Appendix A below).
 - (ii) Financial instruments to be held to maturity, other than derivatives.
 - (iii) Loans and receivables originated by the company unless they are held for trading.
 - (iv) Interests in subsidiary undertakings, associated undertakings and joint ventures.
 - (v) Equity instruments issued by the company (outside the scope of Sections 11 and 12).
 - (vi) Contracts for contingent consideration in a business combination (outside the scope of Sections 11 and 12).
- And
- (vii) Other financial instruments with such special characteristics that the instruments, according to generally accounting principles or practice must be accounted for differently from other financial instruments. [FRS 102.A3.12].

In addition, the law stipulates that a financial instrument can only be held at fair value when its fair value can be reliably measured. [1 Sch 36(5)(SC), 1 Sch 36(5), 2 Sch 44(5), 3 Sch 30(5), 1 Sch 36(5)(LLP SC), 1 Sch 36(5)(LLP)].

The fair value accounting rules in the Regulations require that all fair value gains on financial instruments measured at fair value be recognised in the profit or loss account except when the financial instrument is a hedging instrument or an available-for-sale security. [1 Sch 40 (SC), 1 Sch 40, 2 Sch 48, 3 Sch 34, 1 Sch 40 (LLP SC), 1 Sch 40 (LLP)].

The Small Companies Regulations, the Regulations, the LLP (SC) and the LLP Regulations were written with the application of IAS 39 in mind and terms such as 'loans and receivables', 'held to maturity', 'held for trading' and 'available for sale' are not defined in FRS 102, although it would be logical to apply the same definitions as set out in IAS 39.

4.4.2 Impact of the legal restrictions

IFRS 9 is the point of reference for determining which financial instruments may be accounted for at fair value through profit or loss under UK-adopted IFRS.

The following financial instruments are either required or allowed to be carried at fair value through profit or loss according to IFRS 9:

1. *Financial assets that fail the business model or contractual cash flows assessment:* IFRS 9 requires financial instruments to be recognised at fair value through profit or loss unless they pass both the following so called tests:

- (a) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

And

- (b) The financial asset is not held within a business model whose objective is either to hold financial assets in order to collect contractual cash flows, or to collect contractual cash flows and sell the financial assets. [IFRS 9.4.1.4].

These usually include investments in equity instruments, derivatives and debts instruments held for trading.

2. *Financial liabilities held for trading*
3. *Hybrid contracts:* when an embedded derivative that is required by IFRS 9 to be separated from its host contract cannot be measured separately either at acquisition or at the end of the reporting period, IFRS 9 requires that the hybrid contract is designated at profit or loss. [IFRS 9.4.3.6].
4. *Fair value option:* IFRS 9 also permits designation at fair value through profit or loss (the fair value option) on initial recognition of a financial liability in any of the following circumstances:
 - (a) Where doing so eliminates or reduces a measurement or recognition inconsistency, i.e., 'an accounting mismatch'.
 - (b) A group of financial instruments is managed and their performance evaluated on a fair value basis.

Or

 - (c) For a hybrid financial instrument which contains an embedded derivative, unless the embedded derivative does not significantly modify the cash flows or it is clear, with little or no analysis, that separation of that derivative would be prohibited. [IFRS 9.4.2.2, IFRS 9.4.3.5, FRS 102.A3.12A]. In this case, the main point is that the fair value option is available for a hybrid instrument but only as long as the embedded derivative could be recognised separately.

IFRS 9 also permits designation of the fair value option on initial recognition of a financial asset in circumstance a) above.

Given that the comparison is to IFRS 9, entities that choose to apply IFRS 9 for recognition and measurement as an accounting policy choice under FRS 102 will not be subject to any legal restrictions (see 4.1 above). However, the legal restrictions could have an impact on entities that instead choose Sections 11 and 12 or IAS 39 for recognition and measurement of financial instruments. We discuss the potential impact in more detail at 4.4.2.A and 4.4.2.B below. We also discuss the restriction on recognition of gains and losses through other comprehensive income for entities choosing to apply IFRS 9 at 4.4.2.C.

4.4.2.A Impact on entities that choose to apply Sections 11 and 12 of FRS 102

Due to the legal restrictions, as set out above, a debt financial instrument that fails to be classified as 'basic' under FRS 102 can only be recorded at fair value through profit or loss if fair value is permitted in accordance with UK-adopted IFRS - which is IFRS 9.

We expect in most cases those financial instruments which would fail to be classified as 'basic' under FRS 102 would be required or permitted to be recorded at fair value through profit or loss under IFRS 9. Therefore, the impact of the restrictions is expected to be limited.

The basis for conclusions to FRS 102 highlights as one of those limited areas of impact from the restrictions the example of financial instruments for which the cash flows are linked to non-financial variables specific to one party to the contract. The examples below arise from analysing hybrid contracts with a host that contains one or more embedded instruments linked to non-financial variables.

Hybrid contracts - Financial assets

The holders of debt instruments that are linked to non-financial variables specific to one party to the contract would usually fail the assessment of contractual cash flows characteristics under IFRS 9 and therefore would be required to be carried at fair value through profit or loss. FRS 102 would require financial assets that are similarly linked to non-financial variables specific to one party to the contract to be classified as 'other' and measured at fair value through profit or loss. Therefore, there would be no divergence, so the issue has limited impact on financial assets.

The basis for conclusions to FRS 102 clarifies that measuring the hybrid instrument at fair value is only allowed if this is also permitted under UK-adopted IFRS, which in some cases is restricted to fair value through other comprehensive income [FRS 102.BC.B11.24].

How we see it

This clarification was initially written in the context of IAS 39. However, under IFRS 9, we would expect that most financial assets linked to non-financial variables would fail to pass the required contractual characteristics test and would be required to be carried at fair value through profit or loss. Thus, only in rare occasions would the legal restrictions prevent debt instruments from being carried at fair value through profit or loss under Sections 11 and 12.

Hybrid contracts - financial liabilities

A financial liability arising from a hybrid contract is not problematic when:

(a) The hybrid contract is held for trading.

Or

(b) The fair value option is applied on the basis that 1) fair value is used to address an accounting mismatch, or that 2) the instruments are managed on a fair value basis. This is because the fair value option in FRS 102 (see 6.4. below) is consistent with these two routes under the fair value option in IFRS 9.

But the analysis of the legal restrictions applicable to a financial liability arising from a hybrid contract under different circumstances requires additional considerations. The only other route available under the fair value option in IFRS 9 (see 4(c) at 4.4.2 above) requires the embedded instrument in the hybrid contract to meet, amongst others, the following two conditions:

- i) A separate instrument with the same terms as the embedded feature would meet the definition of a derivative, and for that purpose.
And
- ii) The underlying to that embedded instrument should not be a non-financial variable specific to one of the parties to the contract.

The FRC has acknowledged the existence of divergent views on what constitutes a non-financial variable. For example, there is no clear consensus on whether measures of performance such as turnover, profits or EBITDA are 'non-financial variables ... specific to a party to the contract' (or whether they are financial variables). The FRC was unable to resolve this divergence as to do so would involve interpreting UK-adopted IFRS on an issue on which the IFRS Interpretations Committee had so far not reached a definitive conclusion. [FRS 102.BC.B11.23]. The assessment of whether the underlying in the embedded instrument is a non-financial variable specific to one of the parties to the contract may have an impact on the ability of the entity to use the fair value option for that hybrid instrument under IFRS 9 and hence may prohibit a fair value through profit or loss classification under FRS 102.

Given the wording in the law and the lack of clarity as to what constitutes a non-financial variable specific to one of the parties to the contract, there is diversity in practice in the assessment of when non-basic debt instruments are required by law, and hence by FRS 102, to be recorded at amortised cost. Hence it is likely that situations may arise such that entities conclude that financial liabilities classified as non-basic debt instruments under FRS 102, contain an embedded derivative for which the underlying is a 'non-financial variable' specific to one of the parties to the contract, which must therefore be recorded at amortised cost, unless held for trading or one of other two routes for the fair value option (to address an accounting mismatch or when managed on a fair value basis) is applicable.

How we see it

In practice, we believe that an entity may make an accounting policy choice as to whether the entity's turnover, EBITDA or other measures taken or derived from the entity's financial statements, are financial or non-financial variables. Once an entity elects a particular policy, it must consistently apply that approach to all similar transactions.

The below is an example of the analysis required to apply the legal restrictions discussed above.

Illustration 4-11: A loan with interest equal to a percentage of the profits of the issuer

Bank A has given Entity X a loan for which the interest payable equals a percentage of the profits of Entity X. The contractual return is neither a fixed rate or amount, nor a variable rate linked to a single observable interest rate or index of general price inflation. Therefore, the return breaches Condition 1.

In addition, the loan is inconsistent with the principle-based description of a 'basic' debt instrument because the linkage to the profits of Entity X introduces exposure to a risk that is not consistent with a basic lending arrangement.

The instrument would therefore be classified as 'other' financial instrument and would be measured at fair value by the holder (Bank A). However, Entity X will need to consider whether measurement of the liability at fair value is permitted by the Regulations. The Regulations prohibit the measurement of financial liabilities at fair value, except for those held as part of a trading portfolio, those that are derivatives and when permitted by UK-adopted IFRS.

If the loan has an embedded derivative that requires separation, Entity X would be permitted under IFRS 9 to apply the fair value option and accounting for the debt at fair value through profit or loss. However, if the terms of the debt include 'a non-financial variable specific to a party to a contract', then separation of the associated embedded derivative is prohibited, and the fair value option is similarly not available for that reason.

Therefore, if the issuer concludes that their profits are 'a non-financial variable specific to a party to a contract', then under UK-adopted IFRS they are not able to measure the instrument at fair value.

[IFRS 9.4.3.5(b)]. As a result, a preparer applying Section 11 and 12 must measure the instrument at amortised cost, rather than at fair value. [FRS 102.11.9.E10].

Non-hybrid contracts

The basis for conclusions also acknowledges that though there may be other non-basic financial instruments that UK-adopted IFRS and the Regulations would not permit to be measured at fair value through profit or loss, it is expected such instruments would be rare in practice. [FRS 102.BC.B11.25].

4.4.2.B Impact on entities that choose to apply IAS 39

IFRS 9 became effective for accounting periods beginning on or after 1 January 2018. Entities choosing to continue to apply IAS 39 for periods starting on or after 1 January 2018 may need to assess whether there are any restrictions to the use of fair value when compared to IFRS 9. However, we expect that only in rare circumstances would IFRS 9 not allow an instrument to be carried at fair value through profit or loss when IAS 39 allows it.

4.4.2.C Accounting for fair value gains and losses in other comprehensive income for entities that choose to apply IFRS 9

The endorsement of IFRS 9 eliminated any legal restrictions discussed at 4.4.1 above on the inclusion in the financial statements of financial instruments at fair value through profit or loss for entities choosing to apply IFRS 9 as an accounting policy choice under FRS 102. [FRS 102.12.8(c), 1 Sch 36 (SC), 1 Sch 36, 2 Sch 44, 3 Sch 30, 1 Sch 36 (LLP SC), 1 Sch 36 (LLP)].

However, under the current wording of the law, the fair value accounting rules in the Regulations permit the use of other comprehensive income for fair value gains and losses only for a financial instrument that is a hedging instrument or an available-for-sale security. [FRS 102.A3.12C, 1 Sch 40 (SC), 1 Sch 40, 2 Sch 48, 3 Sch 34, 1 Sch 40 (LLP SC), 1 Sch 40 (LLP)]. In other words, the Regulations have not been updated for IFRS 9.

IFRS 9 has the following circumstances in which fair value gains or losses are recorded in other comprehensive income:

- (i) When fair value changes in respect of financial liabilities attributable to changes in own credit risk are recorded in other comprehensive income unless that treatment would create or enlarge an accounting mismatch in profit or loss. [IFRS 9.5.7.7, IFRS 9.5.7.8, IFRS 9.5.7.9].
- (ii) If, on initial recognition, an entity makes an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an equity instrument that is neither held for trading nor contingent consideration. [IFRS 9.5.7.5, IFRS 9.5.7.6].

And

- (iii) Investment in debt instruments measured at fair value through other comprehensive income which are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. [IFRS 9.4.1.2A].

The Note on Legal Requirements to FRS 102 states that accounting for fair value gains and losses on financial liabilities attributable to changes in credit risk in other comprehensive income in accordance with IFRS 9 will usually be a departure from the requirement of the Regulations and will therefore require the use of a true and fair override if such accounting is applied in the financial statements. [FRS 102.A3.12C]. This implies the FRC expect a true and fair override to be used in order to comply with IFRS 9 and override the prohibition from accounting for fair value gains and losses in other comprehensive income for changes in credit risk of financial liabilities in the Regulations.

The Note on Legal Requirements is silent about the other two circumstances in IFRS 9, described above, in which fair value gains and losses are recorded in other comprehensive income.

How we see it

In our view:

- (a) Accounting for changes in the fair value of an equity instrument through other comprehensive income (without recycling of fair value changes to profit or loss) makes use of the alternative accounting rules in the Small Company Regulations, the Regulations, the LLP (SC) and LLP Regulations and does not therefore require the use of a true and fair override (see Chapter 6 at 8.2.2).

And

- (b) The model used for accounting for changes in the fair value of a debt instrument through other comprehensive income is similar, but not identical, to the available-for-sale asset model under IAS 39. In our view, it is inferred from the Accounting Council's silence on the matter that this model is included within the fair value accounting rules in the Small Company Regulations, the Regulations, the LLP (SC) and the LLP Regulations and does not therefore require the use of a true and fair override to apply.

5 Initial recognition and measurement

5.1 Initial recognition

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument. [FRS 102.11.12, FRS 102.12.6].

Planned future transactions (forecast transactions), no matter how likely, must not be recognised as financial assets or liabilities since the entity has not become a party to a contract.

5.2 Initial measurement

5.2.1 General rule

Basic financial instruments within the scope of Section 11 are measured initially at the transaction price, adjusted for transaction costs, unless they are subsequently measured at fair value through profit or loss (see exception in 5.2.2 below).

For basic financial instruments designated as at fair value through profit or loss and other financial instruments within the scope of Section 12, initial measurement is at fair value, which is normally the transaction price. [FRS 102.11.13, FRS 102.12.7].

In essence, the main difference in the initial measurement is in the treatment of transaction costs. Transaction costs are capitalised as part of the initial carrying value for those financial instruments subsequently measured at amortised cost or cost and expensed in profit or loss for those instruments that are subsequently measured at fair value through profit or loss.

5.2.2 Exception: financing transactions

There is one exception to the general rule of initially measuring a financial instrument measured at amortised cost at its transaction price, in the case of 'financing transactions'. In November 2024 the FRC issued FRS 102 *Fact Sheet 4 - Financial Instruments*⁹³ ('Fact Sheet 4'), which provides guidance on the measurement requirements applicable to financing transactions and replaced 'Staff Education Note 16 - *Financing Transactions*'.

A financing transaction is an arrangement for which payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. FRS 102 provides the example of a seller providing interest-free credit to a buyer for the sale of goods or an interest-free or below market interest rate loan made to an employee. [FRS 102.11.13, FRS 102.12.7].

Sections 11 and 12 require financing transactions to be initially measured at the present value of the future payments, discounted at a market rate of interest for a similar debt instrument as determined at initial recognition and adjusted for transaction costs. [FRS 102.11.13, FRS 102.12.7]. By requiring the instrument to be recorded initially at its net present value, the future yield will be approximately the market rate. When there is no initial payment at the time of the transaction, the difference between the net present value and the transaction price is effectively interest income or expense and is accounted for in the subsequent measurement of the receivable/payable by applying the effective interest method under the amortised cost model.

In applying this requirement to the sale of goods or services on deferred payment terms, an entity may use the current cash price of the goods or services on an arm's length basis as an estimate for the present value of the future payments. However, if there is no cash sale alternative or the cash selling price is the same as the price when buying on credit, the entity must calculate the present value of the future cash flows.

The present value of a financial asset or financial liability that is repayable on demand is equal to the undiscounted cash amount payable reflecting the lender's right to demand immediate payment. This does not constitute a financing transaction.

Consider the following examples:

Illustration 5-1: The sale of goods on deferred payment terms

Fact Sheet 4 provides the example of a manufacturer that sells a piece of machinery to a customer on credit for £1,000 on 1 January 20X0, agreeing with the customer that full payment is due in two years' time on 31

⁹³ [FRS 102 Factsheet 4 - Financial instruments](#), November 2024, available on the FRC's website (accessed on 21 October 2025).

December 20X1. Under normal business terms the piece of machinery is sold for cash and the current cash selling price is £900, the cost price of the machinery was £450. Sales taxes are ignored in this example.

Accounting by manufacturer

On 1 January 20X0, the manufacturer recognises the revenue from the sale at the cash selling price of the piece of machinery of £900. The trade receivable is also measured at the cash selling price of £900 as an estimate of the present value of the future receipts. The manufacturer records the following accounting entries when the piece of machinery is sold:

Dr Trade receivable	£900	
Cr Revenue		£900
+		
Dr Cost of sales	£450	
Cr Inventory		£450

Each subsequent year, the manufacturer recognises the interest earned based on the annual effective interest rate of 5.4%^(a) in the period with the following accounting entries.

For the year ended 31 December 20X0, interest income is calculated applying the effective interest rate (5.4%) on the opening balance (£900):

Dr Trade receivable	£49	
Cr Interest income		£49

For the year ended 31 December 20X0, interest income is calculated applying the effective interest rate (5.4%) on the opening balance of the year (£949):

Dr Trade receivable	£51	
Cr Interest income		£51

When the cash is received, the manufacturer will record the following journal entry:

Dr Cash	£1,000	
Cr Trade receivable		£1,000

Accounting by customer

On 1 January 20X0 the purchase of the piece of machinery is recorded by the customer at the cash selling price of £900. The customer also records a trade payable measured at the cash selling price of £900 as an estimate of the present value of the future payments. The customer records the following accounting entries when the piece of machinery is purchased:

Dr Property, plant and equipment	£900	
Cr Trade payable		£900

Each subsequent year, the customer recognises the finance cost for the period with the following accounting entries based on the calculations described above for the seller.

For the year ended 31 December 20X0:

Dr Interest expense	£49	
Cr Trade payable		£49

For the year ended 31 December 20X1:

Dr Interest expense	£51	
Cr Trade payable		£51

When the customer settles the obligation, it will record the following journal entry:

Dr Trade payable	£1,000	
Cr Cash		£1,000

(a) The effective interest rate was calculated as the annual compound rate that discounts the transaction price of £1,000 payable in 2 years to the £900 cash price.

In Illustration 5-1 above, after initial recognition both the manufacturer and the customer account for this basic debt instrument at amortised cost using the effective interest method; the difference of £100 between the present value of £900 and the transaction price of £1,000 is therefore recorded as interest income (for the manufacturer) or interest expense (for the customer) over the two years until payment is due from the customer, at which time the amortised cost will match the transaction price of £1,000 as shown in the Illustration 5-1 above.

Illustration 5-2: Parent company provides a loan to its subsidiary at an off-market interest rate

A parent lends £100,000 to its subsidiary at 4% per annum for three years. Interest is payable annually in arrears, while the principal repayment is due at maturity. If the subsidiary were to borrow the same amount from a bank, it would be charged 5%. Hence, 5% would represent the market interest rate and this would constitute a financing transaction as the parent has lent to the subsidiary at an off-market rate. The calculation of the present value would take into account the sum of the annual interest payments of £4,000 and the principal repayment at the end of three years, discounted by 5% as follows:

Present value = $£4,000/1.05 + £4,000/1.05^2 + (£4,000 + £100,000)/1.05^3 = £97,277$

In this example, the parent would record a loan receivable from its subsidiary of £97,277 in its separate financial statements. Fact Sheet 4 explains that to determine the accounting treatment for the difference, an entity should assess the particular facts and circumstances of each arrangement. In that regard it is particularly important to establish the reasons a lender decided to make a loan at a non-market rate of interest. For example, a lender may make the loan because of an ownership interest in the borrower. If so, the lender is, in its capacity as the owner, effectively making an additional investment in the entity when making a loan at a below market rate of interest. This is the assumption we have taken for the below journal entries.

Accounting by the parent

The parent records the following journal entries when the cash is advanced:

Dr Loan receivable from subsidiary	£97,277
Dr Investment in subsidiary	£2,723
Cr Cash	£100,000

At the end of the first reporting period, the parent will record the following journal entries:

Dr Cash	£4,000
Dr Loan receivable from subsidiary	£864
Cr Interest income	£4,864

At the end of the second reporting period, parent will record the following journal entries:

Dr Cash	£4,000
Dr Loan receivable from subsidiary	£907
Cr Interest income	£4,907

At the end of the third reporting period, parent will record the following journal entries:

Dr Cash	£104,000
Dr Loan receivable from subsidiary	£952
Cr Interest income	£4,952
Cr Loan receivable from subsidiary	£100,000

Accounting by the subsidiary

The subsidiary records the following journal entries when the cash is received:

Dr Cash	£100,000
Cr Loan payable to parent	£97,277
Cr Equity - capital contribution	£2,723

At the end of the first reporting period, the subsidiary will record the following journal entries:

Dr Interest expense	£4,864
Cr Loan payable to parent	£864
Cr Cash	£4,000

At the end of the second reporting period, the subsidiary will record the following journal entries:

Dr Interest expense	£4,907
Cr Loan payable to parent	£907
Cr Cash	£4,000

At the end of the third reporting period, the subsidiary will record the following journal entries:

Dr Loan payable to parent	£100,000
Dr Interest expense	£4,952
Cr Loan payable	£952
Cr Cash	£104,000

The accounting for financing transactions raises the question of how to account for the difference between the initial measurement and the transaction price. When the transaction is a fixed term loan with no interest or with a below market rate of interest, the cash exchanged upon initial recognition will differ from present value calculated in accordance with the initial measurement rules for financing transactions discussed above (as shown in Illustration 5-2 above). This difference reflects that the lender has made a loan at a lower than market rate of interest and thereby has provided an additional benefit to the borrower. FRS 102 does not set out specific accounting requirements for that difference on initial recognition of the financing transaction, instead entities avail themselves of the guidance provided by the FRC in Fact Sheet 4.

In this Fact Sheet, the FRC explains that to determine the accounting treatment for the difference, an entity needs to assess the particular facts and circumstances of each arrangement. In that regard it is particularly important to establish the reasons a lender decided to make a loan at a non-market rate of interest.

In most cases, these types of loans take place between related parties. When that is the case, Fact Sheet 4 states that the accounting for the difference will be determined by the nature of the related party relationship:

- a. Fixed term loans between a parent and a subsidiary: Loans between parents and their subsidiaries are often made on interest-free terms. It can be presumed that a loan is made on these terms because the parent owns and controls its subsidiary. The difference between the amount initially paid or received and the present value of a fixed-term loan at a market rate of interest represents in essence a capital contribution from the parent to the subsidiary (when the parent is the lender) or a distribution from the subsidiary to the parent (when the subsidiary is the lender).
- b. Fixed term loans between fellow subsidiaries: In a situation where fellow subsidiaries enter into a loan which constitutes a financing transaction, it can generally be presumed that the loan was made on the direction of their parent. However, sometimes the facts and circumstances may indicate otherwise, for example when a fixed term interest-free loan is made in return for receiving goods or services at a discounted price, in which case the recognition of the financing component may have an impact on the accounting for the related goods or services acquired.

If an interest-free loan is made on the direction of the parent, the subsidiaries account for the transaction as if it had been conducted through the parent. The lending subsidiary accounts for the measurement difference as a distribution to its parent (i.e., as if it had made a loan to its parent) and the borrowing subsidiary accounts for the loan as a contribution from its parent (i.e., as if it had received a loan from its parent). The transaction is not required to be reflected in the parent's own financial statements because the parent is not directly involved.

- c. Fixed term loans between entities owned by the same person: In some instances, a fixed term interest-free loan is made between entities that are not members of the same group, but the entities are related parties because they are owned and controlled by the same person. Unless the facts and circumstances indicate that the loan is made on these terms for a reason other than that the entities are controlled by the same owner, the accounting for the loan will be the same as shown above for a fixed term interest-free loan between fellow subsidiaries.

- d. Fixed-term loans between entities and their directors: A fixed term interest-free loan may be made between an entity and its director(s). The accounting for the measurement difference arising on the initial recognition of the loan will depend on whether the loan was made in the director's capacity as a shareholder or for another reason. For example, in a situation where a director is the majority shareholder it can be presumed that the loan was made in the director's capacity as a shareholder. This presumption can be rebutted, if, for example, loans between the entity and other third parties without an ownership interest in the entity (e.g., employees) are made on the same or similar terms.

If a fixed term interest-free loan is made between the entity and a director in its capacity as a shareholder, the accounting for the loan is similar to the accounting for a fixed term interest-free loan between a parent and its subsidiary shown above.

If an interest-free loan is made between an entity and a director who has no direct ownership interest in the entity, the terms of the loan and the reasons for making it need to be assessed carefully as this is relevant for determining the appropriate accounting under FRS 102. For example, an entity may offer interest-free loans to all employees, including its directors, as an additional employee benefit. Often these loans are made for a specific purpose, for example to purchase a travel season ticket. In this situation the entity accounts for the measurement difference as an employee benefit cost in accordance with Section 28 *Employee Benefits*.

When a director without ownership interest makes a loan to the entity, the director's motives have to be identified, as the director would not normally directly benefit from making a loan on these terms. The appropriate accounting for the measurement difference will be dependent on the individual circumstances of each transaction.

If the reporting entity is a small entity, there is some relief in the accounting of these types of loans. We further discuss this situation at 5.2.3 below.

In all of the scenarios of fixed term loans between related parties described above, the debits and credits for the cash exchanged and the resulting basic debt instrument are the same. Taking the information in Illustration 5-2 above:

For the lender:

Dr Loan receivable	£97,277	
Cr Cash		£100,000

For the borrower:

Dr Cash	£100,000	
Cr Loan payable		£97,277

The table below shows how the difference of £2,723 would be accounted for in each of the scenarios discussed above:

	Lender	Borrower	Lender books (Dr)	Borrower books (Cr)
a)	Parent	Subsidiary	Investment in subsidiary ¹	Capital contribution (equity)
a)	Subsidiary	Parent	Distribution to parent (equity) ²	Distribution received from subsidiary (P&L or OCI) ³
b)	Subsidiary	Subsidiary	Distribution to parent (equity) ²	Capital contribution from parent (equity)
c)	Entities owned by the same person		Distribution (equity) ²	Capital contribution (equity)
d)	Director (as Shareholder)	Entity		Capital contribution (equity)
d)	Entity	Director (as shareholder)	Distribution to owner (equity) ²	
d)	Entity	Director (as Director)	Employee benefits (P&L)	

- 1 Investments in subsidiaries are subject to impairment under Section 27 *Impairment of Assets*. An entity must apply the relevant accounting requirements in FRS 102 to determine whether an investment is impaired.
- 2 A distribution is recorded as a reduction of equity. A distribution recorded in the financial statements in accordance with FRS 102 may not be a distribution as a matter of law. The legal requirements on distributable profits are not addressed here. For limited companies subject to CA 2006, the ICAEW/ICAS Technical Release TECH 02/17BL - *Guidance on Realised and Distributable Profits under the Companies Act 2006* ('TECH 02/17BL') considers issues concerning the determination of distributable profits and entities may refer to this or any successor document for more guidance.
- 3 For limited companies subject to the CA 2006, only profits realised at the reporting date are included in profit or loss. Therefore, depending on whether the distribution corresponds to realised gains and losses or not, the distribution received from the subsidiary could be reflected in the income statement or as OCI respectively. The legal requirements on realised profits are not addressed here. TECH 02/17BL considers issues concerning the determination of realised profits and entities may refer to this or any successor document for more guidance.

After initial recognition both the lender and the borrower will account for this basic debt instrument at amortised cost using the effective interest method over the term of the loan, at the end of which the amortised cost will match the transaction price. The effective interest rate used for this purpose will reflect a market rate of interest. [FRS 102.11.14(a)(iii)].

5.2.3 Financing transactions with simplified accounting

The FRC continues to believe that the accounting for financing transactions as discussed at 5.2.2 above is generally appropriate accounting as it reflects the fact that such transactions contain both an interest-bearing loan and the transfer of value representing the benefit compared to market rates of interest. [FRS 102.BC.B11.32]. However, it recognises that occasional specific exemptions may be granted in order to meet the principle of providing proportionate and practical solutions.

The simplified accounting is intended to provide relief to small owner-managed businesses. In determining the scope of the simplified accounting, the FRC took into consideration that some small businesses are operated and financed by a group of family members who may have varying interests in the business. It also extended a similar relief to small limited liability partnerships. [FRS 102.BC.B11.39].

The resulting relief allows a basic financial liability of a small entity to be carried at transaction price (with no subsequent recognition of interest expense) if specific conditions in paragraph 13A(a) of Section 11 of the standard are met. [FRS 102.11.13A(a)]. For a further discussion on the exemption, including when a small entity becomes or ceases to be eligible for the exemption, [FRS 102.11.13B, FRS 102.11.13B], see Chapter 5 at 3.1.1 and 3.1.2. There is also simplified accounting available for public benefit entities, which is discussed in Chapter 36 at 6.6.

5.2.4 Difference between fair value and transaction price

As noted at 5.2.1 above, even though financial instruments within the scope of Section 12 are required to be initially measured at fair value, Section 12 acknowledges that the initial fair value is 'normally' the transaction price [FRS 102.12.7]. A difference will only arise in rare circumstances where fair value does not equate to the transaction price.

One such example is the wholesale markets for dealers in financial instruments, where such dealers are able to recognise a profit, being the margin that has been 'locked in' as a result of the differential between the price charged to a customer and the prices available to the dealer in wholesale markets.

In addition, in some markets, dealers charge minimal or no explicit transaction costs but instead quote differential prices for purchases and sales. Such prices are often referred to as 'bid' and 'asking' (or 'offer') prices. The term bid-ask spread is normally interpreted as the difference between the quoted bid and offer prices. The following Illustration 5-3 demonstrates this point:

Illustration 5-3: Application of a bid-ask spread in the initial measurement of a financial instrument to be measured at fair value through profit or loss

A company acquires a quoted bond in an active market, where no explicit transaction costs are charged but separate bid and offer prices are quoted. On acquisition, the bond has an asking price of £102,000, which is the amount the purchaser is required to pay, and a bid price of £97,000, which is what the seller would receive were it to sell the bond. The company has determined that the bid price is the most representative of fair value in these circumstances and therefore it will initially measure the bond at £97,000. This would result in an immediate loss of £5,000, the difference between the initial fair value and the cash paid. Section 11 does not address the accounting for the £5,000 loss.

How we see it

In our view, the £5,000 loss must be treated as a transaction cost (in which case it would be included in the initial measurement if the bond is not carried at fair value through profit or loss) rather than a dealing loss, which would be consistent with the accounting under IFRS.

6 Subsequent measurement

6.1 Introduction

The subsequent measurement of financial instruments depends on the type of instrument:

- Basic debt instruments are measured at amortised cost using the effective interest method with the following exceptions:
 - (i) The amortised cost for non-interest bearing basic debt instruments payable or receivable within one year on normal business terms (i.e., that do not constitute a financing transaction) is calculated as the undiscounted amount expected to be paid or received instead of using the effective interest method. See 6.2.1 below.
 - (ii) Basic debt instruments that are financing transactions (see 5.2.2 above) but qualify for either of the three exceptions below are carried at transaction price:
 - (a) A basic financial liability of a small entity that is a loan from a person who is within a director's group of close family members, when that group contains at least one shareholder or member in the entity (see 5.2.3 above).
 - (b) A public benefit entity concessionary loan (see Chapter 36 at 6.6). *[FRS 102.11.13A(b), FRS 102.11.14].*
And
 - (c) A trade receivable or contract asset when, at contract inception, payment is expected within 12 months or less from when the entity transfers the good or service. *[FRS 102.11.13A(c)].*
- Basic commitments to receive or make a loan are measured at cost less impairment. *[FRS 102.11.14(c)].*
- All basic debt instruments and basic commitments to receive or make a loan may be designated as at fair value through profit or loss upon initial recognition when certain criteria are met. *[FRS 102.11.14(b)].* We further discuss this 'fair value option' at 6.4 below.
- Investments in non-derivative instruments that are equity of the issuer and the issuer is not a member of the same group as the holder and derivatives linked to such instruments that, if exercised, will result in the delivery of such instruments, must be measured at fair value through profit or loss; however if fair value cannot be measured reliably, they must be measured at cost less impairment. *[FRS 102.11.14(d), FRS 102.12.8(a)].*
- Investments in non-derivative instruments that are equity of the issuer, and the issuer is a member of the same group as the holder must be accounted for in line with an accounting policy choice which is required to be applied to all investments in a single class:
 - (i) Cost less impairment.
 - (ii) Fair value with changes recognised in other comprehensive income, except for the following changes that are required to be recognised in profit or loss:
 - (a) Decreases that exceed cumulative fair value gains accumulated in other comprehensive income in respect of those instruments.
And
 - (b) Increases that reverse decreases previously recognised in profit or loss in accordance with (a) in respect of the same instrument.
 - (iii) Fair value with changes in fair value recognised in profit or loss. *[FRS 102.11.14(d), FRS 102.17.15E, FRS 102.17.15F].*
- All other instruments within the scope of Section 12 are measured at fair value through profit or loss, in accordance with Section 2A *Fair Value Measurement*, *[FRS 102.12.10]*, with the exception of:
 - (a) Financial instruments that are not permitted to be measured at fair value through profit or loss by the Small Company Regulations, the Regulations, the Small LLP Regulations or the LLP Regulations; such instruments will be measured at amortised cost. *[FRS 102.12.8(c)].* These legal restrictions are discussed at 4.4 above.
 - (b) Hedging instruments in a designated hedging relationship accounted for in accordance with the cash flow hedge rules (see Chapter 14). *[FRS 102.12.8(b)].*

Instruments can only be measured at fair value if this can be reliably established. If a reliable measure of fair value is no longer available for a financial asset or financial liability that is not publicly traded but is measured at fair value through profit or loss, its fair value at the last date the instrument was reliably measurable is treated as the cost of the instrument. The entity shall measure the instrument at this cost amount less impairment until a reliable measure of fair value becomes available. *[FRS 102.12.9].*

6.2 Amortised cost and the effective interest method

The amortised cost of a financial instrument is defined as the amount at which it was measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the 'effective interest method' of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

[FRS 102.11.15].

The effective interest method is a method of calculating the amortised cost of a financial instrument (or group of instruments) and of allocating the interest income or expense over the relevant period.

[FRS 102 Appendix I].

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the carrying amount of the financial asset or financial liability. [FRS 102 Appendix I]. The effective interest rate is determined on the basis of the carrying amount of the financial asset or liability at initial recognition. Under the effective interest method:

- (a) The amortised cost of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate.

And

- (b) In the absence of capital repayments, the interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of a period multiplied by the effective interest rate for the period. [FRS 102.11.16(b)].

Estimated cash flows

The effective interest rate is normally based on estimated, not contractual cash flows and there is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. When calculating the effective interest rate at initial recognition, an entity must estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) and known credit losses that have already been incurred. For variable rate financial assets and variable rate financial liabilities, the current market rate of interest or index of general price inflation may be used when estimating the contractual cash flows. These cash flows must also include any related fees, finance charges paid or received, transaction costs and other premiums or discounts. It must not include possible future credit losses not yet incurred. [FRS 102.11.17, FRS 102.11.18].

Future credit losses will be accounted for in line with the impairment model of FRS 102 that is based on incurred credit losses (see 6.5 below). The requirement to consider incurred credit losses on initial recognition in the calculation of the effective interest rate may be particularly important for financial assets acquired at a deep discount, as such a discount will likely reflect incurred credit losses. FRS 102 requires such incurred credit losses to be included in the estimated cash flows when computing the effective interest rate on initial recognition. The estimated cash flows should reflect the impact of the incurred credit losses in the form of expected repayments lower than the contractual cash flows and additional costs required for settlement (e.g., foreclosure costs for a collateralised loan).

Costs and fees

FRS 102 states that entities are required to include related costs or fees into the calculation of the effective interest rate [FRS 102.11.18]. It does however not specify what is meant with 'related'. A similar issue exists within IFRS where costs and fees are only included in the effective interest rate if they are considered 'integral' [IFRS 9.B5.4.2, IFRS 9.B5.4.3]. IFRS includes some examples that show the difference between costs and fees that are included within the effective interest rate calculation and those that are not, which must be accounted for under IFRS 15 *Revenue from Contracts with Customers*. These examples are not in FRS 102, but FRS 102 reporters could look to IFRS and determine whether this guidance, and any principles that are drawn from them, are appropriate for their entity, considering the requirements of Section 10. [FRS 102.10.4, FRS 102.10.6].

Extract from IFRS 9

B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:

- (a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.
- (b) commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.
- (c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

B5.4.3 Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with IFRS 15 include:

- (a) fees charged for servicing a loan;
- (b) commitment fees to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is unlikely that a specific lending arrangement will be entered into; and
- (c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

Expected life

The effective interest rate has to be calculated over the expected life of the instrument, consistent with the estimated cash flows approach. [FRS 102.11.16].

Prepayment, call and similar options that allow the debt instrument to be settled prior to its contractual maturity can have a significant impact in estimating the expected life. The assessment of the impact of these options on the expected life should be considered at initial recognition and at the subsequent measurement dates. [FRS 102.11.17, FRS 102.11.20].

Whilst payments, receipts, discounts and premiums included in the effective interest method calculation are normally amortised over the expected life of the instrument, there may be situations when they are amortised over a shorter period. This will be the case when the variable to which they relate reprices to market rates before the expected maturity of the instrument. In such cases, the appropriate amortisation period is the period to the next re-pricing date. [FRS 102.11.18].

Changes in cash flows

For variable rate financial assets and liabilities, periodic re-estimation of cash flows to reflect changes in market rates of interest or an index of general price inflation alters the effective interest rate. If such instruments are recognised initially at an amount equal to the principal receivable or payable at maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability. [FRS 102.11.19]. This is typically interpreted to mean that entities should simply account for periodic floating rate payments on an accruals basis in the period to which they relate. However, there is a view that entities should forecast all future cash flows and so estimate the floating rate payments over the instrument life, with an adjustment to this rate whenever expectations change, treated in accordance with the approach described in the next paragraph. We would not expect most FRS 102 reporters to take the latter view.

In contrast to the treatment of variable rates, in cases where estimates of payments or receipts (e.g., expectations of prepayments) are revised, an adjustment is required to the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The revised carrying amount is recalculated by computing the present value of the revised estimated future cash flows at the financial instrument's original effective interest rate (assuming it is a fixed rate instrument) or at the most recent effective interest rate if it is a variable rate instrument. The adjustment is recognised as income or expense in profit or loss at the date of the revision. [FRS 102.11.20].

These requirements are identical to those in paragraphs B5.4.5 and B5.4.6 of IFRS 9 (and paragraphs AG7 and AG8 of IAS 39). The point to note is that changing cash flow assumptions such as, for instance, estimates of prepayments, has potentially a significant impact on profit or loss, as this involves booking 'catch up' adjustments to the recorded value of the financial instrument through profit or loss.

Examples

A simple example for determining the amortised cost for a five-year bond is shown below. This Illustration 6-1 is based on the example included in Section 11. [FRS 102.11.20].

Illustration 6-1: Determining the effective interest rate and its application to the measurement of amortised cost

A bond is acquired for £95,000 on 1 January 20X6 and transaction costs amount to £1,000. The interest rate on the bond is 4%, paid annually in arrears, and the redemption value at maturity, which is in five years, is £100,000. The expected cash flows are the annual interest payments of £4,000 (i.e., 4% multiplied by the redemption value of £100,000) and a final bullet repayment of £100,000. The initial carrying amount is the acquisition price of £95,000 and £1,000 of transaction costs, equating to £96,000. The effective interest rate of 4.922% is the rate that discounts the expected cash flows to the initial carrying amount.

The formula is as follows:

$$\frac{£4,000}{(1 + 4.922\%)} + \frac{£4,000}{(1 + 4.922\%)^2} + \frac{£4,000}{(1 + 4.922\%)^3} + \frac{£4,000}{(1 + 4.922\%)^4} + \frac{£100,000 + £4,000}{(1 + 4.922\%)^5} = £96,000$$

Year	Carrying amount at the beginning of the period (£)	Interest income @ 4.922% (£)*	Cash inflow (£)	Carrying amount at the end of the period (£)
20X6	96,000	4,725	(4,000)	96,725
20X7	96,725	4,761	(4,000)	97,486
20X8	97,486	4,798	(4,000)	98,284
20X9	98,284	4,838	(4,000)	99,122
20X0	99,122	4,878	(104,000)	-

* Interest income for each period has been calculated by applying the effective interest rate of 4.922% on the carrying amount at the beginning of the period.

The accounting for amortised cost in the case of financing transactions (see 5.2.2 above) is usually straightforward once the effective interest rate is determined and follows a pattern similar to that presented in Illustration 6-1 above. However, certain circumstances or terms could require more consideration. Illustration 6-2 below discusses the instance of certain more problematic terms observed in intra-group loans.

Illustration 6-2: Rolling intra-group loans

A subsidiary has received an interest free inter-company loan from its parent which has a rolling 367-day notice period. There are no other characteristics that would affect its classification as a basic debt instrument. If the loan is not called before the reporting date, the loan will remain in place for more than a year.

As the instrument is not repayable within one year, FRS 102 does not allow it to be measured at the undiscounted cash flow and requires the use of amortised cost. Since at each reporting date it would be at least 367 days until the payment is due, the entities should continue to measure the loan at an amount that takes account of the 367-day discount. Until notice is given, in order to determine the amortised cost at each reporting date the subsidiary will estimate the cash flows (which would be the bullet payment of the full amount of the loan) and will discount the cash flows using the effective interest rate. In practice, this means that at each reporting date the carrying value of the loan will remain the same. However, between each reporting date, interest would be charged on the loan on an ongoing basis. How should the resulting interest be accounted for?

Following the logic at 5.2.2 above for financing transactions, the interest resulting from applying amortised cost to a contractually interest-free loan between a parent and a subsidiary would result in a capital contribution. Until notice is given, the resulting interest would continually be added to the carrying amount of the investment of the parent in the subsidiary:

On initial recognition:

In the subsidiary's books:

Dr Cash	100	
Cr Loan payable		90
Cr Equity		10

In the parent's books:

Dr Loan receivable	90	
Dr Investment in subsidiary	10	
Cr Cash		100

Between reporting periods:

In the subsidiary's books:

Dr Interest expense	10	
Cr Loan payable		10

In the parent's books:

Dr Loan receivable	10	
Cr Interest income		10

However, at each reporting date, the carrying amount (which would reflect the initial measurement plus any accrued interest from the last reporting date) would need to be adjusted to reflect the amortised cost at that date taking into consideration the treatment of changes in cash flows. As discussed at 6.2 above, the resulting adjustment must be recognised in profit or loss.

In the subsidiary's books:

Dr Loan payable	10	
Cr Interest expense		10

In the parent's books:

Dr Interest income	10	
Cr loan receivable		10

This adjustment would offset the interest charged during the period. The net effect is that no interest is charged until notice is given. This is consistent with the accounting for a loan that is repayable on demand, where no interest is charged regardless of the ultimate duration. Once notice is given, the resulting interest is included in the amortised cost which at the maturity date will match the maturity amount.

Use of contractual terms

FRS 102 is silent on the rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of instruments).

How we see it

In our view, in those rare cases when it is not possible to estimate the cash flows or the expected life of a financial instrument (or group of financial instruments) reliably, the contractual cash flows over the full contractual term of the financial instrument (or group of instruments) may be used as a reasonable proxy, by applying IFRS requirements under the Section 10 hierarchy.

6.2.1 Debt instruments due within 1 year

Basic non-interest bearing debt instruments that at initial recognition are payable or receivable within one year must be measured at their undiscounted amount expected to be paid or received, unless the arrangement is a financing transaction as explained at 5.2.2 above. [FRS 102.11.14(a)(ii)]. FRS 102 refers to this method as amortised cost but clarifies that in calculating the amortised cost for these instruments, the amortisation using the effective interest method does not apply. [FRS 102.11.15]. The underlying objective of the one-year rule was to simplify the measurement basis for trade receivables, which are by their nature, normally short-term and interest free. On the other hand, basic interest-bearing debt instruments due within one year are not excluded from the general rules on amortised cost, hence amortisation using the effective interest method is required.

6.2.2 Interest rate benchmark reform

As a result of the reforms mandated by the Financial Stability Board following the Financial Crisis, regulators pushed for Interbank Offered Rates (IBORs) to be replaced by new 'official' benchmark rates, known as Risk Free Rates (RFRs), a process referred to as 'IBOR Reform'. For instance, in the UK, the new official benchmark is Sterling Overnight Interest Average (SONIA) and banks are no longer required to quote LIBOR. IBOR Reform is substantially complete as the most significant IBORs, including all the LIBORs, have now ceased and have been replaced. However, there remain some local IBORs for which the work to replace them is still in progress or has only very recently been completed. For those remaining IBORs still in the process of change, the change affects future cash flows in both contractual floating rate financial instruments currently referenced to IBOR.

IBOR Reform raises a number of accounting questions, many of which relate to hedge accounting, but also in relation to the accounting for the subsequent measurement of debt instruments. The IASB responded with two separate amendments to IFRS: Phase 1 and Phase 2 Amendments addressing the accounting consequences that arise during the period before and after financial instruments transition from referencing IBORs to referencing replacement benchmark interest rates. Once IBOR Reform is complete and the RFRs have become established in the market, the Phase 1 and Phase 2 amendments will cease to be required.

In line with the IASB's approach, the FRC issued corresponding amendments to FRS 102. These amendments provide a practical expedient for the accounting for financial assets and financial liabilities when contractual cash flows change because interest rate benchmarks are being replaced [FRS 102.11.20A, FRS 102.11.20B, FRS 102.11.20C, FRS 102.11.20D, FRS 102.11.20E].

These amendments reflect the temporary reliefs introduced by the IASB. For further details, please refer to the EY publication, International GAAP®.

6.3 Measurement at cost

Loan commitments within the scope of Section 11 and equity instruments for which a fair value cannot be reliably measured are measured at cost less impairment. [FRS 102.11.14(c), FRS 102.11.14(d), FRS 102.12.8(a)]. At 6.3.1 and 6.3.2 below we discuss certain considerations in determining cost for financial instruments carried at cost less impairment. The calculation of impairment is discussed at 6.5 below.

6.3.1 Loan commitments

Basic commitments to receive a loan and to make a loan that are within the scope of Section 11 (see 6.1 above) must be measured at cost (which may sometimes be nil) less impairment. [FRS 102.11.14(c)]. The reference to cost is presumably in respect of any fees or premiums that have been paid by the borrower (representing a financial asset) and received by the lender (representing a financial liability).

FRS 102 is silent on how such costs should be accounted for once the loan is effectively withdrawn or if it is never utilised. Therefore, the entity will have to use judgement in developing and applying an accounting policy that results in reliable and relevant information. It could consider following the guidance in IFRS 9 to develop such a policy, although other judgements could also be acceptable. [FRS 102.10.6]. In the below paragraph we consider the IFRS treatment in further detail.

The guidance in IFRS 9 in relation to commitment fees received by the entity to originate a loan is as follows:

- (a) If it is probable that the entity will enter into a specific lending arrangement, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. Together with the related transaction costs, the commitment fee is deferred and recognised as an adjustment to the effective interest rate when the loan is drawn. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. [IFRS 9.B.5.4.2(b)].
- (b) If it is unlikely that a specific lending arrangement will be entered into, the commitment fee is recognised as revenue on a time-proportionate basis over the commitment period. [IFRS 9.B.5.4.3(b)]. An FRS 102 preparer applying this paragraph in IFRS by analogy, would apply Section 23 *Revenue from Contracts with Customers* instead of IFRS 15.

How we see it

We expect the accounting treatment for loan commitments by the issuer (i.e., the lender) as prescribed in IFRS 9 to be symmetrical for the holder (i.e., the borrower). This means that in the situation described at (b) above, the resulting charge would represent compensation for the service received (i.e., the availability of cash during the commitment period), resulting in a charge on a time-proportionate basis over the commitment period.

6.3.2 Investments in equity instruments

As long as a reliable measure of fair value is available, investments in equity instruments must be measured at fair value through profit or loss. [FRS 102.11.14(d)(iv), FRS 102.12.8]. However, when a reliable measure of fair value is not available, investments in equity instruments are measured at cost less impairment. [FRS 102.11.14(d)(v), FRS 102.12.8(a)].

As discussed at 4.4.1 above, the requirement to use cost less impairment for those equity investments that cannot be reliably measured is similar to that in IAS 39 (but not IFRS 9). The hurdle to overcome before concluding on the unreliability of the fair value measurement in a market that is not active is high, since FRS 102 assumes that normally it is possible to estimate the fair value of equity instruments that an entity has acquired from an outside party (see Chapter 10 at 4.11.5).

Dividends from these investments are recognised in profit or loss when the right to receive payment is established, the amount of the dividend can be measured reliably and it is probable that economic benefits will flow to the entity. [FRS 102.11.14A, 102.12.9A]. However, if the dividend clearly represents a recovery of part of the cost of the investment, it is not recognised in profit and loss (see Chapter 8 at 4.2.1.D). Determining when a dividend does or does not clearly represent a recovery of the cost of the investment can be highly judgemental, and a thorough understanding of the particular facts and circumstances is needed.

6.4 The fair value option

Basic debt financial instruments and basic commitments to receive or make a loan may, upon initial recognition, be designated as at fair value through profit or loss, provided that doing so results in more relevant information. This will be because either:

- (i) Use of fair value eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise.

Or

- (ii) A group of debt instruments or debt instruments and other financial assets is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information is provided on that basis to the entity's key management personnel (as defined in Section 33 *Related Party Disclosures*), for example, members of the entity's board of directors and its chief executive officer. [FRS 102.11.14(b)].

This is similar to the fair value option under IAS 39 (for financial assets and liabilities) and under IFRS 9 (for financial liabilities), where designation is only possible at initial recognition of a financial instrument and not thereafter. However, unlike IAS 39 and IFRS 9, FRS 102 does not contain the further provision that the designation at initial recognition is irrevocable. [IAS 39.50(b), IFRS 9.4.4.2]. Having said that, we do not believe that it was the FRC's intention for the designation to be revocable.

The fair value option has a greater relevance under FRS 102 than under IAS 39 or IFRS 9, as there is no concept in the measurement rules of 'held for trading'. Basic debt instruments that are held for trading purposes are not automatically measured at fair value through profit or loss. To do so requires the use of the fair value option, on the grounds that such instruments are managed and their performance is evaluated on a fair value basis. This means that entities have a choice of whether to apply amortised cost or fair value for such instruments.

One of the reasons for including the fair value option in FRS 102 was to mitigate some of the anomalies that would result from a mixed measurement model. It eliminates problems arising where financial assets are measured at fair value and related financial liabilities are measured at amortised cost, or *vice versa*. Its use can eliminate the burden of designating hedges, tracking and analysing hedge effectiveness, which is discussed in Chapter 14.

An example is the issuance of debt to fund the acquisition of trading assets such as bonds or equities. As the trading assets are bought and sold frequently to maximise/minimise their profits/losses, it may make sense to measure the assets, together with their funding at fair value through profit or loss. This would avoid an accounting mismatch that would otherwise arise by measuring the assets at fair value through profit or loss and the liabilities at amortised cost.

In respect of the second situation in which the fair value option may be applied, the requirement is that the group of instruments must be managed and its performance evaluated on a fair value basis and information is provided on that basis to key management personnel. As a result, the accounting would be consistent with the underlying business objective for the portfolio as that is how its performance is assessed. It is unlikely that outside the financial services or commodity trading sectors, there will be many entities that use the fair value option in this situation.

6.5 Impairment of financial assets measured at cost or amortised cost

6.5.1 Introduction

The concept of impairment is relevant to financial assets that are measured at cost or amortised cost. FRS 102 uses the same principles and criteria as the incurred loss model under IAS 39, but with one major difference. Unlike IAS 39, under FRS 102, there is no requirement for assets that have been individually assessed for impairment and found not to be impaired, to be subsequently included in a collective assessment of impairment. [IAS 39.64]. The FRS 102 requirements are set out at 6.5.2 below.

Sections 11 and 12 of FRS 102 do not use the expected credit loss model. As part of the FRC's Triennial Review 2017, the FRC confirmed that further evidence-gathering and analysis will be undertaken before a decision is made on reflecting the principles of the expected credit loss model of IFRS 9 in FRS 102, if at all. [FRS 102.BC.B11.49]. Subsequently, as part of the Periodic Review 2024, the FRC made no amendment to incorporate the expected credit loss model into FRS 102. The FRC intends to reconsider this matter in due course, taking into account the IASB's third edition of the *IFRS for SMEs Accounting Standard* when finalised. New disclosure requirements were inserted in paragraphs 48ZA and 48ZB of Section 11 of the standard for entities already applying the expected credit loss model from IFRS 9. [FRS 102.BC.B11.49ZA]. However, if entities would like to use the expected credit loss model, they are able to choose to apply IFRS 9 for recognition and measurement purposes as discussed at 3 above.

The effect of moving from the current incurred loss model of FRS 102 and IAS 39 to the IFRS 9 expected loss approach is that entities recognise impairment losses earlier. Under IFRS 9, entities are required to recognise either 12-month or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk since initial recognition. The measurement of expected credit losses must reflect a probability-weighted amount, the time value of money and be based on reasonable and supportable information. Further information regarding impairment under IFRS 9 can be found in the most recent version of the EY publication, *International GAAP*®.

In the sections below, comparisons and references to IFRS are mostly made to IAS 39 as its principles and criteria are also based on incurred credit losses. We do not further discuss differences with the expected credit loss approach in IFRS 9 as it is substantially different.

6.5.2 Recognition of impairment

Under FRS 102, an entity assesses at the end of each reporting period whether there is objective evidence of impairment of any financial assets that are measured at cost or amortised cost. [FRS 102.11.21, FRS 102.12.13]. If there is objective evidence of impairment, the entity recognises an impairment loss in profit or loss immediately. [FRS 102.11.21].

Financial assets carried at fair value through profit or loss are not subject to an impairment assessment, since decreases in value are reflected in the fair value and related profit or loss.

6.5.2.A Objective evidence of impairment

Objective evidence that a financial asset or group of assets is impaired includes observable data that come to the attention of the holder of the asset about the following loss events:

- (i) Significant financial difficulty of the issuer or obligor.
- (ii) A breach of contract, such as a default or delinquency in interest or principal payments.
- (iii) The creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider.
- (iv) It has become probable that the debtor will enter bankruptcy or other financial reorganisation.

And

- (v) Observable data indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions. [FRS 102.11.22].

The above is not an exhaustive list and other factors may also be evidence of impairment, including significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates. [FRS 102.11.23].

6.5.2.B Individual and group assessment

All equity instruments recorded at cost, regardless of their significance, and other financial assets that are individually significant must be assessed individually for impairment. [FRS 102.11.24(a), FRS 102.11.24(b)].

How we see it

There is no guidance in FRS 102 as to how 'individually significant' is interpreted, and therefore, will require judgement.

All other financial assets that are not individually significant are assessed either individually or grouped on the basis of similar credit risk characteristics. [FRS 102.11.24]. As previously mentioned at 2.2 and 6.5.1 above, assets that have been individually assessed for impairment and found not to be impaired, are subsequently not required to be included in a collective assessment of impairment. Even though this appears to be a difference with IAS 39, in practice, the same conclusion might be reached.

How we see it

Grouping financial assets based on similar credit risk characteristics will be a matter of judgement for entities. For example, a bank might split its loans to customers into several categories such as unsecured retail loans, secured retail loans, corporate loans and mortgages. Further stratification of these groupings might be appropriate; for example, mortgages might be split based on their loan-to-value ratios, or the location of the properties, while smaller corporate loans might be split based on the industry in which the borrower operates. A non-financial institution might stratify their trade receivables based on their country of operation, lines of business or even brand names.

6.5.3 Measurement of impairment

6.5.3.A Financial assets measured at amortised cost

For debt instruments measured at amortised cost (see 4.1.2 and 6.1 above) for which there is objective evidence of impairment, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated cash flows, discounted at the asset's original effective interest rate. If it is a variable interest rate, the discount rate for measuring the impairment loss is the current effective interest rate determined under the contract. [FRS 102.11.25(a)]. Subsequently, the amortised cost of an impaired financial asset is calculated by applying the effective interest rate on the carrying amount net of impairment. [FRS 102.11.15(d)].

The following Illustration builds on Illustration 6-1 above to show the measurement of impairment.

Illustration 6-3: Calculating the impairment loss for amortised cost debt instruments

For a bond measured at amortised cost, at the end of 20X7, due to continuing deterioration in the borrower's financial performance, the lender assesses that 25% of all future cash flows (in 20X8 to 20X0) will not be recoverable. The future cash flows that were due were the 4% coupon per annum (i.e., £100,000 × 4%) and the principal repayment of £100,000 at the end of 20X0, which works out to £4,000 in 20X8 and 20X9 respectively and £104,000 in 20X0. If the 25% default rate were to be applied to these cash flows, the revised cash inflows would be £3,000 in 20X8 and 20X9 and £78,000 in 20X0. As mentioned above, the impairment loss will be the difference between the present value of the revised future cash flows less the carrying amount before the impairment, which was £97,486. The present value of the revised future cash flows is £73,114 after discounting by the original effective interest rate of 4.922%. This is worked out as:

$\text{£3,000}/(1 + 4.922\%) + \text{£3,000}/(1 + 4.922\%)^2 + \text{£78,000}/(1 + 4.922\%)^3 = \text{£73,114}$. Hence, the impairment loss is £24,372, being the difference between £97,486 and £73,114.

Year	Carrying amount at the beginning of the period (£)	Interest income @ 4.922% * (£)	Cash inflow (£)	Impairment loss (£)	Carrying amount at the end of the period (£)
20X6	96,000	4,725	(4,000)	-	96,725
20X7 (pre-impairment)	96,725	4,761	(4,000)	-	97,486
20X7 (post-impairment)	97,486	-	-	(24,372)	73,114
20X8	73,114	3,599	(3,000)	-	73,713
20X9	73,713	3,628	(3,000)	-	74,341
20X0	74,341	3,659	(78,000)	-	-

* Interest income for each period has been calculated by applying the effective interest rate of 4.922% on the carrying amount at the beginning of the period, which includes any impairment provision.

6.5.3.B Financial assets measured at cost

For investments in equity instruments (see 4.1.1, 6.1 and 6.3.2 above) and basic loan commitments to receive or make a loan (see 4.1.3 and 6.3.1 above) measured at cost, the impairment loss will be the difference between the asset's carrying amount and the best estimate of the amount that the entity would receive for the asset if it were sold at the reporting date. The best estimate will inevitably be an approximation and might be zero. [FRS 102.11.25(b)].

In the case of investments in equity instruments carried at cost denominated in a foreign currency, the assessment for impairment is carried out in the functional currency of the reporting entity, as the cost of such investments is not remeasured after initial recognition (see Chapter 32 at 3.4.8). Therefore, a change in exchange rates could have an impact on their impairment.

6.5.3.C Commitments to receive or make a loan

Section 11 requires that basic commitments either to receive a loan or to make a loan to another party are measured at cost (which sometimes is nil) less impairment. [FRS 102.11.14(c)]. As discussed at 6.3.1 above, in the case of a basic commitment to make a loan, the reference to cost is presumably in respect of any fees or premiums received from the borrower, in which case the cost will represent a financial liability to the lender.

Given that the impairment rules in Section 11 for loan commitments state that the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) that the entity would receive for the asset if it were to be sold at the reporting date, [FRS 102.11.25(b)], this is problematic. First, as already mentioned, the loan commitment will be a liability and not an asset and second, the entity will need to pay to be relieved of the commitment.

How we see it

For loan commitments that are impaired, we assume that entities are expected to substitute the references to 'asset' and 'receive' with 'liability' and 'pay'.

Financial institutions that apply IAS 39 are required to measure impairment on commitments to make a loan in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, which is also similar in its requirements to Section 21. [IAS 39.2(h)]. This differs from the treatment under IFRS 9, where loan commitments are subject to the assessment of expected credit losses. [IFRS 9.2.1(g)].

6.5.4 Reversal of impairment

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed and recognised in profit or loss, either directly or by adjusting an allowance account. However, the reversal must not result in a carrying amount of the financial asset (net of any allowance account) that exceeds what the carrying amount would have been had the impairment not previously been recognised. [FRS 102.11.26].

FRS 102 does not specifically prohibit the reversal of impairment in the case of investments in equity instruments. This constitutes a difference compared to IAS 39, since the IASB could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value of available-for-sale equity instruments. Therefore, the IASB decided to preclude such reversals for equity instruments. [IAS 39.BC129, IAS 39.BC130]. Similarly, equity instruments are normally measured at fair value rather than at cost under IFRS 9, and as such are not subject to impairment. [IFRS 9.5.7.1, IFRS 9.5.7.5].

7 Derecognition

7.1 Introduction

The FRS 102 derecognition requirements are located in paragraphs 33 to 38 of Section 11, however, they are also applicable to:

- (a) Financial assets and financial liabilities within the scope of Section 12. *[FRS 102.12.14]*.
And
- (b) Receivables recognised by a lessor and payables recognised by a lessee. *[FRS 102.11.7(c)]*.

7.2 Derecognition of financial assets

The FRS 102 derecognition principles for financial assets are similar to those in IFRS 9 and IAS 39 but they have been simplified and do not contain the full body of guidance that can be found in IFRS 9 and IAS 39.

Under FRS 102, a financial asset is derecognised only when:

- (a) The contractual rights to the cash flows from the financial asset expire or are settled.
Or
- (b) The entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset.
Or
- (c) The entity, despite having retained some, but not substantially all, risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. *[FRS 102.11.33]*.

How we see it

In our view, the derecognition guidance in FRS 102 should be viewed as broadly equivalent to the model set out in IFRS 9 and IAS 39, with the exception of pass-through arrangements which is not addressed in FRS 102 (see 2.2.4.A above).

As such, there are three derecognition situations:

- (i) Where the transferor has transferred substantially all the risks and rewards, as set out in (b) above, in which case it must derecognise the asset.
Or
- (ii) Where the transferor has neither transferred nor retained substantially all the risks and rewards, in which case the accounting treatment depends on whether control has been transferred, as set out in (c) above.
Or
- (iii) Where the transferor has retained substantially all the risks and rewards, in which case the asset should not be derecognised.

This third situation will include transactions such as repurchase obligations (i.e., repos), stock lending agreements and factoring arrangements when the transferee has recourse to the transferor and hence has retained substantially all the risks and rewards.

FRS 102 includes two examples that illustrate the situation (i) and (iii) above, the accounting for situation (ii) will depend on whether the entity has transferred control. If it has, it would follow (i), and (iii) if it has not.

Illustration 7-1: Transfer that qualifies for derecognition

An entity sells a group of its accounts receivable to a bank at less than their face amount. The entity continues to handle collections from the debtors on behalf of the bank, including sending monthly statements, and the bank pays the entity a market rate fee for servicing the receivables. The entity is obliged to remit promptly to the bank any and all amounts collected, but it has no obligation to the bank for slow payment or non-payment by the debtors.

In this case, the entity has transferred to the bank substantially all of the risks and rewards of ownership of the receivables. Accordingly, it removes the receivables from its statement of financial position (i.e., derecognises them), and it shows no liability in respect of the proceeds received from the bank. The entity recognises a loss calculated as the difference between the carrying amount of the receivables at the time of sale and the proceeds received from the bank. The entity recognises a liability to the extent that it has collected funds from the debtors but has not yet remitted them to the bank. [FRS 102.11.35].

Illustration 7-2: Transfer that does not qualify for derecognition

The facts are the same as the preceding example except that the entity has agreed to buy back from the bank any receivables for which the debtor is in arrears as to principal or interest for more than 120 days. In this case, the entity has retained the risk of slow payment or non-payment by the debtors – a significant risk with respect to receivables. Accordingly, the entity does not treat the receivables as having been sold to the bank, and it does not derecognise them. Instead, it treats the proceeds from the bank as a loan secured by the receivables. The entity continues to recognise the receivables as an asset until they are collected or written off as uncollectible [FRS 102.11.35].

Where financial assets are transferred, the derecognition assessment first needs to consider the extent to which the entity is still exposed to the risk and rewards associated with the asset following the transfer. If the entity has retained some of the risks and rewards, it will also need to consider whether it still has control over the asset. In essence, the substance of the transaction needs to be evaluated in assessing derecognition; the mere transfer of legal ownership is not sufficient.

In most cases, we would expect the application of these requirements by FRS 102 reporters to be straightforward. That is, in the case of a financial asset such as a loan which is settled on its scheduled maturity date or is redeemed before maturity by the borrower in accordance with the stipulated terms of the loan, the loan would be derecognised on settlement. Another simple example would be the unconditional sale of a financial asset for a fixed price. It is only when an entity embarks on more complex transactions, such as factoring or securitisations, that the application of the requirements become more challenging.

7.2.1 Transfer of risks and rewards of ownership of the asset

FRS 102 does not provide any guidance as to what constitutes the transfer to another party of substantially all the risks and rewards of ownership. [FRS 102.11.33(b)]. The analysis needs to consider all facts and circumstances and the most common risks to be evaluated will usually include credit risk, foreign exchange risk, late payment risk and price risk.

In the case of trade receivables, which are usually short-term in nature, the main risks are normally late payment risk (e.g., the debtor does not settle within the stipulated credit period such as 30 days or 90 days, but does eventually make payment in full for the amount due) or credit risk (i.e., the debtor is unable to make full payment for the amount owing and it results in a bad debt for the creditor).

7.2.1.A Sale with option to buy back or sell back at some point in the future

The analysis is more challenging when the asset is sold but either party or both have an option to buy/sell back the asset at some point in the future. As there is no specific guidance included in FRS 102, an entity could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IFRS. [FRS 102.10.6]. In this section we consider the applicable guidance in IFRS 9.

Extract from IFRS 9

B3.2.16 (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

(g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.

In order to analyse the implications of the option on the risk and rewards assessment, the exercise price of the option relative to the current fair value of the asset would need to be considered, together with the term of the option.

In the case of a call option that is deeply in the money (i.e., the exercise price of the option is favourable when compared to the current market price of the asset and is expected to remain so), it is highly likely that the option will be exercised by the transferor before expiry. Consequently, derecognition would not be appropriate based on 7.2(iii) above, as the transferor has retained substantially all the risks and rewards. However, if the circumstances were reversed, that is, the option is deeply out of the money and is highly unlikely to go into the money before maturity, derecognition would be appropriate as the transferor has transferred substantially all risks and rewards. In these situations, it is almost impossible to set bright lines as to when an option is considered deeply in or out of the money, hence, judgement is required by evaluating all relevant facts and circumstances on a case-by-case basis.

7.2.1.B Sale of trade receivables

The same assessment will need to be made in respect of the sale of trade receivables, by analysing the extent to which the seller has retained any risks and rewards following the sale. If the seller has not retained substantially any of the risks and rewards, derecognition would be appropriate. However, if the seller agrees to reimburse the buyer for all likely bad debts and late payments that will occur, the seller has retained substantially all risks and rewards, thus, derecognition would not be appropriate. Both scenarios have been illustrated in 7.2 above.

The determination of whether the seller has transferred or retained substantially all the risks and rewards will be more difficult in situations where the seller retains, for example, the risk associated to the first £10m of future credit losses. The answer will depend on an assessment of the quality of the receivables that were sold. If it is likely that the first £10m of future losses represent a substantial portion of the total losses that are expected to occur, derecognition would not be appropriate as the seller has retained substantially all the risks and rewards. On the other hand, if the first £10m represents an immaterial portion of the total expected future losses, derecognition may be appropriate, as it is clear that the seller has transferred substantially all the risks and rewards.

7.2.2 Transfer of control of the financial asset

In between the two extremes of transferring or retaining substantially all the risks and rewards, the transferor may have retained some risks and rewards. The derecognition assessment is then dependent on whether the transferor has retained control of the asset or not. This will depend on whether the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and whether the transferee is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. [FRS 102.11.33(c)].

There is no further guidance given in FRS 102 on what is meant by 'practical ability'. Consequently, an entity could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IFRS. [FRS 102.10.6]. In this section we consider the applicable guidance in IFRS 9, which we expect most FRS 102 reporters will use when assessing the practical ability test.

Paragraph B3.2.7 of IFRS 9 contains the following guidance, which is identical to paragraph AG42 of IAS 39:

Extract from IFRS 9

B3.2.7 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

Consider the following example, which helps illustrate these requirements:

Illustration 7-3: The sale of quoted bonds subject to a call option to buy them back

Company Y holds 8,000 corporate bonds issued by a listed company, Company X. Similar to Company X's equity shares, the corporate bonds are listed on an exchange and are subject to regular trading in the market. The market price of the bonds at 31 December 20X6 is at par £100, thus, the investment's fair value is £800,000. The bonds meet the criteria to be classified as basic financial instruments and are thus measured at amortised cost. However, there is currently no material difference between the amortised cost and the fair value of the bonds. On the same day, Company Y sells the bonds to a hedge fund for £750,000 but simultaneously obtains a call option to buy back the bonds on 31 December 20X7 for £850,000. The sale agreement does not prevent the hedge fund from selling, exchanging or pledging the bonds to another party. In these circumstances, due to the existence of the option, it is assessed that Company Y has retained some, but not substantially all risk and rewards of ownership of the bonds. This is because it will be able to benefit from fair value movements above the call option exercise price of £850,000 by exercising the option, however, it is not exposed to fair value movements below the call option exercise price.

In addition, because the bonds are listed and traded on an active market, (see Chapter 10 for the definition of an active market), it is considered that the hedge fund has the practical ability to sell the bonds. Even if the hedge fund sells the bonds and Company Y decides to exercise its call option, the hedge fund can repurchase the bonds in the market in order to sell them back to Company Y. Therefore, Company Y has transferred control of the bonds to the hedge fund. Consequently, Company Y derecognises the bonds and recognises an option asset, which is a new right that has arisen following the transfer. At 31 December 20X6 the call option is 'out of the money' because the exercise price of £850,000 is greater than the fair value of £800,000. The premium paid on the option is £50,000, being the difference between the fair value of the bonds of £800,000 and the sale consideration of £750,000. The following accounting entries would be made by Company Y:

Dr Cash received from sale	£750,000
Dr Fair value of call option	£50,000
Cr Bond holding in Company X	£800,000

The call option is a derivative, which falls within the scope of Section 12 and thus would need to be measured at fair value through profit or loss until it expires (see 6.1 above). In this example, the practical ability test has been satisfied as the bonds are listed on an exchange and they are regularly traded; however, being exchange-listed is not necessarily itself a requirement, it is sufficient for there to be an active market.

In the example above, if the corporate bonds were not traded in an active market, with all other things being equal, the transaction would have failed the practical ability test, and the corporate bonds would not have been derecognised. See further discussion on the accounting in this situation at 7.2.3.A and 7.2.3.B below.

7.2.3 Accounting for derecognition of financial assets

7.2.3.A Transfers that qualify for derecognition

When it is concluded that the transfer qualifies for derecognition, the asset should be derecognised and any rights and obligations retained or created should be recognised separately. The carrying amount of the transferred asset must be allocated between the rights or obligations retained and those transferred on the basis of their relative fair values at the transfer date. Newly created rights and obligations must be measured at their fair values at that date. Any difference between the consideration received and the amounts recognised and derecognised is recognised in profit or loss. [FRS 102.11.33(c)].

These accounting requirements are explained by Illustration 7-2 at 7.2 above.

7.2.3.B Transfers that do not qualify for derecognition

If a transfer does not result in derecognition because the entity has retained substantially all risks and rewards of ownership of the transferred asset, the entity should continue to recognise the transferred asset in its entirety and should recognise a financial liability for the consideration received. The asset and liability should not be offset. In subsequent periods, the entity should recognise any income on the transferred asset and any expense incurred on the financial liability. [FRS 102.11.34]. This describes the gross presentation of assets and liabilities in the statement of financial position and their related income and expenses in the income statement to represent the substance of a collateralised borrowing transaction.

FRS 102 only refers to transactions where the entity has retained substantially all risks and rewards. For transactions where the transferor has retained some, but not substantially all the risks and rewards, but has retained control of the financial assets (see 7.2.2 above), we would also expect a financial liability to be recognised. These are transactions where there is a continuing involvement with the assets, which are not addressed by FRS 102. We further discuss these transactions at 2.4.2 above.

7.3 Accounting for collateral

FRS 102 also deals with the accounting consequences of transactions where a transferor provides non-cash (such as debt or equity instruments) collateral to the transferee. The accounting for non-cash collateral by the transferor and the transferee depends on:

- (a) Whether the transferee has the right to sell or repledge the collateral.

And

- (b) Whether the transferor has defaulted.

If the transferee has the right by contract to sell or re-pledge the collateral, the transferor should reclassify that asset in its statement of financial position separately from other assets. For example, it could be disclosed as a loaned asset or pledged asset.

If the transferee sells collateral pledged to it, it should recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it should derecognise the collateral, and the transferee should recognise the collateral as its asset, initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.

In all circumstances, the transferor must continue to recognise the collateral as its asset, unless the transferor has defaulted and is no longer entitled to redeem the collateral. [FRS 102.11.35].

7.4 Derecognition of financial liabilities

7.4.1 General rule: extinguishment

The derecognition requirements in FRS 102 require reporters to derecognise a financial liability or part of a financial liability only when it is extinguished. In essence, a financial liability or a part of it is only extinguished when the obligations specified in the contract are discharged, are cancelled or expire.

[FRS 102.11.36].

Unlike IFRS 9 (see 2.4.1.C above), FRS 102 does not further elaborate on the moment when the discharge of a liability has occurred. Therefore, an entity needs to have a developed their own accounting policy that aligns with FRS 102.11.36 and addresses the particulars of the payment method, such as the use of cheques. This policy needs to be followed consistently.

7.4.2 Exchange and modification

If an existing borrower and lender exchange financial instruments with substantially different terms or substantially modify the terms of an existing financial liability, the transaction must be accounted for as an extinguishment of the original financial liability and the recognition of a new one. [FRS 102.11.37].

FRS 102 does not contain the additional guidance on what constitutes 'substantially different'. As there is no specific guidance included in FRS 102, an entity could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IFRS. [FRS 102.10.6].

The subsequent accounting for exchanges or modifications that fail derecognition is discussed at 7.5 below.

7.4.3 Gains and losses on derecognition

Any difference that may arise between the carrying amount of the financial liability that has been extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss. [FRS 102.11.38].

7.5 Exchange or modification that does not qualify for derecognition

FRS 102 does not provide specific guidance on the subsequent accounting where it is determined that an exchange of financial instruments with different terms is not a substantial modification of the terms of the existing financial asset or liability. FRS 102 does not contain the additional guidance in IAS 39 and IFRS 9 on what constitutes 'substantially different'. As there is no specific guidance included in FRS 102, an entity could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IFRS. [FRS 102.10.6]. Further information on accounting for an exchange or modification that does not qualify for derecognition can be found in the most recent version of the EY publication, International GAAP®.

How we see it

We believe that entities have an accounting policy choice to either:

- (a) Account for the changes in cash flows prospectively through a revised effective interest rate.
Or
- (b) Adjust the carrying amount of the financial liability to reflect the modified cash flows, discounted at the original effective interest rate of the existing financial liability (see 6.2 above), which is aligned with paragraph 5.4.3 of IFRS 9.

8 Offsetting of financial instruments

8.1 Offsetting requirements

The rules regarding offsetting, sometimes called 'netting', of a financial asset and a financial liability are contained in both Sections 11 and 12. However, the guidance is identical. A financial asset and a financial liability must be offset and the net amount presented in the statement of financial position when and only when, an entity:

- (a) Currently has a legally enforceable right to set off the recognised amounts.

And

- (b) Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

[FRS 102.11.38A, FRS 102.12.25B].

The offsetting requirements set out above are identical to that in IAS 32 but without the additional guidance contained in IAS 32. The IASB decided to incorporate additional guidance into IAS 32 to deal with historical ambiguities as well as emerging practical application issues arising from the growth in the clearing of financial instruments. The additional guidance has helped to clarify aspects such as current legal enforceability and simultaneous settlement.

As there is no specific guidance included in FRS 102 to deal with more complex offsetting situations, such as when a central counterparty clearing house (CCP) is used to clear financial instruments, an entity could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IAS 32.

[FRS 102.10.6]. Further information on offsetting under IAS 32 can be found in the most recent version of the EY publication, International GAAP®.

The effect of the offsetting rules described above is that, when the requirements are met, in effect the entity presents a single financial asset or liability which represents the net cash flow intended to be received or paid. When the requirements are not met, the financial asset and the financial liability need to be presented separately.

8.2 Interaction with derecognition rules

Offsetting and derecognition are different. Offsetting does not result in derecognition of the financial asset or liability from the statement of financial position, but in their net presentation on the statement of financial position as either a net financial asset or a net financial liability. Offsetting does not have an impact on the income statement as there is no gain or loss arising from the net presentation.

When a transfer of financial assets does not qualify for derecognition, the entity has to recognise an associated liability as discussed at 7.2.3.B above. In such cases, the financial asset retained in the statement of financial position and the resulting financial liability cannot be offset. *[FRS 102.11.34].*

9 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS 9/IAS 32/IAS 39
Accounting policy choice	Option to apply the recognition and measurement requirements of Sections 11 and 12, IAS 39 or IFRS 9. No matter the option chosen, entities must apply disclosure requirements of Sections 11 and 12.	Option to apply hedge accounting requirements of IAS 39 in full.
Classification and Measurement	Instruments are classified as basic or other. All basic instruments other than investments in equity instruments are carried at amortised cost or cost less impairment. Investments in equity instruments and all other instruments must be carried at fair value, except when not reliably measured or prohibited by law. No concept of held for trading, thus, such instruments could theoretically be measured at amortised cost unless the fair value option is elected. No concept of fair value through other comprehensive income.	Under IFRS 9, classification of financial assets is based on a contractual characteristics test and business model test leading to the following classifications: 1. Amortised cost 2. Fair value through OCI (with or without recycling) 3. Fair value through profit or loss Financial liabilities can be carried at amortised cost, although the fair value option is available under certain circumstances (and for financial assets but in more restricted circumstances). Changes in fair value due to own credit risk of financial liabilities designated at fair value are recognised through OCI.
Derivatives	No concept of embedded derivatives. Derivatives recognised and measured at fair value through profit or loss.	Derivatives and certain embedded derivatives in financial liabilities or non-financial items are recognised and measured at fair value through profit or loss.
Impairment	Incurred loss model with assessment of objective evidence of impairment. Credit losses for impaired assets are calculated based on the difference between the asset's carrying amount and the present value of discounted cash flows or the best estimate of the amount receivable if the assets were sold.	IFRS 9 impairment requirements is based on an expected credit loss model. Credit losses for impaired assets are calculated based on the difference between the discounted contractual cashflows and the expected cashflows. Recognition of 12-month expected credit losses until there is a significant increase in credit risk at which point lifetime expected credit losses are recognised.
Derecognition	Similar principles to IFRS but less guidance. No concept of 'continuing involvement' or 'pass through' unlike IFRS 9, no accounting policy exception for electronic payment systems.	Complex rules.
Disclosures	Disclosures as set out in Sections 11 and 12 and additional disclosures if considered a financial institution (Section 34 <i>Specialised Activities</i>).	Extensive disclosures (IFRS 7 and IFRS 13 <i>Fair Value Measurement</i>).

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
amortised cost (of a financial asset or financial liability)	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position.
derivative	A financial instrument or other contract with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the carrying amount of the financial asset or financial liability.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of FRS 102, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
financial asset	Any asset that is: (a) cash; (b) an equity instrument of another entity; (c) a contractual right: (i) to receive cash or another financial asset from another entity, or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

	(d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
financial instrument	A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
financial liability	Any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
firm commitment	Binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
forecast transaction	Uncommitted but anticipated future transaction.
probable	More likely than not.
publicly traded (debt or equity instruments)	Traded, or in process of being issued for trading, in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
transaction costs (financial instruments)	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, or the issue or reacquisition of an entity's own equity instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.

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Overview

This chapter deals with the requirements of Section 12 *Other Financial Instruments Issues* in relation to hedge accounting.

This includes the various criteria that must be met in order to apply hedge accounting, as well as the associated accounting when hedge accounting is applied. There are three permitted types of hedge relationships: a fair value hedge, a cash flow hedge and the hedge of a net investment in a foreign operation. In order to apply hedge accounting the hedge relationship must be formally documented up front and must include only eligible hedged item(s) and hedging instrument(s). The qualification criteria for the application of hedge accounting must be met at inception of the hedge relationship and on an ongoing basis.

The application of hedge accounting is incremental to the usual treatment for the hedged item and/or hedging instrument in accordance with FRS 102. The accounting treatment of financial instruments as required by FRS 102 is dealt with in earlier chapters. In particular, Chapter 11 deals with derivatives and Chapter 13 deals with the subsequent measurement of financial instruments.

The accounting entries for the application of hedge accounting are driven by the change in fair value of the hedging instrument and the change in present value of the hedged item. There is an expectation that such changes in value will largely offset, however to the extent this is not the case, it is likely to result in hedge ineffectiveness being recorded in profit or loss.

What you need to know

- Hedge accounting changes either the accounting for the hedged item or the hedging instrument in order to better represent an entity's risk management activities in the financial statements.
- There are strict criteria for the application of hedge accounting, such as what qualifies as a hedging instrument or a hedged item to achieve hedge accounting. Meeting the criteria for both the initial and ongoing application of hedge accounting can be complex.
- The application of hedge accounting is driven by the hedge documentation and can only be applied prospectively. The use of hindsight is not permitted.
- Although the application of hedge accounting may reduce levels of profit or loss volatility from instruments transacted for risk management purposes, such as derivatives, it does not always follow that profit or loss volatility will be eliminated completely. It depends on the existence of any sources of ineffectiveness within the hedge relationship.
- Under UK GAAP, Section 12 of FRS 102 contains the requirements for hedge accounting.
- Entities can make an accounting policy choice for recognition and measurement of financial instruments to apply either:
 - Sections 11 and 12.
Or
 - IAS 39 (as adopted in the EU) as the standard applies prior to the application of IFRS 9. First-time adopters can only apply this policy choice if this would make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included.
Or
 - IFRS 9, and IAS 39 (as amended following the publication of IFRS 9) as far as it remains applicable when IFRS 9 is applied. [FRS 102.11.2, FRS 102.12.2]. On application of IFRS 9 entities are permitted to continue to apply the IAS 39 hedge accounting requirements with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities. (Following the publication of IFRS 9, IAS 39 was amended to include only the guidance necessary to continue to apply such a hedge relationship.)
- The choice of framework can have a significant implication for the qualifications criteria, documentation and effectiveness testing of hedging relationships.
- The presentation and disclosure requirements of Sections 11 and 12 are still applicable regardless of the accounting policy choice above. In addition, the disclosure requirements of Section 34 are also applicable for financial institutions. In cases where the risks arising from financial instruments are particularly significant to the business which may be the case for entities with material hedging relationships, more detailed disclosures may be needed to meet the objectives of the standard.

1 Introduction

Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* contain the accounting and disclosure requirements for financial instruments. Section 34 *Specialised Activities* contains additional disclosure requirements for financial instruments that apply to financial institutions.

Section 11 deals with what are termed 'basic' financial instruments, which are certain non-complex debt instruments and equity securities. It sets out the criteria for basic financial instruments and how they are measured, along with the impairment requirements. It also includes the derecognition requirements for financial instruments, and various disclosure provisions for all financial instruments. Section 11 has been structured to provide all the financial instrument accounting requirements for many entities, who do not enter into more complex transactions.

Section 12 applies to all other financial instruments, which need to be measured at fair value through profit or loss, and addresses the hedge accounting requirements. It also contains associated disclosure provisions (see Chapter 15).

However, instead of applying the recognition and measurement requirements of Section 11 and 12, FRS 102 reporters have the choice of applying the recognition and measurement provisions of IAS 39 *Financial Instruments: Recognition and Measurement* (as adopted in the EU) or IFRS 9 *Financial Instruments* and IAS 39 (as amended following the publication of IFRS 9 as far as it remains applicable when IFRS 9 is applied). This accounting policy choice applies to all financial instruments - entities cannot decide to elect to use IAS 39 or IFRS 9 only for certain items. Consistent with any change in accounting policy, a subsequent change in this accounting policy choice is allowed only when the change will lead to more reliable and relevant information. [FRS 102.10.8(b)]. Note that on first-time adoption of FRS 102, an entity can only choose to apply IAS 39 for recognition and measurement if this would make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included.

[FRS 102.35.8C].

The FRS 102 hedge accounting requirements are similar to those in IFRS 9, but with some simplifications and without the detailed guidance of IFRS 9. Accordingly, FRS 102 incorporates a more principles-based approach to hedge accounting compared to IAS 39.

The Periodic Review 2024 includes amendments to Sections 11, 12 and 22 to FRS 102 as issued in January 2022. These amendments are mandatory for accounting periods beginning on or after 1 January 2026.

The key change affecting Sections 11, 12, 22 and 34 of FRS 102 in relation to hedge accounting is that entities are no longer permitted to change their accounting policy for recognition and measurement of financial instruments from applying full Section 11 and Section 12 or a combination of IFRS 9 and IAS 39 to applying IAS 39 alone, except to make the policies consistent with consolidated financial statements in which the entity is included.

Apart from this restriction, there are no changes to the hedge accounting requirements other than temporary amendments specific to interest rate benchmark reform (see 4.10.3 below).

When an entity first applies the Periodic Review 2024 amendments above, retrospective application is required unless specified otherwise (see Chapter 37). [FRS 102.1.39].

2 Comparison between Sections 11, 12, 22 and IFRS

The comparable extant IFRSs are IAS 32, IFRS 9 and IFRS 7. FRS 102 contains an accounting policy choice for the recognition and measurement of financial instruments for entities to apply either:

- Sections 11 and 12 in full.
Or
- IAS 39 (as adopted in the EU) as the standard applies prior to the application of IFRS 9. First-time adopters of FRS 102 can only apply this policy choice if this would make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included.
Or
- IFRS 9 (as adopted in the EU), and IAS 39 (as amended following the publication of IFRS 9) as far as it remains applicable when IFRS 9 is applied. [FRS 102.11.2, FRS 102.12.2].

On application of IFRS 9, entities are permitted to continue to apply the IAS 39 hedge accounting requirements with respect to the fair value hedge of interest rate exposures of a portfolio of financial assets and liabilities. [FRS 102.12.15A]. Following the publication of IFRS 9, IAS 39 was amended to include only the guidance necessary to continue to apply such a hedge relationship.

The main differences between FRS 102 and IFRS in relation to hedge accounting are discussed below.

The FRS 102 hedge accounting requirements are similar to those in IFRS 9, but with some simplifications and without the detailed guidance of IFRS 9. For example, certain complexities present in IFRS 9, such as rebalancing, aggregated exposures and costs of hedging are not incorporated within FRS 102.

Accordingly, FRS 102 incorporates a more principles-based approach to hedge accounting compared to IAS 39.

An important difference relates to discontinuation of hedge accounting - under FRS 102 (and IAS 39), entities have the option to voluntarily discontinue hedge accounting. Under IFRS 9, hedge accounting is continued as long as the qualifying criteria are met.

2.1 Hedged items - risk components

A significant difference to IAS 39 is that, consistent with IFRS 9, it is possible to designate risk components of non-financial items where these are separately identifiable and reliably measurable.

2.2 Hedging instruments - non-derivatives

Under FRS 102, the requirements for qualifying hedging instruments are based on a simplified version of IFRS 9, such that non-derivative financial assets or liabilities at FVTPL are eligible to be designated hedging instruments. Additionally, the foreign currency (FX) risk component of a non-derivative financial instrument may also qualify as a hedging instrument under FRS 102.

Under IAS 39, non-derivatives can only be used as hedging instruments for hedges of FX risk.

2.3 Hedge effectiveness assessment

The requirements for assessing hedge effectiveness for hedge accounting are based on a simplified version of the IFRS 9 requirements and are significantly different compared to IAS 39. Entities are not required to perform an onerous quantitative effectiveness assessment to demonstrate that the hedge relationship in any period was highly effective, using the 80%-125% bright line. Instead, the FRS 102 effectiveness test uses a different approach based on IFRS 9 that focuses on the existence of an economic relationship between the hedged item and hedging instrument. IFRS 9 has additional effectiveness requirements that are not replicated within FRS 102. However, there is a need to measure any actual hedge ineffectiveness and record it in the same way as under IFRS 9 and IAS 39.

2.4 Hedges of a net investment

Under FRS 102, the gain or loss arising from a hedge of a net investment in a foreign operation that is accumulated in equity is not recycled to profit or loss on disposal or partial disposal of the foreign operation. In contrast, both IFRS 9 and IAS 39 require that such gains and losses be recycled from equity to profit or loss when the foreign operation is disposed of.

3 Scope of Sections 11 and 12

Sections 11, 12 and 22 contain scope exceptions which are largely consistent with those in IFRS 9, IAS 39 and IAS 32. Section 12 applies to hedge accounting for qualifying items when an entity chooses to apply hedge accounting. Certain financial instruments, such as insurance contracts, share based payments and some own use contracts are excluded from the scope of these sections - see Chapter 11 for more detail.

4 Hedge accounting

4.1 Introduction

The hedge accounting model in FRS 102 is designed to allow entities to reflect their hedging activities in the financial statements in a manner that is consistent with the entity's risk management objectives. The hedge accounting approach in FRS 102 is based on a simplified version of that in IFRS 9. Hedge accounting is optional, and an entity can choose not to designate exposures it is economically hedging. In that case the normal measurement rules in Sections 11 and 12 will apply.

Of course, if the entity has chosen to apply IAS 39 or IFRS 9 to its financial instruments, then it will apply the hedge accounting requirements of those standards (see 1 above).

The two main elements of a hedging relationship are the hedging instrument and the hedged item. Provided the qualifying conditions in Section 12 are met, hedge accounting can be applied prospectively from the date all of the conditions are met and documented. [FRS 102.12.15]. The below focuses on the definitions and criteria for hedge accounting under FRS 102.

4.1.1 What is hedge accounting?

Every entity is exposed to business risks from its daily operations. Many of those risks have an impact on the cash flows or the value of assets and liabilities, and therefore, ultimately affect profit or loss. In order to manage these risk exposures, companies often enter into derivative contracts (or, less commonly, other financial instruments) to hedge these risks. 'Hedging' can therefore be seen as a risk management activity in order to change an entity's risk profile.

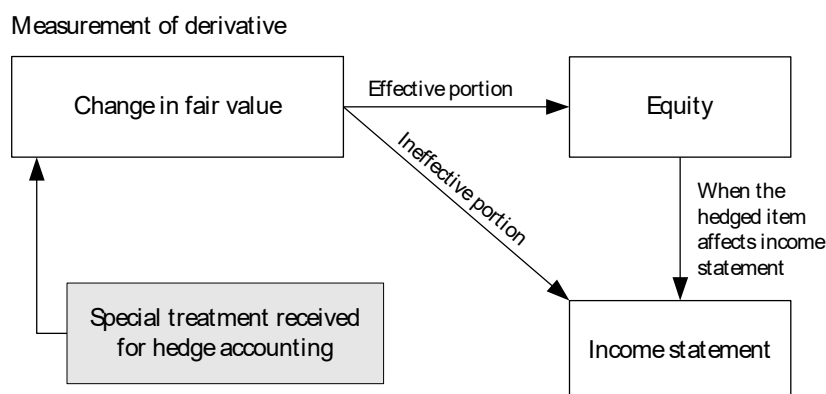
Applying FRS 102 to those risk management activities can result in accounting mismatches when the gains or losses on a hedging instrument are not recognised in the same period(s) and/or in the same place in the financial statements as gains or losses on the hedged exposure. The idea of hedge accounting is to reduce this mismatch by changing either the measurement or (in the case of certain firm commitments) recognition of the hedged exposure, or alternatively, the accounting for the hedging instrument.

Under FRS 102, all derivatives are recorded on the balance sheet at fair value with subsequent fair value changes recorded in the profit and loss account. [FRS 102.11.6(b), FRS 102.12.8]. The impact on profit or loss from derivatives may be reduced if the hedge accounting criteria are met. FRS 102 describes three types of hedging relationships:

- Fair value hedges (see 4.7 below)
- Or
- Cash flow hedges (see 4.8 below)
- Or
- Hedges of net investments in foreign operations (see 4.9 below). [FRS 102.12.19].

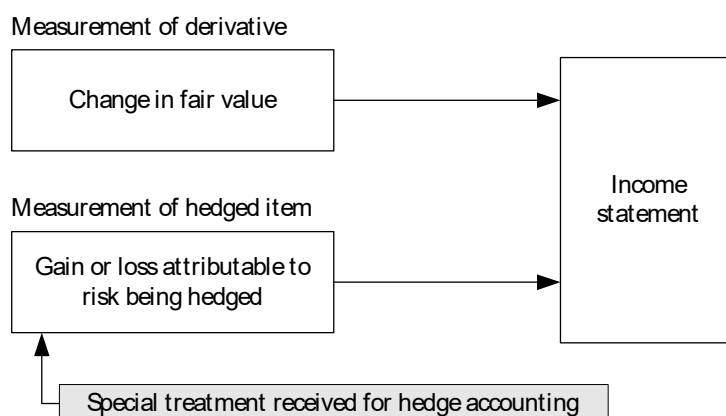
The resultant hedge accounting entries depend on the type of hedge accounting relationship.

For example, an entity with sterling functional currency may expect highly probable future revenue of US\$200 in 3 months' time. As £/US\$ foreign currency exchange rates change, the revenue recognised by the entity in profit or loss will also change, as the entity's cash flows are exposed to foreign exchange risk. To reduce this potential profit or loss volatility, the entity may enter into a forward currency contract to pay US\$200 and receive a fixed sterling equivalent. Under FRS 102, the forward currency contract will be recorded at fair value through profit or loss, and the forecast revenue will not be recognised until it occurs, resulting in a measurement and timing mismatch in profit or loss. If FRS 102 hedge accounting is applied, the forward currency contract would be accounted for differently, to reduce the mismatch. This is an example of a cash flow hedge, as the hedging instrument is reducing variability in the cash flows of the hedged item. The associated hedge accounting is to remove the effective portion of the change in fair value of the hedging derivative from profit or loss and recognise it initially in other comprehensive income (OCI), thereby reducing volatility in profit or loss. The amounts recorded in OCI are then recycled to be reflected in profit or loss at the same time as the forecast revenue is recognised, so that the revenue is recorded at the hedged rate (see 4.8.3 below).

Figure 4-1: Cash flow hedge accounting model

The special treatment for hedge accounting of a net investment in a foreign operation is consistent with that described above for a cash flow hedge (see 4.9 below).

An entity may also transact a derivative that converts a fixed exposure into a variable one. This is described as a fair value hedge. An example of a fair value hedge would be where an entity that has issued fixed rate debt and enters into an interest rate swap in which it receives a fixed rate and pays a variable rate of interest on an underlying notional value. The entity might view this as converting the fixed interest flow into a variable interest flow, but this activity is described in the standard as eliminating variability in fair value with respect to interest rate risk. On application of FRS 102 (without hedge accounting) the interest rate swap is accounted for at fair value through profit or loss whilst the debt would be held at amortised cost, resulting in an accounting mismatch. If FRS 102 hedge accounting is applied to this fact pattern, an adjustment is made to the carrying amount of the debt and to profit or loss, to reflect the revaluation of the debt with respect to interest rate risk. This hedge accounting adjustment mitigates some of the volatility in profit or loss from fair value changes in the derivative (see 4.7.3 below).

Figure 4-2: Fair value hedge accounting model

4.1.2 Hedge accounting overview

An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in order to achieve hedge accounting. [FRS 102.12.18]. Prior to hedge accounting being applied, all of the following steps must have been completed:

- Identification of eligible hedged item(s) and hedging instrument(s) (see 4.2 and 4.3 below).
- Ensuring that the hedge relationship meets the definition of one of the permitted types (a fair value, cash flow or net investment hedge) (see 4.7, 4.8 and 4.9 below).
- Ensuring that the hedge relationship is consistent with the entity's risk management objective for undertaking the hedges (see 4.4.2 below).
- Assessing that there is an economic relationship between the hedged item(s) and hedging instrument(s) (see 4.4.3 below).
- Formal designation of the hedge relationship, including identification of the hedged risk (see 4.4.4 below).

And

- The sources of hedge ineffectiveness are determined and documented (see 4.5 below).

Once these requirements are met, hedge accounting can be applied prospectively, but the ongoing qualifying criteria and assessments must continue to be met, otherwise hedge accounting will cease (see 4.10 below).

The table below summarises the application of hedge accounting for the three types of hedge relationships:

Figure 4-3: Accounting for hedge relationships

Hedge type	Fair value	Cash flow	Net investment
Hedged item	Carrying amount adjusted for changes in fair value with respect to the hedged risk. Adjusted through profit or loss.	N/A	N/A
Hedging instrument	N/A	No change to carrying amount, but effective portion of change in fair value is recorded in OCI.	No change to carrying amount, but effective portion of change in fair value is recorded in OCI.
Resultant profit or loss	Ineffective portion	Ineffective portion	Ineffective portion

As it can be seen from the above, for a fair value hedge, an adjustment is made to the carrying value of the hedged item to reflect the change in value of the hedged risk since designation, also adjusting profit or loss to provide an offset to profit or loss for the change in value of the hedging instrument. Where the offset is not complete, this will result in ineffectiveness to be recorded in profit or loss (see 4.5 below).

However, for both a cash flow and net investment hedge, the carrying amount of the hedged item, which for a cash flow hedge may not even yet be recognised, is unchanged. The effect of cash flow and net investment hedge accounting is to defer the effective portion of the change in value of the hedging instrument in OCI. Any ineffective portion will remain in profit or loss as ineffectiveness.

4.2 Hedged items

4.2.1 Introduction

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction, a net investment in a foreign operation, or a component of any such item, provided the item is reliably measurable. [FRS 102.12.16].

Recognised assets and liabilities can include financial items and non-financial items such as inventory. Eligible hedged items under FRS 102 are not limited to financial instruments within the scope of Section 11 and 12. For example, lease liabilities recognised under Section 20 Leases, although outside of the scope of these sections, can qualify as hedged items where relevant such as for foreign currency risk. This consideration may become more relevant as entities apply the revised Section 20 which brings operating leases onto the balance sheet. As a result, lease liabilities that were previously off-balance sheet operating leases may now be eligible hedged items.

Only assets, liabilities, firm commitments and forecast transactions with a party external to the reporting entity can qualify as hedged items. This means that hedge accounting can only be applied to transactions between entities in the same group in the individual financial statements of those entities, and not in the consolidated financial statements. Three exceptions to this rule are given: [FRS 102.12.16A]

- Transactions with subsidiaries, where the subsidiaries are not consolidated in the consolidated financial statements.
- Foreign currency risk of an intragroup monetary item if that foreign currency risk affects consolidated profit or loss. By way of example, foreign currency risk from intra group monetary items will usually affect consolidated profit or loss when the intra group monetary item is transacted between two group entities that have different functional currencies, as it will not be eliminated on consolidation.

Or

- Foreign currency risk of a highly probable forecast intragroup transaction denominated in a currency other than the functional currency of the entity entering into the transaction, if the foreign currency risk affects consolidated profit or loss. For example, a forecast sale or purchase of inventory between members of the same group will affect profit or loss if there is an onward sale of the inventory to a party external to the group. The designated hedged item is the forecast intragroup transaction, which is therefore subject to the usual eligibility criteria for hedge accounting. However, the highly probable criterion is also relevant for the existence of the external transaction in order to meet the requirement that the forecast foreign currency risk will affect consolidated profit or loss.

The exceptions apply solely to the eligibility of the intragroup items as hedged item in the consolidated financial statements. An equivalent exception does not exist to allow such items to be designated as hedging instruments in the consolidated financial statements.

Transactions in an entity's own equity instruments (including distributions to holders of such instruments) are generally recognised directly in equity by the issuer and do not affect profit or loss. [FRS 102.12.19]. Therefore, such instruments cannot be designated as a hedged item. Similarly, a forecast transaction in an entity's own equity instruments (e.g., a forecast dividend payment) cannot qualify as a hedged item. However, a declared dividend that qualifies for recognition as a financial liability, e.g., because the entity has become legally obliged to make the payment, could qualify as a hedged item. For example, a recognised liability to pay a dividend in a foreign currency gives rise to foreign currency risk.

4.2.2 Components

FRS 102 permits components of an item to be hedged (including combinations of components). For example, rather than having to consider all risks within a hedged item, an item may be hedged with respect to the risks associated with only a portion of its cash flow variability or fair value change, as long as the risk component is separately identifiable and reliably measurable. [FRS 102.12.16C]. For example, if an entity issued debt paying a coupon of SONIA + 2%, it would be possible to only include the SONIA component of the total interest rate exposure within the hedge accounting relationship. Similarly, for fixed rate debt, it would also be possible to identify, say, a 5% coupon component of debt paying a 6% fixed rate coupon.

If a risk component is contractually specified, as in the above SONIA debt issued example, it would usually be considered separately identifiable. In this circumstance, the contractually specified risk component would usually be referenced to observable data, such as a published price index. Therefore, the risk component would usually also be considered reliably measurable.

FRS 102 permits an entity to hedge specific risk components while choosing not to hedge other risk components inherent in the hedged item. Similarly, it is possible to designate more than one risk component of the hedged item within a single hedge relationship. These concepts are demonstrated in Illustration 14-1 below.

Illustration 14-1: Cash flow hedge of specified risk component

On 31 Dec 20X6, Company A, which has Sterling as its functional currency, hedges the highly probable anticipated purchase of 50 tonnes of aluminium on 31 March 20X7 by buying 50 tonnes of aluminium futures on the LME. Although A's aluminium purchase price is determined in US\$, A does not wish to eliminate the associated foreign currency risk as it expects to have sufficient US\$ funds available from anticipated US\$ sales also in March 20X3.

Given the market structure in which A purchases the aluminium, A has identified the US\$ LME aluminium price as an eligible risk component in the highly probable anticipated purchase of aluminium. A designates the futures contract as the hedging instrument in a cash flow hedge of changes in the LME US\$ aluminium price risk component of the anticipated purchases. Other changes in A's anticipated purchase price for the 50 tonnes of aluminium are not considered within the hedge relationship, as hedge accounting is restricted to changes in the eligible risk component, in this case the US\$ LME aluminium price.

In this example, A has chosen to hedge the aluminium price risk. Instead, it could have chosen to hedge the foreign currency risk or both the price risk and the foreign currency risk depending on its risk management strategies. [FRS 102.12.16C].

Ordinary purchase or sales agreements sometimes contain clauses that determine the contract price via a specified formula linked into a benchmark commodity price. Accordingly, these contracts may also contain components that are separately identifiable and reliably measurable. Examples of contractually specified risk components in purchase and sale contracts are as follows:

- The price of wires contractually linked in part to a copper benchmark price and in part to a variable tolling charge reflecting energy costs.
- And

- The price of coffee contractually linked in part to a benchmark price of Arabica coffee and in part to transportation charges that include a diesel price indexation.

While it is certainly easier to determine that a risk component is separately identifiable and reliably measurable if it is specified in the contract, it is not a requirement that a component must be contractually specified in order for it to be eligible as a hedged item. For example, under IFRS it has been common practice to identify a non-contractually specified risk-free interest rate or other benchmark interest rate component of the total interest rate exposure of a fixed rate financial instrument. This approach is supported by an example provided within the application guidance of IFRS 9, and IAS 39 also provides support for this approach as follows: “for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable”. [IFRS 9.B6.3.10(d), IAS 39.AG99F(a)]. This rationale is equally valid under FRS 102.

How we see it

We believe that in order to determine that the risk component is separately identifiable and reliably measurable and qualify for hedging, it must have a distinguishable effect on changes in the value or the cash flows that an entity is exposed to. For example, if the price of a fixed rate financial instrument varies directly in response to changes in a risk-free interest rate or other benchmark interest rate, it could be determined that the rate is a separately identifiable and reliably measurable risk component of the fixed rate debt.

The fact that a commodity is a major physical input in a production process does not automatically translate into a separately identifiable effect on the price of the item as a whole, but it might. For example, although crude oil price changes might influence the long-term price of plastic toys to some degree, they are unlikely to have a distinguishable effect on the retail price in the short term. Similarly, the price for pasta at food retailers in the medium to long term also responds to changes in the price for wheat, but there is no distinguishable direct effect of wheat price changes on the retail price for pasta, which remains unchanged for longer periods even though the wheat price changes. If retail prices are periodically adjusted in a way that also directionally reflects the effect of wheat price changes, that is not sufficient to constitute a separately identifiable risk component. The evaluation is always based on relevant facts and circumstances. An example of a risk component that has a distinguishable effect on changes in the cash flows an entity is exposed to is provided in the application guidance to IFRS 9.

Illustration 14-2: Hedge of a non-contractually specified risk component

An entity purchases a particular quality of coffee of a particular origin from its supplier under a contract that sets out a variable price linked to the benchmark price for coffee. The price is represented by the coffee futures price plus a fixed spread, reflecting the different quality of the coffee purchased compared to the benchmark plus a variable logistics services charge reflecting that the delivery is at a specific manufacturing site of the entity. The fixed spread is set for the current harvest period. For the deliveries that fall into the next harvest period this type of supply contract is not available.

The entity analyses the market structure for its coffee supplies, taking into account how the eventual deliveries of coffee that it receives are priced. The entity can enter into similar supply contracts for each harvest period once the crop relevant for its particular purchases is known and the spread can be set. In that sense, the knowledge about the pricing under the supply contracts also informs the entity's analysis of the market structure more widely, including forecast purchases which are not yet contractually specified. This allows the entity to conclude that its exposure to variability of cash flows resulting from changes in the benchmark coffee price is a risk component that is separately identifiable and reliably measurable for coffee purchases under the variable price supply contract for the current harvest period as well as for forecast purchases that fall into the next harvest period. [IFRS 9 Appendix B.6.3.10(b)].

Other components that can be hedged include selected contractual cash flows and a specified part of the nominal amount of an item and combinations of these items. [FRS 102.12.16C(b), FRS 102.12.16C(c)]. FRS 102 does not provide detail on what is meant by a ‘specified part of the nominal amount of an item’. The hedge accounting rules in FRS 102 are based on IFRS 9 which states that such a component of a nominal amount could be a proportion of an entire item (such as, 60% of a fixed rate loan of £10 million) or a layer component (for example, the first £6 million of sales). [IFRS 9 Appendix B.6.3.16].

IFRS 9 contains some restrictions when hedging a layer component that includes a prepayment option. In particular, a layer component that includes a prepayment option does not qualify as a hedged item in a fair value hedge if the fair value of the prepayment option is affected by changes in the hedged risk (unless the changes in fair value of the prepayment option as a result of changes in the hedged risk are included when measuring the change in fair value of the hedged item). However, this restriction is not included in FRS 102 and there is no requirement to analogise to the requirements of IFRS 9 or to assume that IFRS 9 applies where FRS 102 is silent. Hence, an entity applying FRS 102 does not encounter this issue and can designate a layer component in a fair value hedge, although the effect of the related prepayment option on the layer's fair value with respect to the hedged risk will still need to be included.

In FRS 102, risk components may also include a designation of changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (i.e., a one-sided risk). [FRS 102.12.16C(a)]. For example, an entity could hedge the cash flow losses resulting from an increase in the price of a forecast commodity purchase above a specified level. This is useful when economically hedging with options, which only provide protection above or below a specified price level.

An issue that entities have faced under IAS 39 and IFRS 9 is the prohibition on hedge accounting for changes in LIBOR when the hedged item attracts an interest rate below LIBOR, e.g., LIBOR-0.25%. Historically this was often referred to as the 'sub-LIBOR issue', however now that markets have moved away from LIBOR as the predominant benchmark interest rate following global Interest Rate Benchmark Reform, it is more commonly referred to as the 'sub-benchmark issue'. Application of hedge accounting to the benchmark rate component is not permitted under IFRS for a 'sub-benchmark' instrument because the hedged component cannot be more than the total cash flows of the hedged item.

The restriction also applies under FRS 102 due to the requirement that the designated component of a hedged item comprises less than the entire fair value change or cash flow variability of the item. [FRS 102.12.16C]. Part of the rationale for this prohibition is that if benchmark rate fell to 0.25% in this example, any changes in benchmark rate below 0.25% would not ordinarily cause any further variability in cash flows on the hedged item, as there is usually an inherent floor. However, an entity could still achieve hedge accounting by designating the cash flows of the hedged item in their entirety (e.g., benchmark rate-0.25%) with, for example, a benchmark rate swap as the hedging instrument, although some ineffectiveness may arise and need to be recorded in profit or loss.

4.2.3 Groups of items as hedged items

Hedging relationships typically include a single hedging instrument (e.g., an interest rate swap) hedging a single item (e.g., a loan). However, for operational reasons entities often economically hedge several items together on a group basis (e.g., a number of purchases in a foreign currency could be hedged with a single forward contract).

FRS 102 explains that a hedged item can either be a single item or a group of items, including components of items, provided that all of the following conditions for groups of items are met:

- The group consists of items that are individually eligible hedged items.
- The items in the group share the same risk.
- The items in the group are managed together on a group basis for risk management purposes.

And

- The group does not include items with offsetting risk positions. [FRS 102.12.16B].

Whether the items in the group are managed together on a group basis is a matter of fact, i.e., it depends on an entity's behaviour and cannot be achieved by mere documentation. Examples of groups of items that could be eligible for hedging if all of the conditions are met are a portfolio of customer loans that pay interest based on SONIA, or a portfolio of shares of Swiss companies that replicates the Swiss Market Index (SMI).

Hedge accounting for a net position (e.g., a group of assets and liabilities or income and expenses) is not permitted, as this would include offsetting risk positions. However, where an entity undertakes economic hedge accounting of a net position, the entity could still achieve hedge accounting under FRS 102 by designating a specified component of the gross hedged items. For example, consider an entity with sterling functional currency that has forecast foreign currency sales of €100 and purchases of €80, both in 6 months. It hedges the net exposure using a single forward contract to sell €20 in 6 months. Hedge accounting could be achieved by designating the forward contract as hedging €20 of the €100 forecast sales.

4.3 Hedging instruments

4.3.1 Introduction

FRS 102 defines a hedging instrument as a financial instrument measured at fair value through profit or loss that is a contract with a party external to the reporting entity and is not a written option unless:

- The written option is an offset to a purchased option in the hedged item and the combination is not a net written option.

Or

- The written option is combined with a purchased option and the combination is not a net written option. [FRS 102.12.17, FRS 102.12.17C].

Entities are therefore permitted to designate derivatives as hedging instruments, but also non-derivative financial assets or non-derivative financial liabilities that are accounted for at fair value through profit or loss are eligible hedging instruments. This can be helpful if an entity does not have access to derivatives markets or does not want to be subject to margining requirements and could also be operationally simpler than transacting derivatives.

If a derivative is not measured at fair value (for example, if the fair value cannot be reliably measured), then the derivative cannot be designated as a hedging instrument. [FRS 102.2A.23J]. With the exception of certain written options, the circumstances in which a derivative recorded at fair value through profit or loss may be designated as a hedging instrument are not restricted, provided the relevant conditions for hedge accounting are met. The reason written options cannot be designated as hedging instruments is because net options written by an entity do not reduce risk exposure or the potential effect on profit or loss - the potential loss on a written option could be significantly greater than the potential gain in value of a related hedged item. In contrast, a purchased option has potential gains equal to or greater than potential losses on a related hedged item and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, a purchased option can qualify as a hedging instrument.

Accordingly, determining whether an option contract or a combination of options constitutes a net written option is an important step in hedge designation, and can require judgement. Some guidance on this is given in the basis for conclusions to IFRS 9. The following factors, taken together, indicate that an instrument or combination of instruments is not a net written option:

- No net premium is received, either at inception or over the life of the combination of options - the distinguishing feature of a written option is the receipt of a premium to compensate for the risk incurred.
- Except for the strike prices, the critical terms and conditions of the written and purchased option components are the same, including underlying variable(s), currency denomination and maturity date. And
- The notional amount of the written option component is not greater than that of the purchased option component. [IFRS 9.BC6.153].

In practice many so-called 'zero cost collars' (i.e., a combination of a put and call option, one of which is purchased and the other sold, priced so that the premiums offset to zero) are transacted as legally separate written and purchased options. However, the standard includes an example of a zero-cost interest rate collar to illustrate circumstances under which a written option is combined with a purchased option such that the combination is not a net written option and hence is eligible as a hedging instrument per the second exception above). [FRS 102.12.17C].

FRS 102 also permits the foreign currency risk component of a non-derivative financial instrument (for example, a basic foreign currency loan carried at amortised cost or a lease liability or finance lease receivable within the scope of Section 20 rather than Sections 11 and 12) to be designated as a hedging instrument in the hedge of foreign currency risk. [FRS 102.12.17B].

How we see it

FRS 102 does not explicitly provide guidance on how the foreign currency risk component is determined. In practice, entities are expected to apply a similar approach to that outlined in IFRS 9, which is clear that the foreign currency component is determined using IAS 21 *Foreign Currency Transactions*.

This is shown in the following Illustration.

Illustration 14-3: Hedging using a foreign currency component of a non-derivative instrument

Company J has GBP functional currency. J issued fixed rate debt with principal of JPY 5 million due on maturity in two years. J had also entered into a fixed price sales commitment, accounted for as an executory contract, for JPY 5 million that will be paid in two years as well.

J could designate the foreign currency component (IAS 21 retranslation) of the fixed rate debt as a hedging instrument in a cash flow hedge for the foreign currency exposure associated with the future receipt of JPY 5m on the fixed price sales commitment.

Similarly, as for hedged items, a hedging instrument must be a contract with a party external to the reporting entity and there are no exceptions to this unlike for hedged items (see 4.2.1 above).

[FRS 102.12.17(b)].

4.3.2 Combinations of hedging instruments

A combination of instruments that individually meet the criteria to be treated as hedging instruments to be designated in a hedge relationship are permitted to be jointly designated in the hedging relationship. Hence a purchased bond measured at fair value through profit or loss and an interest rate swap could be jointly designated as 'the hedging instrument'. However, just a combination of derivatives such as interest rate swaps with different counterparties is a more common combination. [FRS 102.12.17A].

4.3.3 Proportions and components of instruments

FRS 102 specifies that a hedging instrument (or a combination of these instruments) can only be designated:

- In its entirety.
- As a proportion or a proportion of a combination of these instruments (e.g., 50% of the nominal amount of the instrument).

Or

- By separating the spot risk element of a foreign currency contract and excluding the forward element, or by separating the intrinsic value of an option and excluding the time value. [FRS 102.12.17A].

A combination of these approaches is also permissible, for example, it is acceptable to designate 50% of the nominal amount of a foreign currency forward contract while excluding the forward element from the hedge.

4.3.3.1 Components of instruments

The requirement to designate a hedging instrument in its entirety rather than a portion or component of it, is consistent with IFRS 9 and IAS 39. The reason given for that original guidance in IAS 39 is because there is normally a single fair value measure for a hedging instrument in its entirety and the factors that cause changes in its fair value are co-dependent. [IAS 39.74].

Similar to IFRS 9 and IAS 39, this means that the entity cannot designate a 'partial-term' component of a financial instrument as the hedging instrument. For example, in the case of a five-year interest rate swap hedging a four-year exposure, the swap payments and receipts over the next four years (i.e., ignoring those in year five) could not be designated as the hedging instrument. Instead, the whole derivative (i.e., including payments and receipts in year five) must be designated as the hedging instrument, although the hedging relationship may itself last for only four years. Likewise, components of particular cash flows in the hedging instrument cannot be designated in hedge relationships.

As noted at 10.3.1 above, for a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument can be designated as a hedging instrument. [FRS 102.12.17B].

4.3.3.2 Proportions of instruments

It is possible to designate a proportion of the entire hedging instrument, such as 50% of the notional amount, in a hedging relationship. The proportion that is not designated is available for designation within other hedge relationships, such that a maximum of 100% of the notional is designated as a hedging instrument. Any proportions of an instrument not designated within hedge relationships are accounted under the usual FRS 102 classification and measurement guidance.

4.3.3.3 Options and forward contracts

The ability to separate the spot risk in a forward foreign currency contract or the intrinsic value in an option contract and exclude the forward element and time value respectively from the hedge relationship is consistent with IAS 39. [IAS 39.74]. The excluded elements of the hedging instrument (i.e., the forward element of a foreign exchange contract, or the time value of an option contract) are accounted under the usual FRS 102 classification and measurement guidance, which will be at fair value through profit or loss for derivatives.

How we see it

No prescriptive guidance is provided as to how the intrinsic value of an option must be calculated if it is designated in a hedging relationship. We believe it is acceptable to calculate the intrinsic value with respect to either the prevailing relevant spot or forward price, consistent with the risk management objective. For example, if an entity is hedging a forecast transaction, the forward price may be more relevant to the intrinsic value, however using the spot price may be operationally simpler. The chosen approach must also be documented and consistently applied for that hedge relationship.

By way of example, when using the forward price, the intrinsic value is calculated by projecting each cash flow using the relevant forward price for the relevant date and comparing that to the strike price. The result, if positive, is then discounted back to the valuation date and aggregated for all positive cash flows to form the intrinsic value of the option contract. A similar calculation is made if using the spot price, but each cash flow comparison is the prevailing spot price versus the strike price.

Changes in value of the excluded forward element in this case, are outside the hedge relationship and will be taken to profit or loss. The value of the forward element is calculated as the difference between:

- The full fair value change in the forward exchange contract.
- And
- The change in the present value of the spot risk element.

There could be some hedge relationships for which it will be easier to determine that an economic relationship exists between the hedged item and the hedging instrument if the forward element of forward contracts or time value of option contracts are excluded from the hedge relationship. For example, if based on the current market situation, the majority of fair value movements of a purchased option (designated as a hedging instrument) are expected to arise from changes in the time value, no offset will arise for changes in the time value unless the time value also exists in the hedged item (see 4.4.3 below).

IFRS 9 has additional guidance that has not been included in FRS 102. IFRS 9 includes guidance on the ability to exclude cross currency basis from a hedging instrument, and to achieve a 'cost of hedging' treatment for the excluded portions of a hedging derivative.

How we see it

Given FRS 102 paragraph 17A requires a hedging instrument to be included in its entirety, unless one of the explicit exclusions is met, we do not believe it is possible to apply the IFRS 9 guidance on excluding cross currency basis from a hedging instrument, or costs of hedging.

The exclusion of the forward element of a foreign currency contract or the time value of an option from an existing hedge relationship is a change to the documented hedged item and risk management objective. Such a change can only be accommodated by discontinuing an existing hedge relationship and starting a new one (see 4.4.2 below).

4.4 Criteria for hedge accounting

4.4.1 Introduction

In order to qualify for hedge accounting a hedging relationship has to consist of eligible hedging instruments and eligible hedged items as described at 4.2 and 4.3 above. In addition:

- The hedging relationship must be consistent with the entity's risk management objectives for undertaking hedges.
- There must be an economic relationship between the hedged item and hedging instrument.
- The entity must document the hedging relationship.
- And

- The entity must determine and document causes of hedge ineffectiveness. [FRS 102.12.18].

Each of these criteria is discussed further below.

An entity is required to discontinue hedge accounting if the conditions for hedge accounting are no longer met. [FRS 102.12.25(b)]. This means that there is an ongoing requirement to assess whether the criteria are met. We would expect entities to undertake the assessment, at a minimum, at each reporting date. If it is determined that the criteria are no longer met, then the standard says that hedge accounting is discontinued prospectively. No further guidance is provided in FRS 102 as to what is meant by 'discontinued prospectively'. IAS 39 states that hedge accounting ceases from the date the hedge relationship last met the effectiveness requirements. [IAS 39.AG113], whereas IFRS 9 states that discontinuation applies prospectively from the date on which the qualifying criteria are no longer met. [IFRS 9 Appendix B.6.5.22].

How we see it

Given the lack of guidance, in FRS 102 and the fact that IAS 39 and IFRS 9 have different requirements, we believe an accounting policy choice can be made as to the date as of which hedge accounting is discontinued.

4.4.2 Risk management objectives

Hedge accounting must reflect the entity's risk management objectives for undertaking a hedge. The risk management objective is set at the level of an individual hedging relationship and defines how a particular hedging instrument is designated to hedge a particular hedged item. For example, a risk management objective for an entity with sterling functional currency might be to designate a foreign exchange forward contract in a hedge of the foreign exchange risk of the first €1m of sales in March 2026 or to designate a particular interest rate swap in a fair value hedge of £10m fixed rate debt. If this objective for the hedge relationship changed, then hedge accounting ceases (see 4.10 below). Accordingly, the risk management objective is written in such a way that it can be determined if it has changed, and therefore whether discontinuation is required or not. [FRS 102.12.25(b)].

4.4.3 Economic relationship

FRS 102 states: [FRS 102.12.18A]

Extract from FRS 102

12.18A An economic relationship between a hedged item and hedging instrument exists when the entity expects that the values of the hedged item and hedging instrument will typically move in opposite directions in response to movements in the same risk, which is the hedged risk.

This relationship is based on an economic rationale rather than just by chance, as could be the case if the relationship is based only on a statistical correlation. Although a statistical correlation on its own is not sufficient to determine the existence of an economic relationship, it may provide corroboration of an economic rationale. That is, while correlation may support an economic rationale, causality cannot be assumed purely from correlation. As noted by the IASB "the mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists." [IFRS 9.B6.4.6].

Where statistical correlation or other quantitative methods are applied to demonstrate the existence of an economic relationship, the standard does not provide any bright lines or other success criteria, hence judgement will be required. The assessment must be based on a sound economic rationale, rather than being driven by coincidental statistics which may not reflect a true economic relationship. In practice, an entity may have assessed the economic relationship for risk management purposes and this assessment may be appropriate for accounting purposes as well. The quantitative method chosen must be one that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness.

This requirement will quite obviously be fulfilled for many hedging relationships, for example if the underlying of the hedging instrument matches or is closely aligned with the hedged risk in the hedged item. For example, an economic relationship clearly exists when hedging the 3-month SONIA variable interest rate payable on a £100,000 loan with a 3-month SONIA (pay fixed, receive floating) interest rate swap with a notional of £100,000. This is because the present value of the changes in the cash flows of the loan and the swap would move systematically in opposite directions in response to changes in the underlying interest rate. However, an economic relationship is unlikely to exist when an entity hedges a currency exposure using a different currency where the two currencies are not pegged or otherwise formally linked.

Even when there are differences between the hedged item and the hedging instrument, the economic relationship will often be capable of being demonstrated using a qualitative assessment. However, when the critical terms of the hedging instrument and hedged item are not closely aligned, it may be necessary to undertake a quantitative assessment.

IFRS 9 includes additional effectiveness criteria such as that credit risk must not dominate the hedge relationship, and an appropriate hedge ratio must be used. [IFRS 9.6.4.1(c)]. There is no expectation that these criteria must be applied for hedge accounting under FRS 102.

4.4.4 Documentation

The FRS 102 documentation requirements are intended to be relatively informal and undemanding (compared to those of IAS 39 or IFRS 9) and are not expected to pose a significant administrative burden on entities. However, appropriate documentation remains an important element of hedge accounting under FRS 102, and hedge accounting cannot be applied until the documentation criteria are met. [FRS 102.12.18(d), FRS 102.12.18(e)]. The documentation supporting the hedge relationship includes the identification of:

- The hedging instrument.
- The hedged item.
- The economic relationship between the hedging instrument and hedged item.
- The nature of the risk being hedged.
- How the hedge fits in with the entity's risk management objectives for undertaking hedges.

And

- The possible causes of hedge ineffectiveness within the hedge relationship.

Designation of a hedge relationship takes effect prospectively from the date all of the criteria for hedging are met. In particular, hedge accounting can be applied only from the date all of the necessary documentation is completed (although there are different rules for transition to FRS 102 - see Chapter 37). Hedge relationships cannot be designated retrospectively. [FRS 102.12.18].

Hedge designation need not take place at the time a hedging instrument or hedged item is entered into. For example, a derivative contract may be designated and formally documented as a hedging instrument any time after entering into the derivative contract. Similarly, a hedge relationship could commence at any point after the acquisition of a loan if the entity chooses to hedge it. However, hedge accounting will only apply prospectively from the date of documentation of the hedge designation, provided all the other conditions are met.

4.5 Hedge ineffectiveness

Hedge ineffectiveness is the difference since designation between the fair value change of a hedging instrument and the fair value change of the hedged item attributable to the hedged risk. This means the hedge relationship has not resulted in perfect offset of the risk it is meant to protect against. All hedge ineffectiveness for fair value hedges is recorded in profit or loss. For cash flow and net investment hedges, ineffectiveness is recognised in profit or loss to the extent that the cumulative change in the fair value or cash flows of the hedging instrument are greater than those on the hedged item (see 4.8.3.1 and 4.9.2 below).

Hedge ineffectiveness can arise due to several reasons and the possible causes of hedge ineffectiveness in hedge relationships must be documented by an entity at the outset. [FRS 102.12.18(e)].

When considering possible causes of ineffectiveness in a hedge relationship, mismatches between the designated hedged item and the hedging instrument are considered. For example, mismatches in the following terms are likely to be causes of ineffectiveness:

- Maturity
- Volume or nominal amount

- Cash flow dates
- Interest rate
- Other market index basis
- Quality and location basis differences
- Day count methods
- Credit risk, including the effect of collateral

Or

- The extent that the hedging instrument is already 'in', or 'out of the money' when first designated

For example, if the interest rates on the hedging instrument and hedged item differ (e.g., 3-month SONIA versus 6-month SONIA), as the two rates may not move in exactly the same way, the value of the hedging instrument and hedged item will change at different rates, leading to mismatches in cash flows and hence ineffectiveness will arise.

Similarly, if an entity hedges a forecast commodity purchase using a forward contract, unless the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase, it won't fully match the forecast purchase and there will be some ineffectiveness. For example, if the forecast purchase is for 1,000 tonnes of copper in three months at a specified location, in order to achieve full offset the forward contract must deliver the same amount at the same time and location and be for the same quality of copper, otherwise the hedge will reduce some risk but not all of it and the difference is hedge ineffectiveness.

Furthermore, changes in the counterparty's credit risk and the value of any collateral held, will be reflected in the fair value of the hedging instrument. However, the hedged item (such as a loan or a forecast transaction) may not be affected in the same way, leading to a mismatch and therefore hedge ineffectiveness.

Another cause of ineffectiveness could be derivative valuation inputs that are not replicated when revaluing the hedged item (in addition to credit risk mentioned above). The hedged item is fair valued for the hedged risk only, whilst the hedging instrument is fair valued in its entirety. This means that ineffectiveness will arise as the hedging instrument will be fair valued for more than just the hedged risk and there will be a mismatch between the change in fair value of the hedged item and hedging instrument. For example, the hedged item might be fair valued for interest rate risk only, whilst the hedging instrument's fair value may additionally change due to factors such as liquidity.

As mentioned at 4.4.4 above, it is possible to designate a hedging instrument in a hedging relationship subsequent to its inception. For non-option derivatives, such as forwards or interest rate swaps, any fair value at inception of the hedge is likely to create 'noise' that may not be fully offset by changes in the hedged item, especially in the case of a cash flow hedge. This is because the derivative contains a 'financing' element (the initial fair value), gains and losses on the remeasurement of which will not be replicated in the hedged item and therefore the hedge contains an inherent source of ineffectiveness.

Ineffectiveness can also arise between interest rate reset dates when using hedging instruments such as interest rate swaps in fair value hedges. This is often referred to as the 'most recently fixed-floating leg' issue. The payments on the floating leg of an interest rate swap are typically 'fixed' at the beginning of a reset period and paid at the end of that period. Between these two dates the swap is no longer a pure pay-fixed receive-variable (or *vice versa*) instrument because not only is the next payment fixed, but the next receipt is also fixed. So, although fair value changes in the fixed rate hedged item may provide some offset to fair value changes in the pay fixed leg of the swap, there is no offset from the hedged item for the fair value of the most recently fixed floating leg.

4.5.1 Time value of money

Entities must consider the time value of money when measuring hedge ineffectiveness. FRS 102 is explicit that the cumulative change in fair value of the hedged item for a cash flow hedge is the present value of the cumulative change of expected future cash flows. Furthermore, for a fair value hedge the hedging gain or loss is defined as the change in fair value of a hedged item that is attributable to the hedged risk.

[FRS 102.12.23(a), FRS 102 Appendix I].

The examples of hedge accounting provided within the standard ignore the effects of discounting presumably to keep the examples simple. However, in practice an entity must determine the value of the hedged item on a present value basis thereby including the effect of the time value of money. The effect of the time value of money is also included when measuring the fair value of financial instruments and derivatives that are used as the hedging instruments as required by Section 2A *Fair Value Measurement* (see Chapter 10).

FRS 102 doesn't provide any guidance on how the time value of the hedged item is determined. However, in the case of a fair value hedge of a fixed rate bond, where the risk being hedged is a benchmark interest rate such as SONIA, the value of the bond is calculated using that same benchmark rate in order to capture the changes in the bond's value due to that specific rate. If the bond was valued using a different rate, the valuation would reflect risks other than the one being hedged.

For a cash flow hedge the discount rate does not necessarily have to match the hedged risk, but a benchmark rate is used for discounting, and the choice must be considered at the inception of the hedge relationship (see 4.4.4 above). The choice of benchmark discount rate could be a further source of hedge ineffectiveness where it differs to the discount rate used for the hedging instrument.

4.6 Hedging relationships

There are three types of hedging relationships in FRS 102, defined as follows: [FRS 102.12.19]

Extract from FRS 102

12.19 There are three types of hedging relationships:

- (a) fair value hedge: a hedge of the exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item that are attributable to a particular risk and could affect profit or loss.
- (b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and could affect profit or loss.
- (c) hedge of a net investment in a foreign operation.

These relationships are considered further in the remainder of this chapter.

4.7 Fair value hedges

4.7.1 Introduction

Typically, a fair value hedge is undertaken where an entity wishes to convert a fixed rate exposure into a variable one. The fair value of an exposure that contractually pays a fixed or 'locked in' market index, such as an interest rate or a commodity price, is sensitive to changes in that market index. By converting the fixed index into a variable one, that fair value sensitivity is reduced. In many circumstances an entity may actually be more focused on creating variable rate cash flows, rather than eliminating fair value sensitivity. However, the two economic perspectives are not dissimilar, and both fall within the FRS 102 description of a fair value hedge for accounting purposes.

An example of a fair value hedge is a hedge of the exposure to changes in the fair value of a fixed rate debt instrument (not measured at fair value through profit or loss) as a result of changes in interest rates - if interest rates increase, the fair value of the debt decreases and *vice versa*. If the debt instrument were to be sold before maturity, the fair value changes affect profit or loss. Such a hedge could be entered into either by the issuer or by the holder.

Another example of a fair value hedge is where an entity wishes to eliminate the ongoing price risk from inventory. If an entity holds 100 tonnes of commodity A as inventory, for which they paid a price of 1 per tonne, the entity may wish to protect the value of that inventory against future changes in the market price that would affect profit or loss when the inventory is sold. In this case the entity would transact a derivative to sell that inventory forward at a locked in price.

4.7.2 Hedges of firm commitments

A hedge of a fixed price firm commitment (for instance, a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electricity utility to purchase fuel at a fixed price) is considered a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge.

However, a hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge. [FRS 102.12.19A]. This is because foreign currency risk affects both fair values and cash flows. This would mean that a foreign currency cash flow hedge of a forecast transaction need not be re-designated as a fair value hedge when the forecast transaction becomes a firm commitment.

4.7.3 Accounting for fair value hedges

From the date the conditions for hedge accounting are met, a fair value hedge is accounted for as follows:

- The gain or loss on the hedging instrument is recognised in profit or loss.
- And
- The hedging gain or loss on the hedged item adjusts the carrying amount of the hedged item (if applicable). [FRS 102.12.20].

The gain or loss on the hedging instrument will be the change in its fair value since designation (subject to any excluded elements, see 4.3.3 above). Accordingly, the application of FRS 102 hedge accounting does not change the usual measurement requirements for the hedging instrument. The hedging gain or loss on the hedged item is the change in its value attributable to the hedged risk since designation, and this must be added to, or subtracted from, the carrying value of the hedged item. This has the effect that the carrying amount of the hedged item is a hybrid value. For example, in the case of debt hedged for interest rate risk, the carrying amount is a combination of amortised cost plus the change in the valuation due to changes in interest rates since hedge designation.

To the extent these amounts differ, a net amount will be recognised in profit or loss, commonly referred to as hedge 'ineffectiveness' (see 4.5 above). For fair value hedges all ineffectiveness is recognised in profit or loss.

The following Illustration shows the basic mechanics of fair value hedge accounting.

Illustration 14-4: Fair value hedge mechanics

On 1 January 2026 an investor purchases a fixed rate debt security for £100 and classified it as a basic financial instrument recorded at amortised cost (see Chapter 13). To protect the value of the investment, the investor entered into a hedge by transacting a derivative (e.g., an interest rate swap) with a nil fair value. The interest rate swap pays fixed rate and receives variable rate interest. During 2026 interest rates fall such that by the end of the year, the change in value of the fixed rate debt attributable to the hedged risk (interest rate) since designation is £10. Other factors that might influence the full fair value of the debt are not included within the hedging gain or loss, as the hedged risk is solely interest rate risk. Meanwhile, the derivative fair value has fallen by £9, resulting in a liability of that amount.

The investor records the following accounting entries:

	£	£
1 January 2026		
Dr Debt security	100	
Cr Cash		100
To reflect the acquisition of the security.		
Dr Derivative	nil	
Cr Cash		nil
To record the acquisition of the derivative at its fair value of nil.		
31 December 2026		
Dr Profit or loss	9	
Cr Derivative		9
To recognise the decrease in the derivative's fair value.		
Dr Debt security	10	
Cr Profit or loss		10
To recognise the change (increase) in value of the fixed rate debt attributable to the hedged risk		

In this example, it can be seen that ineffectiveness of £1 has been recognised as a credit to profit or loss, reflecting some mismatches between the hedged debt security and the hedging derivative.

Where the hedged item is a financial instrument for which the effective interest method of accounting is used, the adjustment to the hedged item referred to above, is amortised to profit or loss. Amortisation may begin as soon as the adjustment exists and begins no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated effective interest rate at the date amortisation begins. [FRS 102.12.22]. The purpose of the amortisation is:

- To reflect the effect of the fair value hedge in profit and loss.
- And
- To ensure the adjustment is fully amortised by maturity so that the carrying amount of the hedged item returns to its redemption amount on maturity.

If the fair value of the hedged component is zero when designated and the hedge relationship remains in place to its maturity, it is likely that no additional amortisation will be required as the cumulative fair value adjustment to the hedged item will naturally revert to zero through ongoing fair value hedge accounting adjustments. However, in other circumstances, such as when the fair value of the hedged component is not zero on designation and/or if the hedge relationship ends before the hedged item matures, the cumulative fair value adjustment to the hedged item will not naturally revert to zero. This means a residual amount will remain on maturity of the hedged item unless an adjustment to the effective interest rate amortisation is applied.

When the hedged item is an unrecognised firm commitment (see 4.7.2 above), the cumulative hedging gain or loss on the hedged item attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss. The initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative hedging gain or loss on the hedged item that was recognised in the statement of financial position. [FRS 102.12.20, FRS 102.12.21].

The following Illustration, based on Example 1 in the Appendix to Section 12, provides a more detailed Illustration of the mechanics of a simple fair value hedge and in particular, a fair value hedge of a firm commitment.

Illustration 14-4: Fair value hedge accounting - hedge of forward foreign currency risk of an unrecognised firm commitment

A hedge of the foreign currency risk of an unrecognised firm commitment may be accounted for as a cash flow or fair value hedge. This example illustrates fair value hedge accounting.

On 9 June 20X5 an entity with CU functional currency, enters into a purchase agreement with a third party to buy a piece of machinery in FC, a foreign currency for FC515,000. On the same day, the entity enters into a forward currency contract to buy FC500,000 for CU1,000,000. Under the purchase agreement, the machinery will be delivered and paid for on 30 March 20X6, the same day the forward currency contract is required to be settled.

In this example the hedged item is the total of the commitment of FC515,000 and the hedging instrument is the forward contract to buy FC500,000. Since the nominal amounts of the two contracts do not match, hedge ineffectiveness arises. It must be noted that in practice an entity could avoid ineffectiveness arising for this reason by identifying an amount of FC500,000 of the total commitment as the hedged item (see 4.2.2).

For simplification, this example disregards other sources of ineffectiveness, e.g., counterparty credit risk associated with the forward currency contract. Also, it is assumed that the effect of discounting is immaterial.

The entity's financial year ends on 31 December. This example assumes that the qualifying conditions for hedge accounting are met from 9 June 20X5.

The table below sets out the applicable forward exchange rates, the fair value of the forward currency contract (the hedging instrument) and the hedging gains/losses on the purchase commitment (the hedged item) on the relevant dates. This example ignores the effects of discounting.

	9 June 20X5	31 Dec 20X5	30 March 20X6
Forward exchange rate (CU:FC)	2.0:1	2.2:1	2.16:1
<i>Forward currency contract (hedging instrument)</i>			
Fair value	Nil	FC500,000 × 0.2 ¹ = CU100,000	FC500,000 × 0.16 ² = =CU80,000
Fair value change	Nil	CU100,000 - 0 = CU100,000	CU80,000 - CU100,000 = (CU20,000)

<i>Purchase commitment (hedged item)</i>			
Cumulative hedging (loss) ³	nil	$(FC515,000) \times 0.2 =$ (CU103,000)	$(FC515,000) \times 0.16$ =(CU82,400)
Hedging (loss)/gain	Nil	$(CU103,000) - 0 =$ (CU103,000)	$(CU82,400) -$ $(CU103,000) =$ CU20,600
1 0.2 is calculated as the different between the forward rates at the start date of the hedge relationship and the reporting date 2 This is the fair value of the contract prior to settlement. 3 The commitment is fair valued only for the hedged risk, which in this example is the forward exchange rate risk			

Hedge accounting:

Note that there are no hedge accounting entries on 9 June 20X5 as the forward contract is initially measured at fair value of nil and the purchase commitment is an executory contract, which remains off balance sheet until delivery of the machinery.

31 December 20X5

Accounting entries:

	Dr	Cr
Forward currency contract	CU100,000	
Profit or loss		CU100,000
To recognise the fair value gain of CU100,000 on the forward currency contract in profit or loss.		
Profit or loss	CU103,000	
Hedged item (commitment)		CU103,000
To record the cumulative hedging loss of CU103,000 on the commitment as a liability with a corresponding loss recognised in profit or loss.		

30 March 20X6

Accounting entries:

	Dr	Cr
Profit or loss	CU20,000	
Forward currency contract		CU20,000
To recognise the change in fair value loss of CU20,000 on the forward currency contract in profit or loss.		
Hedged item (commitment)	CU20,600	
Profit or loss		CU20,600
To recognise the hedging gain on the commitment since 31 December 20X5 of CU20,600 in profit or loss with a corresponding adjustment to the recognised liability from CU103,000 to CU82,400.		
Hedged item (commitment)	CU82,400	
Property, plant and equipment (PP&E)		CU82,400
To adjust the machinery's carrying amount to include the cumulative hedging loss on the hedged item of CU82,400.		

Cash CU80,000

Forward currency contract CU80,000

To reflect the settlement of the forward currency contract in cash for CU80,000 is shown above.

Property, plant and equipment (PP&E) CU1,112,400

Cash CU1,112,400

To reflect the purchase of the machinery at the applicable spot rate of CU2.16:FC1 for CU1,112,400 (settled in cash) is shown above.

The resultant accounting is that the purchased PPE is recognised at CU1,030,000 (=CU1,112,400-CU82,400). This represents the fact that CU500,000 of the purchase price was locked into an exchange rate of 2.0:1, and CU15,000 remain unhedged for foreign currency risk (a designated under hedge). In this case the designated under hedge resulted in ineffectiveness of CU2,400 loss booked in profit or loss.

Had only CU500,000 of the purchase agreement been designated as the hedged item (i.e., a nominal component - see 4.2.2), then the cumulative hedging loss on the hedged item would have been restricted to CU80,000 reflecting the foreign currency risk in the designated CU500,000. No ineffectiveness would be recognised in profit or loss.

4.8 Cash flow hedges

4.8.1 Introduction

Typically, a cash flow hedge is undertaken where an entity wishes to convert a variable rate exposure into a fixed one. An example of a cash flow hedge is the use of an interest rate swap to change floating rate debt to fixed rate debt. The cash flows being hedged are the future interest payments.

An entity with GBP functional currency may have highly probable monthly forecast sales in a foreign currency over the next year. In order to eliminate variability from changes in foreign currency risk in the highly probable forecast revenue, the entity may transact a series of foreign currency forward contracts to lock in the GBP equivalent for that revenue. This scenario is an example of a cash flow hedge of foreign exchange risk.

4.8.2 Highly probable forecast transactions

FRS 102 permits a cash flow hedge of a forecast transaction only where it is considered highly probable. [FRS 102.12.16A]. The glossary to FRS 102 defines 'highly probable' and 'forecast transaction' as: [FRS 102 Appendix I].

Term	Definition
Highly probable	Significantly more likely than probable.
Forecast transaction	Uncommitted but anticipated future transaction.

To meet the 'highly probable' criteria, entities are not required to predict and document the exact date a forecast transaction is expected to occur but must be able to identify and document the forecast transaction within a reasonably specific and generally narrow range of time from a most probable date, as a basis for determining fair values and assessing hedge effectiveness.

The high probability of a transaction must be supported by observable facts and attendant circumstances and is not to be based solely on management intent, because intentions are not verifiable. In making this assessment, entities may find it helpful to consider the following (although this is not an exhaustive list):

- The frequency of similar past transactions.
- The financial and operational ability to carry out the transaction.
- Whether there has already been a substantial commitment of resources to a particular activity, e.g., a manufacturing facility that can be used in the short run only to process a particular type of commodity.
- The extent of loss or disruption of operations that could result if the transaction does not occur.
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose, e.g., there may be several ways of raising cash ranging from a short-term bank loan to a public share offering.

And

- The entity's business plan.

The length of time until a forecast transaction is projected to occur is also a consideration in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is to be considered highly probable and the stronger the evidence that is needed to support an assertion that it is highly probable. For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in only one year. However, forecast interest payments for the next 20 years on variable-rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, the greater the physical quantity or future value of a forecast transaction in proportion to transactions of the same nature, the less likely it is that the transaction would be considered highly probable and the stronger the evidence that would be required to support such an assertion. For example, less evidence would generally be needed to support forecast sales of 500,000 units in the next month than 950,000 units when recent sales have averaged 950,000 units for each of the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur, would call into question both the ability to accurately predict forecast transactions and the propriety of using hedge accounting in the future for similar forecast transactions. However, there are no prescriptive 'tainting' provisions in this area and entities are not automatically prohibited from using cash flow hedge accounting if a forecast transaction fails to occur. Instead, whenever such a situation arises, the particular facts, circumstances and evidence need to be assessed to determine whether doubt has, in fact, been cast on an entity's ongoing hedging strategies.

If a hedged forecast transaction is no longer considered to be highly probable, the hedge must be discontinued prospectively (see 4.4.1 above and 4.10 below).

4.8.3 Accounting for cash flow hedges

From the date the conditions for hedge accounting are met, a cash flow hedge is accounted for as follows:

- (a) The separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):
 - (i) The cumulative gain or loss on the hedging instrument from the date the conditions for hedging are met.

And

 - (ii) The cumulative change in fair value on the hedged item (i.e., the present value of the cumulative change of expected future cash flows) from the date the conditions for hedging are met.
- (b) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e., the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) is recognised in OCI.
- (c) Any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)), is hedge ineffectiveness that is recognised in profit or loss. The reference to 'balance' here refers to the difference between the effective part of a hedge recorded in OCI and the fair value change on the derivative.
- (d) The amount that has been accumulated in the cash flow hedge reserve in accordance with (a) above is accounted for as follows:
 - (i) If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity must remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability (commonly referred to as a 'basis adjustment').
 - (ii) For cash flow hedges other than those covered by (i), that amount must be reclassified from the cash flow hedge reserve to profit or loss in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).
 - (iii) If the amount accumulated in the cash flow hedge reserve is a loss, and all or part of that loss is not expected to be recovered, the amount of the loss not expected to be recovered must be reclassified to profit or loss immediately. [FRS 102.12.23].

FRS 102 and IFRS 9 provide no further guidance on the requirement (d)(iii) above, hence a hierarchy of guidance must be considered in the selection of an appropriate accounting policy, in line with Section 10

Accounting Policies, Estimates and Errors (see Chapter 9). [FRS 102.10.4, FRS 102.10.5, FRS 102.10.6].

Accordingly, consideration is likely to be given to the guidance on the recoverability of assets which is contained in other sections such as Section 27 *Impairment of Assets* on impairment and recoverability testing of non-financial assets or Section 21 *Provisions and Contingencies* on onerous contracts. The outcome of applying these different methodologies could differ. Therefore, judgement is required in determining the most appropriate methodology based on the specific facts and circumstances of the hedge relationship.

4.8.3.1 The 'lower of' test

The cash flow hedge mechanics described in (a) to (c) above are often referred to as the 'lower of' calculation. This can be explained more easily by way of an example which is given in the illustration below.

Illustration 14-5: Cash flow hedge mechanics - 'lower of' calculation

	Scenario A	Scenario B
Change in value of the hedged item (i.e., the present value of the cumulative change of expected future cash flows)	110	100
Change in the fair value of the hedging instrument	(100)	(110)
'Lower of' exposure	Hedging instrument	Hedged item
Accounting entries:		
Other comprehensive income	Dr 100	Dr 100
Profit or loss	Nil	Dr 10
Derivative	Cr 100	Cr 110
Ineffectiveness recognised	Nil	(10)

It can be seen from the above example that, for cash flow hedges, ineffectiveness is only recognised in profit or loss to the extent that the absolute change in fair value of the hedging instrument exceeds the absolute change in fair value of the hedged item. This comparison of value changes is undertaken on a cumulative basis, i.e., the change in value over the life of the designated hedge relationship since inception.

If the hedging instrument's cumulative fair value changes are less than the cumulative fair value changes of the hedged item, no ineffectiveness is recorded in profit or loss (i.e., the full fair value change of the derivative is recorded in OCI). If the hedging instrument's cumulative fair value changes are more than the cumulative fair value changes of the hedged item, the excess is recorded as ineffectiveness in profit or loss.

4.8.3.2 The hypothetical derivative

In practice entities often use what is called the 'hypothetical derivative' method to measure ineffectiveness in a cash flow hedge. As its name suggests, the method involves creating a notional derivative (normally an interest rate swap or forward contract with no unusual terms) and a zero fair value at inception of the hedge relationship that perfectly matches the risk being hedged. The fair value of the hypothetical derivative is then used as a proxy for the net present value of the change in hedged future cash flows (requirement (a)(ii) in 4.8.3 above) against which changes in value of the actual hedging instrument are compared to measure ineffectiveness.

In determining the hypothetical derivative, the variable leg of the hypothetical swap must closely match the cash flows of the hedged item but only to the extent of the specific risk being hedged. For example, if an entity is hedging interest rate variability, the variable leg of the hypothetical swap must match the floating rate and timing of the hedged exposure. The following illustration demonstrates how a hypothetical derivative can be constructed in a cash flow hedge.

Illustration 14-6: Determination of a hypothetical derivative in a cash flow hedge of interest rate risk

Company X has purchased £200m of variable rate 5-year debt securities. The debt securities yield 1-month SONIA plus 100 basis points with coupons paid monthly. Company X wishes to mitigate cash flow variability from the debt securities by transacting a 5-year interest rate swap with £200m notional, receiving a fixed coupon of 2.0% quarterly and paying an overnight SONIA rate, compounded daily. The swap and the debt securities were acquired on the same day at prevailing market rates and designated in a cash flow hedge relationship for changes in 1-month SONIA, i.e., excluding credit risk from the debt securities.

As the hedged item and the hedging swap reference different indices, there is likely to be a difference between the hypothetical derivative and the actual hedging swap.

The hypothetical derivative representing the hedged risk in the issued debt might be determined as follows:

A 5-year interest rate swap with £200m notional, receiving 1-month SONIA, and paying a 2.02% fixed coupon monthly. The fixed coupon of 2.02% is calculated such that the hypothetical derivative has a zero fair value on the date of designation. The 2bp difference with the variable leg of the actual hedging swap reflects the difference between overnight SONIA compounding daily and 1-month SONIA.

The fact that the actual hedging derivative is referenced to overnight SONIA and cash flows occur quarterly has no impact on the determination of the hypothetical derivative. The hypothetical derivative can only be based on features that arise in the hedged item, which attracts a monthly coupon. The difference between the hypothetical derivative and the hedging derivative is likely to lead to ineffectiveness.

When an entity hedges one-sided risk, such as protection against a decline in commodity prices below a specified level (e.g., £90 per tonne), the effectiveness assessment must reflect that only part of the variability in cash flows is being hedged. In such cases, the hypothetical derivative takes the form of the intrinsic value of a hypothetical option contract to represent the one-sided risk exposure and excludes time value. This is because time value is not a component of the hedged forecast transaction and therefore cannot be considered part of the hedged item. If a purchased option is designated as the hedging instrument for a one-sided forecast transaction, the inclusion of the time value in the value of the option, but not in the hedged item, results in ineffectiveness unless it is excluded from the hedge relationship (see 4.3.3.3)

The hypothetical derivative is first determined at inception of the hedge relationship based on the critical terms of the hedged item and prevailing market rates at that time. However, if any of the critical terms of the hedged item change subsequently, e.g., timing, volume or pricing inputs, then the hypothetical derivative will need to be updated to reflect those changes, but still in consideration of the market rates at the time of designation.

The Appendix to Section 12 illustrates the use of the hypothetical derivative method to measure ineffectiveness (see Illustration 14-7 below).

4.8.3.3 Recycling

In order to meet the requirements of FRS 102 (see 4.8.3 above), consideration must be given to the nature of the hedged item. The following are some examples of how amounts recorded in OCI are subsequently recycled. [FRS 102.12.23(d)]

Illustration 14-7: Cash flow hedge mechanics - recycling

	<i>Hedge of purchase of fixed asset in foreign currency</i>	<i>Monthly forecast sale of gas</i>	<i>Floating rate debt</i>
Hedged risk	Foreign currency.	Gas price.	Interest rates.
Timing of recognition of hedged item	Purchase date.	Throughout each month.	Debt is already recognised, but interest is accrued over the remaining life of the debt.
Timing of recycling of effective portion from OCI to profit or loss	Full amount recycled and included in cost of the fixed asset when purchased (a 'basis' adjustment), subsequently recognised in profit and loss through depreciation, impairment or sale of hedged fixed asset.	The relevant component of the effective portion for each month of gas sales is recycled each month.	The relevant component of the effective portion for each hedged interest accrual is to be recycled. This is often achieved by recycling, each period, the net interest accrual on the derivative from OCI into profit or loss.

The purpose of the recycling is so that the impact of the cash flow hedge is reflected in profit or loss to match the timing of recognition of the hedged item.

How we see it

We believe the requirements imply that the reclassification from accumulated other comprehensive income to profit or loss is recognised in the same line item in profit or loss as the hedged transaction to reflect the offsetting effect of hedge accounting (see 4.11 below).

The following Illustration, based on Example 2 in the Appendix to Section 12, illustrates in more detail how to account for a cash flow hedge.

Illustration 14-8: Cash flow hedge accounting - hedge of variability in cash flows in a floating rate loan due to interest rate risk

This example illustrates the accounting for a cash flow hedge of interest rate risk associated with a floating rate loan. An entity, with sterling functional currency, borrows money at a floating rate and enters into an interest rate swap with the effect of paying a fixed rate overall.

On 1 January 20X5, an entity borrows £10,000,000 from a bank at a floating rate of 3-month (Interbank Offered Rate (IBOR) plus 2.5%. The interest is payable annually in arrears on 31 December. The loan is repayable on 31 December 20X7.

On 1 January 20X5 the entity also enters into an interest rate swap with a third party, under which it receives 6-month IBOR and pays a fixed rate of interest of 4.5%. The notional amount of the swap is £10,000,000. The swap is settled annually in arrears on 31 December and expires on 31 December 20X7.

The IBOR rates on the loan and the interest rate swap are reset and fixed annually in advance on 31 December based on the expected IBOR rates applicable at that time. Note that in practice the loan and swap interest rates would be reset and paid more frequently than assumed for the purpose of simplification in this example, in keeping with the 3-month and 6-month IBOR fixings.

The entity hedges the variability of the interest rate payments on the bank loan based on 3-month IBOR. As the entity receives interest based on 6-month IBOR under the interest rate swap, ineffectiveness will arise because the expected cash flows of the hedged item and the hedging instrument differ. The fair value of the interest rate swap may be affected by other factors that cause ineffectiveness, for example counterparty credit risk, but these have been disregarded in this example. This example also ignores the effect of discounting.

There are no transaction costs.

The entity's financial year ends on 31 December.

This example assumes that the qualifying conditions for hedge accounting are met from 1 January 20X5.

The table below sets out the applicable IBOR rates, interest payments and swap settlements. The fair values of the interest rate swap and the hedged item shown in the table are shown for illustrative purposes only.

Note that in practice, when forecast variable interest rate payments are the hedged item, the fair value of a hypothetical swap that would be expected to perfectly offset the hedged cash flows, is used as a proxy of the fair value of the hedged item. The hypothetical derivative in this scenario is a floating to fixed interest rate swap with terms that match those of the loan and a fixed rate of 4.3%, which for the purpose of this example, is the interest rate where the fair value of the hypothetical swap is nil at the inception of the hedging relationship.

	1 Jan 20X5	31 Dec 20X5	31 Dec 20X6	31 Dec 20X7
Actual 3-month IBOR	4.3%	5%	3%	n/a
Actual 6-month IBOR	4.5%	4.9%	3.2%	n/a
Interest payments based on 3-month IBOR	n/a	£10m × (4.3% + 2.5%) = £680,000	£10m × (5% + 2.5%) = £750,000	£10m × (3% + 2.5%) = £550,000
<i>Interest rate swap (hedging instrument)</i>				
Fair value ⁴	nil	£78,000	(£89,000) ¹	(£130,000) ²
Fair value change	nil	£78,000 - 0 = £78,000	(£89,000) - £78,000 = (£167,000)	(£130,000) - (£40,000) ³ - (£89,000) = (£1,000)

Swap settlement receipts/(payments) based on 6-month IBOR	n/a	$\text{£}10\text{m} \times (4.5\% - 4.5\%) = \text{nil}$	$\text{£}10\text{m} \times (4.9\% - 4.5\%) = \text{£}40,000$	$\text{£}10\text{m} \times (3.2\% - 4.5\%) = (\text{£}130,000)$
<i>Hedged item</i>				
Fair value ⁴	nil	(£137,000)	£59,000	£130,000

Key to table:

- 1: This valuation is determined before the receipt of the cash settlement of £40,000 due on 31 December 20X6.
- 2: This valuation is determined before the payment of the cash settlement of £130,000 due on 31 December 20X7.
- 3: £40,000 is the settlement of the interest rate swap as at 31 December 20X6 which affects the fair value of the swap, but is not included in the fair value of the swap at 31 December 20X6 of £89,000.
- 4: The fair values of the interest rate swap and the hedged item shown in the table are those given in Example 2 in the standard but may not reflect the market data given.

31 December 20X5

Accounting entries:

Note that the accounting entries shown are only those relevant to demonstrate the effects of hedge accounting. In practice other accounting entries are required, e.g., an entry to recognise the loan liability.

	Periodic		Cumulative	
	Dr	Cr	Dr	Cr
Interest rate swap	£78,000		£78,000	
OCI		£78,000		£78,000

The cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative gain on the hedging instrument (i.e., the interest rate swap), which equals its fair value, of £78,000 and the cumulative change in fair value of the hedged item (hypothetical derivative), which equals its fair value of (£137,000).

The gain of £78,000 on the interest rate swap is recognised in OCI, with no ineffectiveness in profit or loss.

The fixed interest element on the hypothetical swap is £430,000 (i.e., $\text{£}10\text{m} \times 4.3\%$ (excluding the credit spread as not part of the hedge relationship)), the same amount as the variable rate component. The variability of 3-month IBOR did therefore not affect profit or loss during the period. The reclassification adjustment is nil. (Note that no accounting entry is shown here).

Profit or loss (interest)	£680,000		£680,000	
Cash		£680,000		£680,000

In respect of the interest payments on the loan, reflecting the full coupon of 3 Month IBOR (4.3%) plus 2.5% credit spread. Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

31 December 20X6

Accounting entries:

	Periodic		Cumulative	
	Dr	Cr	Dr	Cr
OCI	£137,000		£59,000	
Profit or loss (ineffectiveness)	£30,000		£30,000	
Interest rate swap		£167,000		£89,000

The cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative loss on the hedging instrument (i.e., the interest rate swap) which equals its fair value of (£89,000) and the cumulative change in fair value of the hedged item, which equals its fair value of £59,000. The cash flow hedge reserve moves from £78,000 to (£59,000), a change of (£137,000).

A loss of £137,000 on the interest rate swap is recognised in OCI, as this is determined to be the effective portion. The remainder of the loss on the interest rate swap of £30,000 is recognised in profit or loss.

	Dr	Cr	Dr	Cr
OCI	£70,000		£129,000	
Profit or loss (interest)		£70,000	£610,000	

The fixed interest element on the hypothetical swap is £430,000, whilst the variable rate component is £500,000 (£10m × 5%). The variability of 3-month IBOR affects profit or loss during the period by £70,000. Accordingly, the reclassification adjustment is £70,000.

Profit or loss (interest)	£750,000		£1,360,000	
Cash		£750,000		£1,430,000

In respect of the interest payments on the loan (£10m × (5% + 2.5%)). Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

Cash	£40,000			£1,390,000
Interest rate swap		£40,000		£129,000

In respect of the settlement of the swap (£10m × (4.9% - 4.5%)).

31 December 20X7

Accounting entries:

	Periodic		Cumulative	
	Dr	Cr	Dr	Cr
OCI	£1,000		£130,000	
Interest rate swap		£1,000		£130,000

The cash flow hedge reserve is adjusted to the lower of (in absolute amounts) the cumulative loss on the hedging instrument (i.e., the interest rate swap) which equals the fair value of (£130,000) and the cumulative change in fair value of the hedged item, which equals its fair value of £130,000.

The cash flow hedge reserve moves from (£129,000) to (£130,000), a change of (£1,000). The loss of £1,000 on the interest rate swap is recognised in OCI.

Profit or loss (interest)	£130,000		£1,490,000	
OCI		£130,000		nil

The fixed interest element on the hypothetical swap is £430,000, whilst the variable rate component is £300,000 (£10m × 3%). The variability of 3-month IBOR affects profit or loss during the period by (£130,000). Accordingly, the reclassification adjustment is (£130,000).

Profit or loss (interest)	£550,000		£2,040,000	
Cash		£550,000		£1,940,000

In respect of the interest payments on the loan (£10m × (3% + 2.5%)). Note that in practice the accrual and payment of interest may be recorded in separate accounting entries.

Interest rate swap	£130,000		nil	
Cash		£130,000		£2,070,000

For illustrative purposes the accounting entry for the settlement of the swap is shown above (£10m × (3.2% - 4.5%)).

The table below summarises the effects of the accounting entries shown above on the interest rate swap, profit or loss and other comprehensive income.

Description	Interest rate Swap	Other comprehensive income	Profit or loss
	£	£	£
<i>31 December 20X5</i>			
Opening balance	nil	nil	-
Interest on the loan			680,000
Interest rate swap fair value movement	78,000	(78,000)	-
Closing balance	78,000	(78,000) ¹	680,000
<i>31 December 20X6</i>			
Opening balance	78,000	(78,000) ¹	680,000
Interest on the loan			750,000
Interest rate swap fair value movement	(167,000)	137,000	30,000 ²
Settlement receipt interest rate swap	(40,000)	-	-
Reclassification from cash flow hedge reserve	-	70,000	(70,000)
Closing balance	(129,000)	129,000 ¹	1,390,000
<i>31 December 20X7</i>			
Opening balance	(129,000)	129,000 ¹	1,390,000
Interest on the loan			550,000
Interest rate swap movement	(1,000)	1,000	-
Settlement receipt interest rate swap	130,000	-	-
Reclassification from cash flow hedge reserve	-	(130,000)	130,000
Closing balance	nil	nil ¹	2,070,000

1 This is the balance of the cash flow hedge reserve.

2 Ineffectiveness

By the end of the hedge, there are no amounts left in the cash flow hedge reserve reflecting the fact that the cumulative gains and losses on the swap have been transferred to profit or loss to offset the hedged interest payments. As a result, the entity's net interest income profile reflects a relatively fixed rate through the period of the hedge (subject to ineffectiveness recognised) despite the underlying loan being floating rate.

4.9 Hedges of net investments in foreign operations

4.9.1 Introduction

Many reporting entities have investments in foreign operations which may be subsidiaries, associates, joint ventures or branches. Section 30 *Foreign Currency Translation* requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of its foreign operation into a presentation currency, on consolidation foreign exchange differences are recognised in other comprehensive income (with no reclassification to profit or loss in future periods). [FRS 102.30.13].

From the perspective of an investor (e.g., a parent) it is clear that an investment in a foreign operation is likely to give rise to a degree of foreign currency exchange rate risk and an entity with many foreign operations may be exposed to a number of foreign currency risks.

FRS 102 defines a net investment in a foreign operation as “The amount of the reporting entity’s interest in the net assets of that operation”. [FRS 102 Appendix I]. A hedge of a net investment in a foreign operation is a hedge of the foreign currency exposure, not a hedge of the change in the value of the investment.

How we see it

Although the definition of a net investment in a foreign operation is described with reference to net assets, there is nothing within the guidance to suggest that a hedge of negative net assets would be precluded. This is because the objective of a net investment hedge is to manage foreign currency risk arising from the translation of the net investment, and that foreign currency risk arises irrespective of whether the net assets are negative or positive.

The net investment hedge accounting rules can also be applied to a monetary item that is accounted for as part of the net investment (see Chapter 32). For example, if a parent grants a foreign currency loan to an overseas subsidiary and settlement is neither planned nor likely in the foreseeable future, the loan can be hedged as part of the net investment in the foreign subsidiary.

Net investment hedge accounting can be applied only when the net assets of the foreign operation (and not fair value or cost less impairment) are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method or those that include a branch or a joint operation. Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. Accordingly, it is also possible to achieve net investment hedge accounting of a foreign branch in an entity’s standalone financial statements under FRS 102, if the other requirements for hedge accounting are met, as confirmed in April 2015 when the FRC issued *FRS 102 - Editorial amendments and clarification statements*.

4.9.2 Accounting for net investment hedges

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, are accounted for similarly to cash flow hedges from the date the conditions for hedging are met:

- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in other comprehensive income.
- And
- The ineffective portion is recognised in profit or loss.

The effective portion is determined by applying the same cash flow hedge ‘lower of’ accounting, as explained at 4.8.3 above. However, the cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in equity is not reclassified from equity to profit or loss in subsequent periods. [FRS 102.12.24]. This ensures consistency with Section 30 which requires that foreign exchange gains and losses relating to the consolidation of a subsidiary are not recycled on disposal of the subsidiary. [FRS 102.30.13].

The following Illustration, based on the Appendix to Section 12, illustrates how to account for a simple net investment hedge.

Illustration 14-8: Hedge accounting: net investment in a foreign operation

On 1 April 20X5 an entity with sterling functional currency acquires an investment in an overseas subsidiary (with functional currency FC) at a cost of FC1,200,000. On the same day, the entity takes out a loan with a third party of FC1,200,000 to finance the investment. This example disregards the effects of interest or other transaction costs associated with the loan.

This example assumes that the foreign operation makes losses of FC200,000 in 20X5 and profits of FC100,000 in 20X6. The reduction in value below FC1,200,000 causes ineffectiveness.

The entity's financial year ends on 31 December.

This example assumes that the qualifying conditions for hedge accounting are met from 1 April 20X5.

The table below sets out the applicable exchange rates, the carrying amount of the loan and the foreign exchange gains and losses on the loan, as well as the retranslation differences on the foreign investment recognised in OCI in accordance with Section 30 (see Chapter 32).

	1 April 20X5	31 December 20X5	31 December 20X6
Spot exchange rate £:FC	0.35:1	0.3:1	0.45:1
<i>Loan (hedging instrument)</i>			
	£	£	£
Carrying amount	420,000 (= FC1,200,000 × 0.35)	360,000 (= FC1,200,000 × 0.3)	540,000 (= FC1,200,000 × 0.45)
Cumulative gain/(loss)	nil	60,000 (= 420,000 - 360,000)	(120,000) (= 420,000 - 540,000)
Periodic gain/(loss)	nil	60,000 (= 420,000 - 360,000)	(180,000) (= 360,000 - 540,000)
<i>Investment in foreign operation (hedged item)</i>			
Translation effect of profit or loss in the period at the date of the transactions and assets and liabilities at the closing rate	nil	5,000 ¹ (= FC200,000 × (0.35 - 0.325))	7,500 ² (= FC100,000 × (0.3 - 0.375))
Translation of the opening net assets at the closing rate	nil	(60,000)	150,000 ³
Total retranslation gain/(loss)	nil	(55,000)	157,500
Cumulative retranslation gain/(loss)	nil	(55,000) (= (55,000) + nil)	102,500 (= (55,000) + 157,500)

1 The calculation is based on the translation of the FC200,000 loss at the average rate of 0.325 £:FC. [FRS 102.30.20(a)].

2 The calculation is based on the translation of the FC100,000 profit at the average rate of 0.375 £:FC. [FRS 102.30.20(a)].

3 The calculation is based on the opening net assets of FC1,000,000, after the losses of FC200,000 during 20X5. [FRS 102.30.20(b)].

31 December 20X5

A component of equity is adjusted to the lower of (in absolute amounts) the cumulative exchange gain on the loan of £60,000 and the cumulative retranslation difference on the net investment of (£55,000).

A gain of £55,000 is recognised in OCI, with the remainder of the gain on the loan of £5,000 is recognised in profit or loss.

Accounting entries:

Note that only the accounting entry in relation to net investment foreign currency retranslation and hedge accounting are shown. Other accounting entries in relation to the loan and the investment in the foreign operation are required in practice.

	Dr	Cr
	£	£
Loan	60,000	
OCI		55,000
Profit or loss		5,000

31 December 20X6

A component of equity is adjusted to the lower of (in absolute amounts) the cumulative exchange loss on the loan of £120,000 and the cumulative exchange difference on the net investment of £102,500.

The amount recorded in equity changes from £55,000 to (£102,500), a change of (£157,500). A loss of £157,500 is recognised in OCI, and the remainder of the loss on the loan of £22,500 is recorded in profit or loss.

Accounting entries:

	Dr	Cr
	£	£
OCI	157,500	
Profit or loss	22,500	
Loan		180,000

In the above illustration the full translation effect of the net investment was considered with respect to hedge accounting, however this will not always be the case. If the entity had instead designated a loan of FC1,000,000 and an amount of FC1,000,000 of the net investment as the hedged item, then only the translation effect of FC1,000,000 of net investment would be considered when calculating the lower of the cumulative exchange gain on the hedging instrument and the cumulative retranslation difference on the net investment. Hence only cumulative losses that reduce the net investment to below FC1,000,000 would result in ineffectiveness.

4.10 Discontinuing hedge accounting

Hedge accounting must be discontinued prospectively if any of the following occurs:

- The hedging instrument expires, is sold or terminated.
- The conditions for hedge accounting are no longer met (see 4.4 above).

Or

- The entity elects to discontinue the hedge. [FRS 102.12.25].

If the entity elects to voluntarily discontinue a hedge, it must document its decision, and the discontinuation is effective prospectively from that date.

The conditions for hedge accounting include a requirement that the hedge relationship is consistent with the entity's risk management objective for undertaking hedges. If that objective changes, then the condition is no longer met, and the hedge relationship must be discontinued. Similarly, if the documented hedged risk, hedged item or hedging instrument no longer exists, or have been replaced with an alternate, then hedge accounting for that hedge relationship must cease prospectively.

In many cases it will be straight forward to determine whether the hedged item exists or not, but in all cases that determination will need to be made with respect to the documented description of the hedged item made on initial designation. The designation and documentation of a hedge relationship play an important role in defining the boundaries of what is being hedged but also the timing of the expected cash flows or exposures. For example, a hedged item might be defined as highly probable sales of \$100,000 in May, June and July of 20X2 as hedged items in a cash flow hedge of the risk of changes in foreign currency rates. If those forecast sales are now expected to be nil in that period, the hedged item, as documented, no longer exists because the hedged item was defined by its timing and a change in the timing would redefine the hedged item such that it is different to the original documented hedged item. The hedge would be discontinued.

By contrast, if the hedged forecast transaction is the highly probable sale of a bespoke luxury yacht, the time period in which the forecast sale is expected to occur must be identified and documented within a reasonably specific and generally narrow range of time from a most probable date in order to determine that the forecast transaction is highly probable. However, a change in the estimate of the timing of the sale of a bespoke luxury yacht does not of itself redefine the hedged item. If the sale is still highly probable the original hedged item will continue to exist and hedge accounting could continue.

Following discontinuation in a fair value hedge of a financial instrument, any adjustment to the hedged item arising as a result of fair value hedging, is amortised as discussed at 4.7.3 above, or written off to profit or loss if the hedged item no longer exists. If the hedged item is not a financial instrument, the entity ceases to make any further adjustment arising from a hedging gain or loss on the hedged item. [FRS 102.12.25A].

In a cash flow hedge, if the hedged future cash flows are no longer expected to occur, the amount that has been accumulated in the cash flow hedge reserve is reclassified from the cash flow hedge reserve to profit or loss immediately. [FRS 102.12.25A].

If cash flow hedge accounting is discontinued and the hedged future cash flows are still expected to occur (for example a future cash flow that is no longer highly probable may still be expected to occur), the cumulative gain or loss in the cash flow hedge reserve either:

- Remains in equity and is recycled to profit or loss in line with 4.8.3(d) above.
- Or
- Is recorded in profit or loss immediately if the amount is a loss and is not expected to be recovered. [FRS 102.12.23(d)].

In a net investment hedge, the amount that has been accumulated in equity is not reclassified to profit or loss. [FRS 102.12.25A].

A new hedge relationship may be designated in order to achieve hedge accounting prospectively, once all the conditions are met.

4.10.1 Rollover strategies

IAS 39 and IFRS 9 sometimes permit a hedging relationship to continue where a hedging instrument is 'rolled-over', replacing an expired or terminated hedging instrument. For example, both standards state that an entity must discontinue hedge accounting if the hedging instrument "expires or is sold, terminated or exercised...the replacement or rollover of a hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy". [IFRS 9.6.5.6, IAS 39.101(a)].

Similarly, FRS 102 states that an entity must discontinue hedge accounting if the hedging instrument has "expired, is sold, terminated or exercised". However, FRS 102 is silent on the issue of rollover strategies. The absence of guidance in FRS 102 does not mean that the guidance in IFRS automatically applies and in this situation, it would appear the difference in the two standards is deliberate. FRS 102 is a simplification of IFRS, and it was not intended that every rule in IFRS would apply to entities applying FRS 102. Hence, under FRS 102, a hedge relationship is discontinued when the hedging instrument expires regardless of whether the instrument is rolled over.

4.10.2 Novation of derivatives

IAS 39 and IFRS 9 both contain guidance on dealing with novation of derivatives that are part of a hedging relationship - the guidance was added following an IFRS IC discussion on the topic of mandated novation of derivatives to a central clearing party. A novation in this context is the act of replacing an existing counterparty to a derivative with a new party, such that all the obligations to the derivative contract must now be performed by the new party. The IFRS IC confirmed that a change in the counterparty of a derivative results in derecognition of the derivative. As noted at 4.10.1 above, it follows therefore that a hedge relationship is discontinued if the derivative is novated, unless the change in counterparty is part of a documented replacement strategy or roll over strategy. IAS 39 was amended to include an additional exception such that a novation of a derivative in a hedge relationship does not result in discontinuation of the hedge relationship if the novation was as a consequence of laws or regulation requiring a change to a central clearing counterparty. The same guidance also appears in IFRS 9.

The basis for conclusions for IAS 39 explains the principle of why a derivative is derecognised when it is novated to another counterparty: financial assets are derecognised when the contractual rights to the cash flows expire; whilst financial liabilities are extinguished when the debtor is legally released from primary responsibility for the liability. In a novation, both of these conditions are met. These conditions are also set out in FRS 102 implying that a derivative that is novated under FRS 102 will be derecognised and the existing hedge will be terminated. [FRS 102.11.33, FRS 102.11.36].

How we see it

However, unlike IAS 39, FRS 102 does not contain the 'exception' for novations that are part of a documented hedging strategy or with a central clearing counterparty. Therefore, in our view, novations result in termination of the hedging relationship under FRS 102.

An entity might be required to, or choose to, novate a hedging instrument from one entity within a consolidated group, to another entity within the same group. For example, a banking group might undertake an internal reorganisation such that a portfolio of derivatives is transferred into a different entity within the same banking group. In this instance a question arises as to whether such a change in hedging derivative counterparty will result in the discontinuation of a hedge relationship. In line with the discussion above, when a derivative is novated or transferred to a different counterparty, the entity that originally held the derivative, derecognises the derivative. Whilst the hedged item remains within the hedging entity, the change in counterparty means the original hedging instrument no longer exists from the entity's perspective. As a result, the existing hedge relationship would ordinarily be de-designated and re-designated. However, the appropriate treatment will depend on the specific facts and circumstances.

4.10.3 Interest rate benchmark reform

As a result of the reforms mandated by the Financial Stability Board following the Financial Crisis, regulators pushed for Interbank Offered Rates (IBORs) to be replaced by new 'official' benchmark rates, known as Risk Free Rates (RFRs), a process referred to as 'IBOR Reform'. For instance, in the UK, the new official benchmark is Sterling Overnight Interest Average (SONIA) and banks are no longer required to quote LIBOR. IBOR Reform is substantially complete as the most significant IBORs, including all the LIBORs, have now ceased and have been replaced. However, there remain some local IBORs for which the work to replace them is still in progress or has only very recently been completed. For those remaining IBORs still in the process of change, the change affects future cash flows in both contractual floating rate financial instruments currently referenced to IBOR, and highly probably forecast transactions for which IBOR is designated as the hedged risk.

IBOR Reform raises a number of accounting questions, many of which relate to hedge accounting. The IASB responded with two separate amendments to IFRS: Phase 1 and Phase 2 Amendments addressing the accounting consequences that arise during the period before and after financial instruments transition from referencing IBORs to referencing replacement benchmark interest rates. Once IBOR Reform is complete and the RFRs have become established in the market, the Phase 1 and Phase 2 amendments will cease to be required.

In line with the IASB's approach, the FRC issued corresponding amendments to FRS 102. [FRS 102.12.25B-V]. These amendments reflect the temporary reliefs introduced by the IASB. For further details, please refer to the EY publication, International GAAP®.

4.11 Presentation

FRS 102 does not address how hedges are presented in profit or loss in the financial statements. IFRS reporters normally try to reflect the effect of the hedged item and hedging instrument in the financial statements so that they offset.

How we see it

For derivatives designated in effective hedge relationships, the profit or loss related to the effective portion of the hedging instrument is normally presented in the same line that the profit or loss arising on the hedged item is recorded. However, this is not mandated. It would also be acceptable to present the profit or loss from hedging derivatives similarly to non-hedging derivatives, if an entity so chooses as its accounting policy.

If a hedge does not qualify for hedge accounting, the profit or loss arising on the derivative is not necessarily presented in the same income or expenditure line as the item that it was intended to hedge. The default is for the gain or loss to be recorded in trading income.

However, gains or losses on interest rate derivatives are sometimes presented in interest income or expense. Also, gains and losses on currency derivatives may be presented in the foreign currency revaluation income or expense line. Presentation may be appropriate in cost of goods sold if the entity does not enter into derivatives for trading purposes and, hence, does not have a line item for trading instruments.

Presentation policies must be applied consistently to all similar instruments and clearly described in the accounting policies.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS for hedge accounting.

	FRS 102	IFRS 9/IAS 32/IAS 39
Accounting policy choice	Option to apply the recognition and measurement requirements of Sections 11 and 12, IAS 39 (limited option for first-time adopters of FRS 102) or IFRS 9 (see Chapter 37 for the detail). No matter the option chosen, entities must apply disclosure requirements of Sections 11 and 12.	Option to apply hedge accounting requirements of IAS 39 in full.
Hedge accounting	Similar principles to IFRS 9 but simpler. Does not include rebalancing, aggregated exposures or costs of hedging. Hedge accounting can be discontinued voluntarily unlike IFRS 9.	IAS 39: Rules based standard IFRS 9: Uses IAS 39 as the basis for the mechanics of hedge accounting, but more principled approach with additional features such as rebalancing, aggregated exposures and costs of hedging. Hedge accounting cannot be discontinued voluntarily unlike IAS 39 and FRS 102.
Hedged items - risk components	Risk components permitted for financial and non-financial instruments.	IAS 39: Only for financial items. IFRS 9: Similar to FRS 102.
Hedging instruments - non derivatives	Based on simplified version of IFRS 9. Non-derivative financial assets or liabilities at FVTPL are eligible as hedging instruments. The FX risk component of a non-derivative may be a hedging instrument.	IAS 39: Non-derivatives may be hedging instruments only for FX risks. IFRS 9: Similar to FRS 102.
Hedge effectiveness assessment	Prospective only, could be qualitative in many instances. A simpler version of IFRS 9 approach, does not require consideration of hedge ratio or whether credit risk dominates.	IAS 39: A quantitative retrospective and prospective test is required (80%-125%). IFRS 9: Prospective assessment only, likely to be qualitative in many instances.
Hedges of a net investment	Gain or loss accumulated in equity is not recycled to profit or loss on disposal of the foreign operation.	IAS 39 and IFRS 9: Gain or loss accumulated in equity is recycled to profit or loss on disposal of the foreign operation.

Appendix A - Defined terms

Extract from FRS 102

Appendix I Glossary

firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
forecast transaction	An uncommitted but anticipated future transaction.
hedging gain or loss	The change in fair value of a hedged item that is attributable to the hedged risk.
highly probable	Significantly more likely than probable.
net investment in a foreign operation	The amount of the reporting entity's interest in the net assets of that operation
probable	More likely than not.

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Chapter 15 Financial instruments: Presentation and Disclosure

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Overview

This Chapter summarises the presentation and disclosure requirements within Section 11 *Basic Financial Instruments*, Section 12 *Other Financial Instruments Issues* and the additional disclosures for financial institutions as set out in Section 34 *Specialised Activities*. Section 11 and 12 apply to both financial and non-financial institutions. Additional disclosures for all entities reporting under UK company law are also discussed below.

The disclosure requirements under Section 11 also apply to those instruments under the scope of Section 12. There are some exemptions available for qualifying entities as defined under Section 1 *Scope* discussed at 4.1.3 below. The offsetting requirements of financial assets and liabilities are discussed at 3.2 below. The classification of financial instruments as equity or financial liabilities, as prescribed by Section 22 *Liabilities and Equity*, is covered in Chapter 12. The classification of financial assets is addressed in Chapter 13.

In the Periodic Review 2024, the FRC added disclosure requirements for supply chain financing and reverse factoring arrangements, see Chapter 7 at 2.4. These new disclosure requirements aim to enhance the transparency and usefulness of the information provided for such arrangements.

What you need to know

- The measurement basis (or bases) and other material accounting policies used for financial instruments are required to be disclosed by Section 11.
- Section 34 sets out additional disclosure requirements for financial institutions.
- Section 11 requires disclosures to be provided to enable users of the entity's financial statements to evaluate the significance of financial instruments for its financial position and performance.
- To offset two or more financial instruments in the statement of financial position, Section 11 and 12 require that an entity must currently have a legally enforceable right of set-off, and an intention to settle on a net basis or realise the asset and settle the liability simultaneously.
- New disclosures have been added to explain the inputs, assumptions and estimation techniques used to determine expected credit losses where an entity is applying IFRS 9 *Financial Instruments*. It must be noted that the FRC took the decision not to introduce an expected credit loss model for financial assets into FRS 102 and therefore entities applying Section 11 and Section 12 will continue to apply an incurred loss model in accounting for financial asset impairment.

1 Introduction

Section 11 and Section 12 contain the accounting and disclosure requirements for financial instruments. Section 34 contains additional disclosure requirements for financial instruments that apply to financial institutions. For UK companies, additional disclosures on financial instruments are required by Schedule 1 to 3 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) (hereafter The Regulations).

The FRC issued an updated version of FRS 102 in September 2024, following the issue of the Amendments to FRS 102 - *The Financial Reporting Standard applicable in the UK and Republic of Ireland - Periodic Review 2024* - issued in March 2024 (the 'Periodic Review 2024'). The Periodic Review 2024 includes amendments to Sections 11, 12 and 34 of FRS 102 as issued in January 2022.

The main amendments are as follows:

- The requirements in Section 11 have been clarified to state that the disclosures set out in Section 11 also apply to those financial instruments under the scope of Section 12. [FRS 102.11.39A, FRS 102.12.26].
- Paragraph 40 of Section 11 has been amended to explicitly require disclosure of material accounting policy information consistent with the requirements in Section 3. [FRS 102.11.40].
- Entities that have made the accounting policy choice to apply IFRS 9, are now required to provide additional disclosure regarding quantitative and qualitative information on amounts arising from expected credit losses. [FRS 102.11.48ZA, FRS 102.11.48ZB].
- The disclosure requirements for financial instruments at fair value through profit or loss have been clarified to distinguish those relating to UK and those relating to the Republic of Ireland entities. [FRS 102.11.48A].
- The references to London Interbank Offered Rate (LIBOR) have been updated to Interbank Offered Rate (IBOR).

The above amendments are mandatory for accounting periods beginning on or after 1 January 2026. However, it must be noted that the disclosure requirements for supplier finance arrangements requirements in Section 7 *Statement of Cash Flows* are mandatory for accounting periods beginning on or after 1 January 2025, see Chapter 7 for further information.

2 Comparison between Sections 11, 12, 34 and IFRS

The comparable extant IFRSs are IAS 32 Financial Instruments: Presentation, IFRS 7 Financial Instruments: Disclosures and IFRS 13 *Fair Value Measurement*. Overall, the disclosure requirements in FRS 102 for financial instruments are less onerous than those of IAS 32, IFRS 7 and IFRS 13 (see 5 below).

3 Requirements of Sections 11 and 12

3.1 Scope

This chapter addresses the presentation and disclosure requirements outlined in Sections 11 and 12. It is important to note that there are certain types of financial instruments that are exempt from these sections, for more details see Chapter 11 at 3.2. Additionally, this chapter covers other disclosure requirements for financial instruments, including those for financial institutions as specified in Section 34, and the disclosure requirements of Schedule 1 to 3 to The Regulations.

3.2 Offsetting of financial instruments

3.2.1 Requirements

The rules regarding the offsetting, sometimes referred to as 'netting', of a financial asset and a financial liability are contained in both Sections 11 and 12. However, the guidance is identical in both sections, that is, a financial asset and a financial liability must be offset and the net amount presented in the statement of financial position when and only when, an entity: *[FRS 102.11.38A, FRS 102.12.25W]*

- Currently has a legally enforceable right to set off the recognised amounts.
- And

- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

The offsetting principle set out above is identical to that in IAS 32, but without the additional guidance contained in IAS 32. The IASB decided to incorporate additional guidance into IAS 32 to deal with historical ambiguities as well as emerging practical application issues arising from the growth in the clearing of financial instruments. The additional guidance has helped to clarify aspects such as current legal enforceability and simultaneous settlement. We would expect FRS 102 reporters to default to the guidance within IAS 32, where helpful, but this would not in itself be a requirement. Further information on offsetting under IAS 32 can be found in the EY publication, International GAAP®.

The effect of the offsetting rules described above is that, when the requirements are met, the entity presents a single financial asset or financial liability which represents the net cash flow intended to be received or paid. When the requirements are not met, the financial asset and the financial liability must be presented separately.

3.2.2 Interaction with derecognition rules

It is worth clarifying that offsetting and derecognition are different. Offsetting does not result in derecognition of the financial asset or liability from the statement of financial position, but in their net presentation in the statement of financial position as either a net financial asset or a net financial liability. Offsetting does not have an impact on the income statement as there is no gain or loss arising from the net presentation.

When a transfer of financial assets does not qualify for derecognition (e.g., the entity has retained significant risks and rewards of ownership of the transferred asset), the entity must recognise an associated liability as discussed in Chapter 13 at 7.2.3.B. In such cases, the financial asset retained in the statement of financial position and the resulting financial liability cannot be offset. *[FRS 102.11.34]*.

3.2.3 Presentation of equity

The presentation of the increase in equity arising on the issue of shares or other equity instruments is discussed in Chapter 12 at 4.4.3.

3.3 Presentation of hedges

Further information on presentation of hedges is discussed in Chapter 14 at 4.11.

4 Disclosures required by Section 11, 12, 34 including related UK company law

4.1 Disclosures

4.1.1 Introduction

The disclosures contained in Section 11 are also applicable to financial instruments within the scope of Section 12, where relevant. [FRS 102.12.26]. The disclosure requirements of Sections 11 and 12 apply to all entities regardless of their accounting policy choice for recognition and measurement of financial instruments (see Chapter 13 at 3). These disclosures apply to all entities, even those that do not prepare financial statements in accordance with UK company law.

However, a qualifying entity which is not a financial institution (i.e., most subsidiaries and parents in their separate financial statements) is not required to make all of the disclosures required by Sections 11 and 12, providing that equivalent disclosures are included in the consolidated financial statements in which the entity is included. [FRS 102.1.8, FRS 102.1.9, FRS 102.1.12(c)]. For the list of exemptions available for a qualifying entity that is not a financial institution and that is not required to prepare Companies Act accounts, see 4.1.3 below. [FRS 102.1.9].

IFRS 7 requires disclosure regarding the expected credit loss approach to impairment of financial assets as required by IFRS 9. The Periodic Review 2024 introduced new requirements within paragraphs 11.48ZA and 11.48ZB. These requirements ensure that entities applying the recognition and measurement requirements of IFRS 9, as outlined in the accounting policy choice discussed in Chapter 13, provide relevant information about the impairment of financial assets (see 4.1.2 below). [FRS 102.BC.B11.49ZA].

When the risks arising from financial instruments are particularly significant to the business of the entity, additional disclosure may be required in relation to the statement of financial position, see 4.1.2 below.

The disclosure requirements are summarised in 4.1.2 to 4.1.7 below:

- The disclosure requirements for entities that do not take the qualifying entity exemptions are at 4.1.2 below.
- The disclosures exemptions available to qualifying entities are discussed at 4.1.3 below.
- The additional disclosures applicable to financial institutions according to Section 34 are at 4.1.4 below.
- The disclosure requirements under Section 11 that may be influenced by climate-related matters is discussed at 4.1.5 below.
- The additional disclosures applicable to entities reporting under UK company law are at 4.1.6 and 4.1.7 below.

4.1.2 Disclosure requirements of Section 11 and 12

The disclosure requirements as set out in Sections 11 and 12 are discussed below.

4.1.2.A Accounting policies

The requirement is to disclose material accounting policy information (see Chapter 6 at 7.2), “including the measurement basis (or bases) for financial instruments used in preparing the financial statements (including the accounting policy choice made in accordance with paragraph 11.2)”. [FRS 102.11.40].

4.1.2.B Statement of financial position - categories

The standard requires separate disclosure of the carrying amounts at the reporting date of:

- Financial assets measured at fair value through profit or loss.
- Financial liabilities measured at fair value through profit or loss. Those that are not held as part of a trading portfolio and are not derivatives must be shown separately. [FRS 102.11.41].

This disclosure may be made separately by category of financial instrument.

Information that enables users of an entity's financial statements to evaluate the significance of financial instruments for its financial position and performance must also be disclosed. For example, for long-term debt, such information would normally include the terms and conditions of the debt instrument (such as interest rate, maturity, repayment schedule, and restrictions that the debt instrument imposes on the entity). When the risks arising from financial instruments are particularly significant to the business (for example because they are principal risks for the entity), additional disclosure may be required.

[FRS 102.11.42].

The disclosure requirements for financial institutions discussed at 4.1.4 below, include examples of disclosure requirements for risks arising from financial instruments that may be relevant in such cases.

[FRS 102.11.42, FRS 102.34.19].

In order to comply with the above, an entity that has taken the accounting policy choice to apply the recognition and measurement provisions of IAS 39 or IFRS 9 may need to consider additional disclosures based on IFRS 7, as it relates to the recognition and measurement policies applied. [FRS 102.BC.B11.50].

However, it must be noted that following the Periodic Review 2024 amendments which are effective from 1 January 2026, the option to elect the recognition and measurement provisions of IAS 39, which were applicable prior to the issuance of IFRS 9, has now been restricted and cannot be elected either on transition to FRS 102 or through a voluntary change in accounting policy. This accounting policy can only be newly adopted if it ensures consistency with the consolidated financial statements that include the entity. Entities that have already implemented this policy may continue to apply it, see Chapter 13 at 3.2.2.

The option to apply the recognition and measurement provisions of IFRS 9 remains available. However, when this option is selected, the amendments have mandated additional disclosure requirements, see quantitative and qualitative information about amounts arising from expected credit losses at 4.1.2.G below.

For all financial assets and financial liabilities measured at fair value, the basis for determining fair value (e.g., quoted market price in an active market or a valuation technique) must also be disclosed. And when a valuation technique is used, the assumptions applied in determining fair value for each class of financial assets or financial liabilities must be disclosed. For example, if applicable, information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. [FRS 102.11.43].

Disclosure of the fact that a reliable measure of fair value is no longer available for any financial instrument that would otherwise be required to be measured at fair value through profit or loss, if that is the case, and the carrying amount of those financial instruments. [FRS 102.11.44].

4.1.2.C Transferred financial assets that do not qualify for derecognition

If an entity has transferred financial assets to another party in a transaction that does not qualify for derecognition (see Chapter 13 at 7.2.3B), the following disclosure is required for each class of such financial assets: [FRS 102.11.45]

- The nature of the assets.
 - The nature of the risks and rewards of ownership to which the entity remains exposed.
- And
- The carrying amounts of the assets and of any associated liabilities that the entity continues to recognise.

4.1.2.D Collateral

When an entity has pledged financial assets as collateral for liabilities or contingent liabilities, the following must be disclosed: [FRS 102.11.46]

- The carrying amount of the financial assets pledged as collateral
- And
- The terms and conditions relating to its pledge

4.1.2.E Defaults and breaches on loans payable

For loans payable recognised at the reporting date for which there is a breach of terms or default of principal, interest, sinking fund, or redemption terms that has not been remedied by the reporting date, disclosure is required of: *[FRS 102.11.47]*

- Details of that breach or default.
 - The carrying amount of the related loans payable at the reporting date.
- And
- Whether the breach or default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

4.1.2.F Items of income, expense, gains or losses

An entity must disclose the following items of income, expense, gains or losses:

- The income, expense, net gains or net losses including changes in fair value recognised on:
 - Financial assets measured at fair value through profit or loss. *[FRS 102.11.48(a)(i)]*.
 - Financial liabilities measured at fair value through profit or loss (with separate disclosure of movements on those which are not held as part of a trading portfolio and are not derivatives). *[FRS 102.11.48(a)(ii)]*.
 - Financial assets measured at amortised cost. *[FRS 102.11.48(a)(iii)]*.
 - Financial liabilities measured at amortised cost. *[FRS 102.11.48(a)(iv)]*.
- And
- Where an entity has elected to apply the classification and measurement requirements of IFRS 9 financial instruments measured at fair value through other comprehensive income. *[FRS 102.11.48(a)(v)]*.
 - Total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not measured at fair value through profit or loss. *[FRS 102.11.48(b)]*.
 - The amount of any impairment loss for each class of financial asset. A class of financial asset is a grouping that is appropriate to the nature of the information disclosed and that takes into account the characteristics of the financial assets.

When an entity has made the accounting policy choice to apply the recognition and measurement provisions of IFRS 9 (see Chapter 13 at 3), the groupings must be based on whether the amount is equal to 12-month expected credit risk losses, equal to the lifetime expected credit losses or financial assets that are purchased or originated credit-impaired. *[FRS 102.11.48(c)]*.

4.1.2.G Quantitative and qualitative information about amounts arising from expected credit losses

When an entity has made the accounting policy choice to apply the recognition and measurement provisions of IFRS 9 (see Chapter 13 at 3), the entity must:

- Explain the inputs, assumptions and estimation techniques used in determining the expected credit losses. Therefore, the entity must disclose: *[FRS 102.11.48ZA]*
 - The basis of inputs and assumptions and the estimation techniques used in the measurement of the expected credit losses.
 - How forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information.
- And
- Changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.
 - Provide a reconciliation from the opening balance to the closing balance of the allowance, in a table, to explain the changes in the allowance for expected credit losses. Section 34 paragraph 21A(b) sets out a similar requirement for financial institutions. *[FRS 102.11.48ZB, FRS 102.34.21A(b)]*.

4.1.2.H Financial instruments at fair value through profit or loss

An entity in the UK, including an entity that is not a company, must provide the disclosures below only for financial instruments that are measured at fair value in accordance with paragraph 36(4) of Schedule 1 to The Regulations (see Chapter 13 at 4.4.1) i.e., those financial instruments that can be accounted for at fair value under UK-adopted IAS. However, this does not include financial liabilities held as part of a trading portfolio nor financial liabilities that are derivatives. *[FRS 102.11.48A]*.

The disclosure requirements referred to above are as follows: *[FRS 102.11.48A]*

- For a financial liability designated at fair value through profit or loss, the amount of change, during the period and cumulatively, in the fair value of the financial instrument that is attributable to changes in the credit risk of that instrument, determined either:
 - As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk.
 - Or
 - Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the instrument.
- The method used to establish the amount of change attributable to changes in own credit risk, or, if the change cannot be measured reliably or is not material, that fact.
- The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- If an instrument contains both a liability and an equity feature, and the instrument has multiple features that substantially modify the cash flows and the values of those features are interdependent (such as a callable convertible debt instrument), the existence of those features.
- If there is a difference between the fair value of a financial instrument at initial recognition and the amount determined at that date using a valuation technique, the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of the changes in the balance of this difference.
- Information that enables users of the entity's financial statements to evaluate the nature and extent of relevant risks arising from financial instruments to which the entity is exposed at the end of the reporting period. These risks typically include, but are not limited to, credit risk, liquidity risk and market risk. The disclosure must include both the entity's exposure to each type of risk and how it manages those risks.

Except for the disclosures required for entities in the Republic of Ireland, the purpose of these disclosures above is compliance with the disclosures in UK-adopted IAS when using fair value accounting according to paragraph 36(4) of Schedule 1 to the Regulations. These disclosure requirements will predominantly apply to certain financial liabilities. However, there may be instances where The Regulations require that the disclosures must also be provided in relation to financial assets, for example investments in subsidiaries, associates or jointly controlled entities measured at fair value. *[FRS 102.9.27B, FRS 102.A3.13]*.

4.1.2.I Interest rate benchmark reform

An entity is required to disclose information on: *[FRS 102.11.49]*

- The nature and extent of risks arising from the financial instruments subject to interest rate benchmark reform.
- How the entity manages those risks.
- And
- The entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates.

When an entity has applied the practical expedient in paragraph 20C of Section 11, the entity must disclose that fact. Furthermore, the entity must consider whether any further disclosure is necessary, for example judgements and estimates in accordance with paragraphs 6 and 7 of Section 8. *[FRS 102.11.50]*.

4.1.2.J Hedge accounting

When hedge accounting is applied, entities are required to make the following additional disclosures: *[FRS 102.12.26]*

- Entities must disclose the following separately for each type of hedging relationships: *[FRS 102.12.27]*
 - A description of the hedge relationship.
 - A description of the financial instruments designated as hedging instruments and their fair values at the reporting date.
 - A description of the hedged item.

And

 - The nature of the risks being hedged.
- For fair value hedges, the following disclosures must be provided: *[FRS 102.12.28]*
 - The amount of the change in fair value of the hedging instrument recognised in profit or loss for the period.

And

 - The amount of the change in fair value of the hedged item recognised in profit or loss for the period.
- For cash flow hedges, entities are required to disclose:
 - The periods when the cash flows are expected to occur and when they are expected to affect profit or loss. *[FRS 102.12.29(a)]*.
 - A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur. *[FRS 102.12.29(b)]*.
 - The amount of the change in fair value of the hedging instrument that was recognised in other comprehensive income during the period. *[FRS 102.12.29(c)]*.
 - The amount, if any, that was reclassified from equity to profit or loss for the period. *[FRS 102.12.29(d)]*.

And

 - The amount, if any, of any hedge ineffectiveness recognised in profit or loss for the period (i.e., any ineffectiveness). *[FRS 102.12.29(e)]*.
- For a hedge of net investment in a foreign operation, entities must disclose separately: *[FRS 102.12.29A]*
 - The amounts recognised in other comprehensive income (i.e., fair value changes in the hedging instrument that were effective hedges).

And

 - The amounts recognised in profit or loss (as ineffectiveness)
- When an entity has utilised the temporary amendments to the hedge accounting requirements specified in paragraphs 25C to 25F of Section 12, it must disclose the following: *[FRS 102.12.30]*
 - That fact.

And

 - The significant interest rate benchmarks to which the entity's hedging relationships are exposed.

4.1.3 Disclosure exemptions for qualifying entities

Entities that are qualifying entities (but not qualifying entities that are financial institutions) may take advantage of the following disclosure exemptions, provided that disclosures equivalent to those required by Section 11 and 12 are included in the consolidated financial statements in which the qualifying entity is included: *[FRS 102.1.12(c)]*

- The disclosures required by paragraph 42 of Section 11 that enable users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.
- The disclosures required by paragraph 44 of Section 11 if a reliable measure of fair value is no longer available.
- For transferred financial assets that do not qualify for derecognition the disclosures required by paragraph 45 of Section 11.
- The disclosures required by paragraph 47 of Section 11 of defaults and breaches on loans payable.

- The disclosures required by paragraphs 48(a)(iii), 48(a)(iv), 48(b) and 48(c) of Section 11 for the items of income, expense, gains or losses relating to financial instruments.
- For Section 12, which includes the hedge accounting disclosures the entity may take advantage of the following exemptions: paragraph 26 (in relation to those cross-referenced paragraphs from which a disclosure exemption is available), and the hedge accounting disclosures in paragraphs 27, 29(a), 29(b), 29A and 30.

4.1.4 Additional disclosures required for financial institutions under Section 34

For financial institutions (as defined in Chapter 3 at 2.5.1.A) additional disclosures are required to be provided in: *[FRS 102.11.48B, FRS 102.34.17]*

- The individual financial statements of the financial institution.
And
- The consolidated financial statements of a group containing a financial institution when the financial instruments held by the financial institution are material to the group. Where this is the case, the disclosures apply regardless of whether the principal activity of the group is being a financial institution or not. However, the disclosures only need to be given in respect of financial instruments held by entities within the group that are financial institutions.

4.1.4.A Significance of financial instruments for financial position and performance

A disaggregation of the statement of financial position line item by class of financial instrument. A class is a grouping of financial instruments that is appropriate to the nature of the information disclosed and that takes into account the characteristics of those financial instruments. *[FRS 102.34.20]*.

4.1.4.B Impairment

Unless a financial institution has made the accounting policy choice to apply the recognition and measurement provision of IFRS 9 (as set out in Chapter 13 at 3), where a separate allowance account is used to record impairments, a reconciliation of changes in that account during the period for each class of financial asset. *[FRS 102.34.21]*.

When a financial institution has made the accounting policy choice to apply the recognition and measurement provisions of IFRS 9 (as set out in Chapter 13 at 3), it must disclose information that enables users of its financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. This must include:

- An explanation of the financial institution's credit risk management practices and how they relate to the recognition and measurement of expected credit losses. This must include, but is not limited to, providing the disclosure as required by Section 11 paragraph 48ZA (see Quantitative and qualitative information about amounts arising from expected credit losses at 4.1.2.G above). *[FRS 102.34.21A(a)]*.
- A reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for: *[FRS 102.34.21A(b)(i)-(iii)]*
 - The loss allowance measured at an amount equal to 12-month expected credit losses.
 - The loss allowance measured at an amount equal to lifetime expected credit losses (showing separately the amount relating to financial instruments for which credit risk has increased significantly since initial recognition).

And

 - Financial assets that are purchased or originated credit-impaired.
- By credit risk rating grade, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts (showing separately information for financial instruments for which the loss allowance is measured at an amount equal to 12-month expected credit losses, for which the loss allowance is measured at an amount equal to lifetime expected credit losses, and that are purchased or originated credit-impaired financial assets). *[FRS 102.34.21A(c)]*.

4.1.4.C Fair value

For financial instruments held at fair value in the statement of financial position, for each class of financial instrument, an analysis of the level in the fair value hierarchy into which the fair value measurements are categorised. *[FRS 102.34.22]*.

To simplify the preparation of disclosures about financial instruments for the entities affected, whilst increasing the consistency with disclosures required by UK-adopted IAS, the three levels in the fair value hierarchy required for disclosures are aligned with those in IFRS 13. The measurement categories are: [FRS 102.34.22]

- Level 1: The unadjusted quoted price in an active market for identical assets or liabilities that the entity can access at the measurement date.
- Level 2: Inputs other than quoted prices included within Level 1 that are observable (i.e., developed using market data) for the asset or liability, either directly or indirectly.
- Level 3: Inputs are unobservable (i.e., for which market data is unavailable) for the asset or liability.

The fair value measurement is categorised in its entirety based on the lowest level input that is significant to the fair value measurement in its entirety with Level 3 being the lowest level. [FRS 102.34.22].

4.1.4.D Nature and extent of risks arising from financial instruments

Information that enables users of the financial institution's financial statements to evaluate the nature and extent of credit risk, liquidity risk and market risk arising from financial instruments to which the institution is exposed at the end of the reporting period. [FRS 102.34.23].

For each type of risk arising from financial instruments: [FRS 102.34.24]

- The exposures to risk and how they arise.
 - The institution's objectives, policies and processes for managing the risk and the methods used to measure the risk.
- And
- Any changes from the previous period.

4.1.4.E Credit risk

Disclose by class of financial instrument that is not subject to the impairment requirements of IFRS 9 due to the accounting policy choice (as set out in Chapter 13 at 3): [FRS 102.34.25(a)-(c)]

- The amount that best represents the institution's maximum exposure to credit risk at the end of the reporting period. This disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk.
 - A description of collateral held as security and of other credit enhancements, and the extent to which these mitigate credit risk.
- And
- The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

Unless a financial institution has made the accounting policy choice to apply the recognition and measurement requirements of IFRS 9 (as set out in Chapter 13 at 3), an analysis by class of financial asset of:

- Information about the credit quality of financial assets that are neither past due nor impaired. [FRS 102.34.25(d)].
 - The age of financial assets that are past due as at the end of the reporting period but not impaired. [FRS 102.34.26(a)].
- And
- The financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the financial institution considered in determining that they are impaired. [FRS 102.34.26(b)].

When financial or non-financial assets are obtained by taking possession of collateral held as security or calling on other credit enhancements (e.g., guarantees), and such assets meet the recognition criteria in other sections of FRS 102, a financial institution must disclose: [FRS 102.34.27]

- The nature and carrying amount of the assets obtained.
- And
- When the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

4.1.4.F Liquidity risk

A maturity analysis for financial liabilities that shows the remaining contractual maturities at undiscounted amounts separated between derivative and non-derivative financial liabilities. Lease liabilities must be presented separately within non-derivative financial liabilities. [FRS 102.34.28].

4.1.4.G Market risk

A sensitivity analysis for each type of market risk (e.g., interest rate risk, currency risk, other price risk) the financial institution is exposed to, showing the impact on profit or loss and equity. Details of the methods and assumptions used must be provided. If a sensitivity analysis, such as value-at-risk is prepared, that reflects interdependencies between risk variables (e.g., interest rates and exchange rates) and the financial institution uses such analysis to manage financial risks, it may use that sensitivity analysis instead.

[FRS 102.34.29, FRS 102.34.30].

4.1.4.G Capital

Information that enables users of the financial institution's financial statements to evaluate its objectives, policies and processes for managing capital. The institution must disclose:

- (a) Qualitative information about its objectives, policies and processes for managing capital, including:
 - (i) A description of what it manages as capital.
 - (ii) When the institution is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital.

And

 - (iii) How it is meeting its objectives for managing capital.
- (b) Summary quantitative data about what the financial institution manages as capital. Some regard certain financial liabilities (e.g., some forms of subordinated debt) as part of capital. Others regard capital as excluding some components of equity (e.g., components arising from cash flow hedges).
 - (c) Any changes in (a) and (b) above from the previous period.
 - (d) Whether during the period the financial institution complied with any externally imposed capital requirements to which it is subject to.
 - (e) When the financial institution has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

A financial institution must base all these disclosures on the information provided internally to key management personnel. [FRS 102.34.31].

A financial institution may manage capital in several ways and be subject to various capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, furthermore those entities may operate in different jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would not provide useful information or would distort a financial statement user's understanding of the financial institution's capital resources, the financial institution must disclose separate information for each capital requirement to which the entity is subject.

[FRS 102.34.32].

4.1.4.H Reporting cash flows on a net basis

Where a statement of cash flows is presented, cash flows arising from each of the following activities may be reported on a net basis: [FRS 102.34.33]

- Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date.
 - The placement of deposits with and withdrawal of deposits from other financial institutions.
- And
- Cash advances and loans made to customers and the repayment of those advances and loans.

4.1.5 Disclosure requirements under Section 11 that may be influenced by climate-related matters

Disclosure requirements within Section 11 may be influenced by climate-related matters, the key ones that may be impacted are as follows:

- Disclosure of any significant risks affecting an entity in relation to the financial instruments it holds. [FRS 102.11.42]. For instance, if an entity possesses equity investments concentrated in a sector particularly susceptible to climate-related issues, such as oil exploration or coal mining, this could represent a significant risk and necessitate disclosure.
- For all financial instruments measured at fair value:
 - Disclosure of the valuation basis, such as market price or valuation technique: Disclosures for valuation techniques must include the assumptions made. [FRS 102.11.43]. For example, a commodity trader may enter in a forward contract to purchase rare earth metals essential for batteries in electric vehicles, with the objective of generating trading profit. In the absence of futures markets for such metals, the valuation of the instrument would encompass assumptions regarding factors such as expected production, demand, and currency fluctuations. These assumptions must be disclosed by the entity.
 - For financial instruments measured at fair value through profit or loss: Disclosure of the risks typically including, but not limited to, credit risk, market risk, and liquidity risk to which the entity is exposed through those instruments, and how these risks are managed. [FRS 102.11.48A]. For example, if an entity has substantial forward purchase and sale contracts, unmatched in time and volume, for a commodity subject to changes in climate-related legislation, such as coal, it would need to disclose the associated market risk it faces. Similarly, if an entity holds debt with covenants linked to ESG measures, related liquidity risk disclosures would need to be made.

4.1.5.A Green bonds

Green bonds are issued by governments, corporations, and NGOs to fund green projects like renewable energy or energy efficiency improvements. These bonds vary in interest rates, terms, and security, catering to different risk appetites. There is no distinct accounting guidance for green bonds, so issuers and holders must follow Sections 11 and 12 of FRS 102 as they would for other bonds. Additionally, climate-related financial arrangements also need to be assessed under Sections 11 and 12 or other relevant sections of FRS 102.

4.1.6 Disclosures applicable to all entities reporting under UK company law

The Regulations require various disclosures in respect of financial instruments. The Regulations include the following categories for Schedule 1 to 3: Schedule 1 - Companies Act Individual accounts: Companies which are not banking or Insurance companies (1 Sch), Schedule 2 - Banking companies: Companies Act Individual accounts (2 Sch) and Schedule 3 - Insurance Companies: Companies Act Individual Accounts (3 Sch).

Entities reporting under such regulations, including qualifying entities, will be required to disclose the following in addition to those discussed at 4.1.2 to 4.1.4 above.

4.1.6.A Investments

- The amount of fixed asset or current asset investments ascribable to listed investments. [1 Sch 54(1), 3 Sch 72]
- The aggregate market value of listed investments where this is different from the amount recorded in the financial statements (and both market value and stock exchange value if market value is higher). [1 Sch 54(2)(a), 1 Sch 54(2)(b)].

4.1.6.B Information about fair value of assets and liabilities

The following must be disclosed where financial instruments are recorded at fair value:

- (a) Significant assumptions underlying any valuation models and techniques used where the fair value has been determined using generally accepted valuation techniques and models. [1 Sch 55(2)(a), 2 Sch 66(2)(a), 3 Sch 73(2)(a)].
- (b) The purchase price, the items affected and the basis of valuation (insurers only). [3 Sch 73(2)(b)].
- (c) The fair value of each category of financial instrument and the changes in value reported in profit and loss or credited/debited to the fair value reserve. [1 Sch 55(2)(b), 2 Sch 66(2)(b), 3 Sch 73(2)(c)].

- (d) For each class of derivatives, the extent and nature of the instruments including significant terms and conditions that may affect the amount, timing and uncertainty of future cash flows. [1 Sch 55(2)(c), 2 Sch 66(2)(c), 3 Sch 73(2)(c and d)].
- (e) Where any amount is transferred to or from the fair value reserve, there must be stated in tabular form, the amount of the reserve at the beginning and end of the reporting period, the amount transferred to/from the reserve in the year and the source and application of the amounts so transferred. [1 Sch 55(3), 2 Sch 66(3), 3 Sch 73(3)].

How we see it

We believe the disclosure requirements included in (a) and (c) above will in most cases be satisfied by disclosure requirements in FRS 102 discussed at 4.1.2.B, 4.1.2.F above.

In addition, entities must disclose:

- The fair values of any derivatives not included at fair value together with the extent and nature of the derivatives. [1 Sch 56, 2 Sch 67, 3 Sch 74]. This disclosure requirement would apply, for example, in the case of a derivative where the underlying investment is an equity instrument for which fair value cannot be reliably measured.
- The fair value of instruments that could be measured at fair value but are measured at a higher amount (i.e., amortised cost), the amount at which these assets are included in the company's accounts and reasons for not making a provision for diminution in value, together with the evidence that provides a basis for recoverability of the amount in the financial statements. [1 Sch 57, 2 Sch 68, 3 Sch 75].

4.1.6.C Fixed assets

For each item within fixed assets: [1 Sch 51(1), 2 Sch 62(1), 3 Sch 69(1)]

- The balance at the beginning and end of the year.
- The effect of any revision of the amount in respect of any assets made during that year on any basis.
- Acquisitions during that year.
- Disposals during that year.
- Any transfers of fixed assets in and out of that item of the balance sheet.

In respect of each asset above, the following must also be disclosed. [1 Sch 51(3), 2 Sch 62(3), 3 Sch 69(3)].

- The cumulative amount of provisions for depreciation or reduction in asset value included under that item as of at the beginning and end of the year.
- The amount of provisions for depreciation made during the financial year.
- The amount of adjustments made to these provisions during the year due to the disposal of assets.
And
- The amount of any other adjustments made to these provisions during the year.

4.1.6.D Details of indebtedness

For the aggregate of all items shown under 'creditors' in the company's balance sheet, the aggregate of the following amounts:

- (a) The amount of any debts which fall due after five years from the date of the balance sheet which are payable other than by instalments. [1 Sch 61(1)(a), 3 Sch 79(1)(a)].
And
- (b) The amount of any debts which are payable in instalments, the amount of any instalments which fall due for payment after the end of five years. [1 Sch 61(1)(b), 3 Sch 79(1)(b)].

For each debt falling into (a) and (b) above, the terms of payment or repayment and the rate of any interest payable on the debt. If the number of debts is such that, in the opinion of the directors, compliance with this requirement would result in excessive length, it is sufficient to provide a general indication of the terms of payment or repayment and the rates of any interest payable on those debts. [1 Sch 61(2)(3), 3 Sch 79(2)(3)].

Furthermore, for each item listed under 'creditors' in the company's balance sheet, the following must be disclosed: [1 Sch 61(4), 3 Sch 79(4)]

- (c) The total amount of debts included under that item for which the company has provided any security.
And
- (d) A description of the nature and form of the securities provided.

It must be noted that the references above to items listed under 'creditors' in the company's balance sheet include references to amounts due to creditors within one year and after more than one year, as distinguished in the balance sheet. In the case of (a) and (b) above it relates to items listed under the latter category, and in the case of (c) and (d) above it relates to items listed under either category [1 Sch 61(5), 3 Sch 79(5)].

4.1.6.F Guarantees and other financial commitments

The following disclosures are required:

- (a) Details must be provided of any charges on the company's assets to secure the liabilities of any other person, including the amount secured. [1 Sch 63(1), 3 Sch 81(1)].
- (b) Details and the total amount of any financial commitments, guarantees, and contingencies that are not included in the balance sheet must be disclosed. [1 Sch 63(2), 2 Sch 77(1), 3 Sch 81(2)].
- (c) A description of the nature and form of any valuable security provided by the company in relation to commitments, guarantees, and contingencies within (b) above must be given. [1 Sch 63(3), 2 Sch 77(2), 3 Sch 81(3)].
- (d) The total amount of any commitments related to pensions, as mentioned in (xiv) above, must be disclosed separately. [1 Sch 63(4), 2 Sch 77(3), 3 Sch 81(4)].
- (e) Details must be provided of pension commitments that are included in the balance sheet. [1 Sch 63(5), 2 Sch 77(4), 3 Sch 81(5)].
- (f) If any commitment within (d) or (e) pertains wholly or partly to pensions payable to past directors of the company, separate details of that commitment must be provided. [1 Sch 63(6), 2 Sch 77(5), 3 Sch 81(6)].
- (g) The total amount of any commitments, guarantees, and contingencies mentioned in (b) above that are undertaken on behalf of or for the benefit of: [1 Sch 63(7), 2 Sch 77(6), 3 Sch 81(7)]
 - (i) Any parent undertaking or fellow subsidiary undertaking of the company.
 - (ii) Any subsidiary undertaking of the company.

Or

 - (iii) Any undertaking in which the company has a participating interest.

Must be separately stated and those within each of paragraphs (i), (ii) and (iii) above must also be stated separately from those within any other of those paragraphs.
- (h) The nature and amount of any contingent liabilities and commitments included in the Memorandum items 1 and 2 to the Regulations which are material in relation to the company's activities must be disclosed. [2 Sch 77(7)].

4.1.6.G Miscellaneous matters

If any outstanding loans made under the authority of section 682(2)(b), (c), or (d) of the Act (various cases of financial assistance by a company for the purchase of its own shares) are included under any item shown in the balance sheet of the company, the aggregate amount of those loans must be disclosed for each relevant item. [1 Sch 64(2), 2 Sch 84(2), 3 Sch 82(2)].

4.1.6.H Fixed cumulative dividends

If the company has fixed cumulative dividends that are in arrears the following must be disclosed: [1 Sch 62, 2 Sch 75, 3 Sch 80]

- The amounts of the arrears.
- And
- Per class of dividend, the period for which they are in arrears.

4.1.6.I Share capital and debentures

The company must disclose following information regarding its share capital:

- If shares of more than one class have been allotted, the number and total nominal value of shares allotted for each class. [1 Sch 47(1)(a), 2 Sch 58(1), 3 Sch 65(1)].
- And
- If shares are held as treasury shares, the number and total nominal value of the treasury shares. Additionally, if shares of more than one class have been allotted, the number and total nominal value of the shares of each class held as treasury shares. [1 Sch 47(1)(b)].

For any portion of the allotted share capital that consists of redeemable shares, the following details must be provided: [1 Sch 47(2), 2 Sch 58(2), 3 Sch 65(2)]

- The earliest and latest dates on which the company has the authority to redeem those shares
- Whether the shares are required to be redeemed under any circumstances or if they are liable to be redeemed at the option of the company or the shareholder.

And

- Whether any premium is payable upon redemption, and if so, the amount of the premium.

For shares that have been allotted during the year, the following details must be provided: [1 Sch 48, 2 Sch 59, 3 Sch 66]

- The class of shares allotted.

And

- For each class of share, the number allotted, their aggregate nominal value and the consideration received by the company for the allotment.

For any contingent right to the allotment of shares in the company, the following must be disclosed:

[1 Sch 49(1), 2 Sch 60(1), 3 Sch 67(1)]

- The number, description and amount of the shares in relation to which the right is exercisable.
- The period during which it is exercisable.

And

- The price to be paid for the shares allotted.

Contingent right to the allotment of shares above refers to any option to subscribe for shares, as well as any other entitlement that gives a person the right to be allotted shares, including through the conversion of other types of securities or by other means. [1 Sch 49(2), 2 Sch 60(2), 3 Sch 67(2)].

If any debentures were issued during the year, the following information must be disclosed: [1 Sch 50(1), 2 Sch 61(1), 3 Sch 68(1)]

- The classes of debentures issued

And

- The amount issued and the consideration received in respect of each class of debenture

It must be noted that when a company's debentures are held by a nominee or trustee for the company, the nominal amount of the debentures and the amount at which they are stated at in the company's accounting records must be disclosed. [1 Sch 50(2), 2 Sch 61(2), 3 Sch 68(2)].

4.1.6.J Reserves and Provisions

The following details must be provided regarding the total amount of reserves or provisions included under the same item, presented in tabular form: [1 Sch 59(2), 2 Sch 70(2), 3 Sch 77(2)]

- The amount of reserves or provisions at the both the beginning and end of the period.
- Any amounts transferred to or from the reserve or provision during the period.

And

- The source and application of any amounts transferred.

This paragraph applies to any case where an amount is transferred: to or from any reserves; to any provision of liabilities or from any provision for liabilities for a purpose other than that for which the provision was originally established. [1 Sch 59(1), 2 Sch 70(1), 3 Sch 77(1)].

Details must be provided for each material provision listed under 'other provisions' in the company's balance sheet. [1 Sch 59(3), 2 Sch 70(3), 3 Sch 77(3)].

4.1.6.K Separate statement of certain items of income and expenditure

For bank loans, overdrafts and other type of loans made to the company (apart from loans from group undertakings) the amount of interest and similar charges must be disclosed. This applies regardless of whether these are secured by debentures or not. [1 Sch 66, 3 Sch 83].

4.1.6.L Reserves and dividends

The following must be disclosed: [1 Sch 43, 2 Sch 56, 3 Sch 64]

- (a) Any amounts that have been, or are proposed to be, allocated to or withdrawn from reserves.
 - (b) The total amount of dividends paid during the financial year, excluding those for which a liability existed at the previous balance sheet date.
 - (c) The total amount of dividends the company is liable to pay as of the balance sheet date.
- And
- (d) The total amount of dividends proposed before the accounts are approved, unless already disclosed under sub-paragraphs (b) or (c).

For the statutory disclosures in Small Companies Regulations and Small LLP Regulations see Chapter 5 at 5.3.2.C.

4.1.7 Disclosures applicable to Banking Companies reporting under UK company law

In addition to the Schedule 2 items noted at 4.1.6 above, Banking Companies will have to disclose the following as required by the Regulations:

Maturity analysis

- (i) A company must separately disclose the aggregate amount of loans and advances and liabilities included within each of the asset items: Loans and advances to banks - Other loans and advances and Loans and advances to customer. The same disclosure is required for each of the liability items: Deposits by banks - With agreed maturity dates or periods of notice, Customer accounts - With agreed maturity dates or periods of notice and Debt securities in issue - Others.

This disclosure is broken down into the following categories: [2 Sch 72(1)]

- (a) Those repayable in not more than three months
 - (b) Those repayable in more than three months but not more than one year
 - (c) Those repayable in more than one year but not more than five years
 - (d) Those repayable in more than five years
- from the balance sheet date.

For the purposes of the above disclosure, where a loan or advance or liability is repayable by instalments, each such instalment is to be treated as a separate loan or advance or liability. [2 Sch 72(3)].

- (ii) A banking company must also disclose the aggregate amounts of all loans and advances falling within the loans and advances to customers assets item which are repayable on demand or are repayable upon short notice for an indeterminate period. [2 Sch 72(2)].

Debt and other fixed-income securities

- (iii) Banking companies must disclose the amount of debt and fixed-income securities included within the debt securities (and other fixed-income securities) assets item and the bonds and medium term notes liabilities item that (in each case) will become due within one year of the balance sheet date. [2 Sch 73].

Subordinated liabilities

- (iv) In relation to any borrowing included within the subordinated liabilities item that exceeds 10% of the total for that item, the following must be disclosed: [2 Sch 74(1)]

- (a) Its amount
- (b) The currency in which it is denominated
- (c) The rate of interest and the maturity date (or the fact that it is perpetual)
- (d) The circumstances in which early repayment may be demanded
- (e) The terms of the subordination

And

- (f) The existence of any provisions whereby it may be converted into capital or some other form of liability and the terms of any such provisions
- (v) The general terms of any other borrowings included within the subordinated liabilities item must also be stated. [2 Sch 74(2)].

Details of assets charged

- (vi) For each liability and memorandum item of the balance sheet format, the following must be disclosed: [2 Sch 76(1)]
- (a) The total amount of any company assets that have been charged/pledged to secure any liability or potential liability under that item.
 - (b) The total amount of the liabilities or potential liabilities that are so secured.
- And
- (c) A description of the nature of the security provided.
- (vii) Details must also be provided of any other charges on the company's assets to secure the liabilities of any other person, including, where possible, the amount secured. [2 Sch 76(2)].

Transferable securities

- (viii) For each of the asset items: Debt securities (and other fixed-income securities); Equity shares (and other variable-yield securities); Participating interests and shares in group undertakings in the balance sheet format, the amount of transferable securities included under those items that are listed and those that are unlisted must be disclosed separately. [2 Sch 79(1)].
- (ix) For each amount shown for listed securities under (viii) above, the aggregate market value of those securities must also be disclosed if it differs from the amount shown. [2 Sch 79(2)].
- (x) For each of the asset items: Debt securities (and other fixed-income securities) and equity shares (and other variable-yield securities), the amount of transferable securities held as financial fixed assets and those not held as such must be disclosed, along with the criterion used by the directors to distinguish between those held as financial fixed assets. [2 Sch 79(3)].

Unmatured forward transactions

- (xi) For unmaturing forward transactions outstanding at the balance sheet date, the following must be disclosed: [2 Sch 83(1)]
- (a) The categories of such transactions, according to an appropriate system of classification.
 - (b) For each such category, disclose whether they have been made primarily for hedging against fluctuations in interest rates, exchange rates, and market prices, or for dealing purposes.
- (xii) Transactions under (xi) above must encompass all those for which income or expenditure is to be included in:
- (a) format 1, item 6 or format 2, items B4 or A3 i.e., dealing profits/losses
 - (b) format 1, items 1 or 2, or format 2, items B1 or A1 (i.e., interest receivable/interest payable), by virtue of notes (1)(b) and (2)(b) to the profit and loss account formats, which relates to: charges arising from covered forward contracts, allocated over the contract's actual duration and akin to interest

5 Summary of GAAP differences

The disclosure requirements for FRS 102 are outlined in Sections 11 and 12. Additional disclosures are set out in Section 34 for entities that are considered a financial institution. The disclosures under IAS 32, IFRS 7 and IFRS 13 are similar but more extensive than those required by FRS 102, as such GAAP differences exist in the level of disclosure required. The disclosures required under UK Company law are not required under IFRS.

Appendix A - Defined terms

Extract from FRS 102 Appendix 1 Glossary

Glossary

Act	The Companies Act 2006
active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
amortised cost (of a financial asset or financial liability)	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
compound financial instrument	A financial instrument that, from the issuer's perspective, contains both a liability and an equity element.
derecognition	The removal of all or part of a recognised asset or liability from an entity's statement of financial position.
derivative	A financial instrument or other contract with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the carrying amount of the financial asset or financial liability.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A Fair Value Measurement shall be used in determining fair value.

financial asset

Any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity, or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

financial institution

Any of the following:

- (a) a bank which is:
 - (i) a firm with a Part 4A permission which includes accepting deposits and:
 - (a) which is a credit institution; or
 - (b) whose Part 4A permission includes a requirement that it complies with the rules in the General Prudential sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks, but which is not a building society, a friendly society or a credit union;
 - (ii) an EEA bank which is a full credit institution;
- (b) a building society which is defined in section 119(1) of the Building Societies Act 1986 as a building society incorporated (or deemed to be incorporated) under that act;
- (c) a credit union, being a body corporate registered under the Co-operative and Community Benefit Societies Act 2014 as a credit union in accordance with the Credit Unions Act 1979, which is an authorised person;
- (d) a custodian bank or broker-dealer;
- (e) an entity that undertakes the business of effecting or carrying out insurance contracts, including general and life assurance entities;
- (f) an incorporated friendly society incorporated under the Friendly Societies Act 1992 or a registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment which it replaced, including any registered branches;
- (g) an investment trust, Irish investment company, venture capital trust, mutual fund, exchange traded fund, unit trust, open-ended investment company (OEIC); or
- (h) [Deleted]

	(i) any other entity whose principal activity is similar to those listed above but is not specifically included in that list. A parent entity whose sole activity is to hold investments in other group entities is not a financial institution.
financial instrument	A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
financial liability	Any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
firm commitment	Binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
forecast transaction	Uncommitted but anticipated future transaction.
hedging gain or loss	The change in fair value of a hedged item that is attributable to the hedged risk.
highly probable	Significantly more likely than probable.
liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. Interest rate risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Currency risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Other price risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
non-controlling interest	The equity in a subsidiary not attributable, directly or indirectly, to a parent.
probable	More likely than not.

publicly traded (debt or equity instruments)	Traded, or in process of being issued for trading, in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
transaction costs (financial instruments)	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability, or the issue or reacquisition of an entity's own equity instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or financial liability, or had not issued or reacquired its own equity instrument.
treasury shares	An entity's own equity instruments, held by that entity or other members of the consolidated group.
UK-adopted international accounting standards	IAS that have been adopted for use within the UK in accordance with the International Accounting Standards and European Public Limited-Liability Company (Amendment etc.) (EU Exit) Regulations 2019 (SI 2019/685).

Chapter 16

Inventories

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Overview

Section 13 *Inventories* of FRS 102 addresses the measurement and disclosure requirements for inventories. Inventories are assets that are held for sale in the ordinary course of business, in the process of production for sale or in the form of materials and supplies that will be consumed in the production process or as part of the rendering of services. This chapter and section of the standard applies to all inventories except for financial instruments and biological assets related to agricultural activity and agricultural produce at the point of harvest.

There have been minor changes arising from the March 2024 amendments to the Standard being:

- The removal of work in progress arising under construction contracts from the scope exceptions of the Section as a result of changes to Section 23 *Revenue*.
- A new paragraph confirming that this Section applies to the presentation and disclosure of refund assets held in inventory for expected product returns.
- The inclusion of right-of-use assets used in the production process within the costs of conversion of inventories, as a result of the changes in Section 20 *Leases*.
- Removal of 'estimated' in relation to costs to sell when considering the initial measurement of agricultural produce at the point of harvest.

The standard's basic rule is that inventories are measured at the lower of cost and net realisable value, except for inventories held for distribution at no or nominal consideration. The use of measurement techniques such as the cost method, the retail method or most recent purchase price is permitted if the result approximates to cost.

What you need to know

- In many industries, inventories are one of the more significant classes of assets and their accounting treatment may have a material impact on the statement of financial position and operating results.
- Significant judgements or assumptions may be required in classifying assets, determining costs to be included in inventory and determining the relevant net realisable value that meets the objectives of the standard.

1 Introduction

Section 13 of FRS 102 addresses the measurement and disclosure requirements for inventories.

The term 'inventories' includes assets held for sale in the ordinary course of business; in the process of production for such sale; or in the form of materials or supplies to be consumed in the production process or in the rendering of services. Inventories can include all types of goods purchased and held for resale and may also include tangible and intangible assets held by an entity for sale in the ordinary course of business. Biological assets related to agricultural activity and agricultural produce at the point of harvest are however dealt with in Section 34 *Specialised Activities* (see Chapter 36). This chapter only deals with inventories within the scope of Section 13.

Costs of inventories comprise expenditure which has been incurred in bringing the inventory to its present location and condition. All costs incurred in respect of inventories are charged to profit and loss, except for those which relate to those unconsumed inventories which are expected to be of future benefit to the entity. These are carried forward as an asset, until the entity transfers control to a third party, at which point revenue is recognised in accordance with Section 23 *Revenue* (see Chapter 25).

Amendments were made in the March 2024 Periodic Review to reflect the changes made for Revenue and Leases.

The principles of Section 13 are broadly consistent with IFRS.

2 Comparison between Section 13 and IFRS

The accounting for inventories under IFRS is addressed by IAS 2 *Inventories*. Section 13 and IAS 2 both use the principle that the primary basis of accounting for inventories is cost unless the amount that the inventories are expected to realise upon sale less costs to complete and sell is lower than cost. Where this is the case, the inventories are written down to that lower amount.

Generally, under Section 13 and IAS 2, the cost of inventories comprises all costs of purchase and costs of conversion based on normal levels of activity and other costs incurred in bringing inventories to their present location and condition.

Both accounting frameworks allow the use of measurement techniques, such as standard costing, provided the measurement technique gives an approximate to cost.

There are, however, some areas of potential difference between the frameworks in accounting for inventories. These differences mainly arise where more specific requirements are contained within IAS 2 than are provided under Section 13. These areas are summarised at 4 below.

3 Requirements of Section 13 for inventories

3.1 Scope

Inventories are assets: *[FRS 102 Appendix I]*

- Held for sale in the ordinary course of business.
- In the process of production for such sale.

Or

- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories can include all types of goods purchased and held for resale including, for example, merchandise purchased by a retailer. The term also encompasses finished goods produced, or work in progress being produced by the entity, and includes materials and supplies awaiting use in the production process. If the entity is a service provider, its inventories may be intangible (e.g., the costs of the service for which the entity has not yet recognised the related revenue).

Section 13 sets out its scope as follows: *[FRS 102.13.2, FRS 102.13.2A, FRS 102.13.3]*

Extract from Section 13

- 13.2** This section applies to all inventories, except:
- (a) [deleted]
 - (b) financial instruments (see Section 11 Basic Financial Instruments and Section 12 Other Financial Instruments issues); and
 - (c) biological assets related to agricultural activity and agricultural produce at the point of harvest (see IAS 41 Agriculture).
- 13.2A** This section applies to the presentation and disclosure of refund assets held in inventory representing expected product returns. An entity shall recognise and measure refund assets in accordance with paragraphs 23.51 to 23.57.
- 13.3** Other than the disclosure requirements in paragraph 13.22, this section does not apply to the measurement of inventories at fair value less costs to sell through profit or loss at each reporting date. Inventories shall not be measured at fair value less costs to sell unless it is a more relevant measure of the entity's performance because the entity operates in an active market where sale can be achieved at published prices, and inventory is a store of readily realisable value.

In addition, the measurement provisions of Section 13 do not apply to inventories measured at fair value through profit and loss at each reporting date. *[FRS 102.13.3]*. Although these inventories are scoped out of the measurement requirements of Section 13, the disclosure requirements of Section 13 continue to apply.

Section 13 states that inventories must not be measured at fair value unless it is a more relevant measure of the entity's performance (i.e., more relevant than cost and estimated selling price less costs to complete and sell) because the entity operates in an active market where sale can be achieved at published prices, and inventory is a store of readily realisable value. *[FRS 102.13.3]*. 'Relevance' will be judged by the criteria in Section 2 and is discussed in Chapter 4 at 3.3.1.A. Measuring inventories at fair value less costs to sell is permitted by company law. *[1 Sch 39, 1 Sch 39 (LLP)]*. However, the Regulations (and LLP Regulations) do not specify how changes in the fair value of stocks are recognised under the fair value accounting rules.

Section 13 requires that fair value movements are recognised in profit or loss on inventories measured at fair value less costs to sell. Although the Regulations require that that only profits realised at the balance sheet date are to be included in the profit and loss account, *[1 Sch 13, 1 Sch 13 (LLP)]*, the measurement of inventory at fair value less costs to sell through profit or loss is permitted only where the entity operates in an active market, where sale can be achieved at published prices, and inventory is a store of readily realisable value, *[FRS 102.13.3]*, and therefore would not require the use of a true and fair override.

The criteria for the use of measurement at fair value in Section 2A of FRS 102 described above is different from that contained in IAS 2 which is limited to certain types of inventories (e.g., agricultural produce and inventories held by commodity broker-traders). *[IAS 2.3]*. In addition, IAS 2 does not contain a requirement that an entity operates in an active market or that inventory is a store of readily realisable value for fair value measurement to be applied.

3.1.1 Scope and recognition issues

For entities operating in some industries, it may not always be clear whether certain assets fall in scope of Section 13 or are covered by another section of FRS 102. Some of the practical application issues are covered further in this chapter. Other practical application issues such as classification of broadcast rights, emission rights and crypto currencies are discussed further in the EY Publication, International GAAP®.

3.1.1.A Spare parts

Many entities carry spare parts for items of property, plant and equipment. Section 17 *Property, Plant and Equipment* requires that spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment if they meet the definition of property, plant and equipment; [FRS 102.17.5] that is, they are tangible assets that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

And

- Are expected to be used during more than one period. [FRS 102 Appendix I].

Otherwise, such items are classified as inventory. [FRS 102.17.5].

There are, of course, practical considerations when determining whether major spare parts must be classified as inventory or property, plant and equipment and these considerations are discussed further at 3.3.1.A of Chapter 20.

3.1.1.B Real estate inventory held for short term sale

Many real estate businesses develop and construct residential properties for sale, often consisting of several units. The strategy is to make a profit from the development and construction of the property rather than to make a profit in the long term from general price increases in the property market. The intention is to sell the property units as soon as possible following their construction and is therefore in the ordinary course of the entity's business. When construction is complete it is not uncommon for individual property units to be leased at market rates to earn revenues to partly cover expenses such as interest, management fees and real estate taxes. Large-scale buyers of property, such as insurance companies, are often reluctant to buy unless tenants are *in situ*, as this assures immediate cash flows from the investment.

How we see it

It is our view that if it is in the entity's ordinary course of business (supported by its strategy) to hold property for short-term sale rather than for long-term capital appreciation or rental income, the entire property (including the leased units) must be accounted for and presented as inventory. This will continue to be the case as long as it remains the intention to sell the property in the short term.

Rent received must be included in other income as it does not represent a reduction in the cost of inventory. The entity does not capitalise rental and related income generated by tenants against the cost of the development as this is incidental to the development of the property and not a 'by-product' of the development process.

Investment property, which is accounted for under Section 16 *Investment Property* is defined as "property (land or a building, or part of a building, or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) for sale in the ordinary course of business". [FRS 102 Appendix I]. Therefore, in the case of large-scale buyers of property outlined above, the property does not meet the definition of investment property. Properties intended for sale in the ordinary course of business - whether leased out or not - are outside the scope of Section 16. However, if property is intended for sale, Section 16 requires it to be transferred from inventory to investment property when there is a change in use. This change can be evidenced by the commencement of an operating lease to another party (see Chapter 19 at 3.4).

The accounting for real estate inventory is discussed in the EY publication, International GAAP®.

3.1.1.C Consignment stock and sale and repurchase agreements

A manufacturer may enter into an arrangement with a distributor where the distributor sells inventory on behalf of the manufacturer. Such consignment arrangements are common in certain industries, such as the automotive industry. Under such arrangements, a manufacturer (consignor) may deliver inventory on a consignment basis to a distributor or dealer (consignee). The consignor retains the legal title to the inventory and consignee acts as a selling agent. Under Section 23 *Revenue* the manufacturer will not recognise revenue for the stock delivered to the consignee because control has not yet transferred (see Chapter 25 at 8.2) and would continue to account for the consignment inventory until control has passed. [FRS 102.23.78].

Similarly, an entity may enter into sale and repurchase agreements with a customer where the entity agrees to repurchase inventory under particular circumstances. For example, an entity may agree to repurchase any inventory that the customer has not sold to a third party after six months.

In a consignment arrangement where the distributor or dealer has physical possession of inventory that an entity controls, inventory must not be derecognised and revenue must not be recognised by the consignor upon delivery of the product held on consignment. [FRS 102.23.86(b)]. Indicators of a consignment arrangement can include:

- Until a specified event occurs, such as the sale of a product to the customer of the distributor, or a specified period expires, the product is controlled by the entity.
 - There is a right to require the return of product or transfer to product to a third party (such as a distributor).
- Or
- The distributor does not have an unconditional obligation to pay for the product (although the payment of a deposit may be required). [FRS 102.23.87].

When an arrangement is accounted for as a financing arrangement, the seller will continue to recognise the inventory on its balance sheet and will also recognise a financial liability for the consideration received. If Section 23 requires the arrangement to be accounted for as a lease, the arrangement must be accounted for in accordance with Section 20. In this case, if the seller is considered to be acting as the lessor in an operating lease, the seller will continue to recognise the inventory on balance sheet. For arrangements that are considered to be a sale with a right of return, inventory will be derecognised and the seller will instead recognise a right of return asset. Sales with a right of return are considered further in at 3.1.1.D below.

The entity will also have to consider appropriate disclosure for material amounts of inventories that are held on consignment or sale and return at a third party's premises.

Consignment stock may also be found in situations other than distribution agreements, for example, when an entity (consignor) outsources part of its production process and transfers the legal title of inventories to a third party (consignee) in a sale transaction to enable that consignee to perform an outsourced task, with the inventories subsequently repurchased by the consignor. This may arise, for example, in the pharmaceutical industry, where a pharmaceutical entity may legally sell large quantities of an active drug principle in bulk to enable repackaging into smaller quantities which are subsequently repurchased by the consignor. Although the transaction takes the legal form of a sale, the seller (consignor) does not transfer control of the goods and therefore, must not derecognise the inventories. Section 23 provides specific application guidance for a promise to deliver goods on a consignment basis to other parties (see Chapter 25 at 8.2) and principal versus agent considerations (see Chapter 25 at 5.4).

3.1.1.D Sales with a right of return

An entity may provide its customers with a right to return goods that it has sold to them. The right may be contractual, or an implicit right that exists due to the entity's customary business practice, or a combination of both. Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept any returned product. Under Section 23, the potential for customer returns needs to be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. Section 23 also requires that the selling entity recognise the amount received or receivable that is expected to be returned to the customer as a refund liability and recognise a return asset for its right to recover goods returned by the customer. The carrying value of the return asset is presented separately from inventory. Sales with a right of return are discussed further in Chapter 25 at 5.7 and 8.7.

3.2 Measurement

Inventories in scope of the measurement provisions of Section 13 must be measured at the lower of cost and estimated selling price less costs to complete and sell. [FRS 102.13.4].

3.2.1 What is included in the cost of inventories?

The cost of inventories must include all costs of purchase, costs of conversion and other costs incurred in bringing inventories to their present location and condition. [FRS 102.13.5].

Other costs must be included in the cost of inventories only to the extent that they are incurred in bringing them into their present location and condition. [FRS 102.13.11]. For example, design costs for a special order for a particular customer must be included in inventory.

3.2.2 Costs of purchase of inventories

Section 13 states that: [FRS 102.13.6]

Extract from Section 13

Costs of purchase

- 6 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

There may be instances in which it is not clear whether payments received from suppliers are a discount, rebate or another similar item, nor whether they relate to inventories, another asset or something else. Unlike Section 23, which addresses the supplier's accounting for such payments, the accounting for the customer/purchaser receiving such a payment is not comprehensively addressed in by FRS 102 or IFRS accounting standards. Neither Section 13 of FRS 102 nor IAS 2 provide guidance on accounting for such payments beyond noting that discounts, rebates and other similar items are deducted from the purchase price. In the absence of guidance, judgement might be needed. For further discussion on the considerations for payments received from suppliers refer to our publication *Applying IFRS: Accounting for Payments from Suppliers*.⁹⁴

Neither Section 13 of FRS 102 nor IAS 2 provide guidance on how to estimate trade discounts or rebates if they are variable. Discretionary rebates and rebates contingent on future purchases cannot be recognised because the resulting asset would not meet the recognition criteria in Section 2 of FRS 102. The IFRS IC discussed in November 2004 whether volume rebates should be recognised only when threshold volumes are achieved, or proportionately where achievement is assessed as probable. The IFRS IC tentatively agreed that there was insufficient evidence of diversity in practice and, therefore, decided not to add this issue to its agenda.⁹⁵

How we see it

In our view, if it is probable that conditions to earn a trade discount or rebate will be met, and the amount can be estimated reliably, the discount or rebate must be recognised as a reduction in the cost of purchase. It follows that such trade discounts or rebates are recognised as an asset with a corresponding deduction from the cost of inventory. Estimating the amount of the rebate to be received often requires the use of judgement.

⁹⁴ Available on ey.com/IFRS.

⁹⁵ [IFRIC Update](#), November 2004, available on the IFRS Foundation's website.

Entities sometimes purchase inventories on deferred settlement terms. In some cases, the arrangement contains an unstated financing element, for example, a difference between the purchase price for normal credit terms and the deferred settlement amount. In these cases, the difference is usually recognised as an interest expense over the period of the financing. It is not added to the cost of inventories unless the inventory is a qualifying asset under Section 25 *Borrowing Costs* and the entity adopts a policy of capitalising finance costs. [FRS 102.13.7]. Inventories manufactured over a short period of time are not qualifying assets. Only inventories produced in small quantities over a long time period of time are likely to be qualifying assets under Section 25. Qualifying assets are discussed further in Chapter 27.

3.2.3 Costs of conversion

The cost of conversion of inventories includes costs directly related to the units of production, such as direct labour. It also includes a systematic allocation of the fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings, equipment and right-of use assets used in the production process, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour. [FRS 102.13.8]. It must be remembered that the inclusion of overheads in the cost of inventories is not optional.

The allocation of fixed production overheads must be based on the normal capacity of the production facilities. Normal capacity is defined as "the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance." While actual capacity may be used if it approximates to normal capacity, increased overheads must not be allocated to production as a result of low production or idle plant. Unallocated overheads must be recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased, as otherwise inventories would be recorded at an amount in excess of cost. [FRS 102.13.9].

The allocation of variable production overheads must be based on the actual use of the production facilities in the period. [FRS 102.13.9].

The occurrence of a natural disaster, epidemic or war may often result in changes to an entity's operations, for example, by interrupting supply chains, restricting operations or increasing operating costs. If production volumes are lower than normal because of a natural disaster, epidemic or war, the entity must not increase the amount of fixed overhead costs allocated to each unit of production. Rather, any unallocated overheads are recognised as an expense in the period in which they are incurred. Conversely, entities may have abnormally high production for certain products, for example due to panic-buying. In these circumstances, an entity needs to decrease the amount of fixed overhead allocated to each unit of production so that inventories are not measured above cost.

Entities need to assess whether wasted materials, labour, or other production costs are abnormal and, if so, they must be expensed as incurred. Entities may incur wasted materials, for example, to repackage goods that were originally destined for the wholesale market now redirected for retail sale to consumers (see 3.2.4 below).

In computing the costs to be allocated using the overhead recovery rate, costs such as distribution and selling must be excluded, together with the cost of storing raw materials and work in progress, unless it is necessary that storage costs be incurred prior to further processing, which may occasionally be the case (see 3.2.4 below).

How we see it

Although not specifically addressed in Section 13, when the revaluation model in Section 17 is applied, depreciation of property, plant and equipment is based on the revalued amount, less the residual value of the asset. Our view is that the depreciation based on the revalued amounts must be used in determining the costs of conversion for inventory valuation purposes.

Some entities may have an obligation to dismantle, remove and restore a production site at some future date. For example, mining companies may have obligations to decommission mines and rehabilitate the impacted area on closure of the mine. Although provisions for such obligations are not specifically addressed by Section 21 *Provisions and Contingencies*, the recognition criteria within Section 21 may require entities to record a provision for these obligations. If the obligation arises as a result of production of inventory during the period, costs in respect of the obligation incurred during the period (measured in accordance with Section 21) must be included within production overheads to be allocated to the cost of inventories. [FRS 102.13.8A]. The estimated costs to dismantle, remove and restore a site which arise either when an item of property, plant or equipment is acquired or as a consequence of having used the property, plant or equipment for purposes other than to produce inventories during the period must be recognised as part of the cost of that item of property, plant and equipment. [FRS 102.17.10].

Illustration 3-1: Inclusion of costs for obligations within production overheads

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it. 10% of the eventual costs arise from the extraction of oil. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted. The amount of the additional provision recognised each year as a result of the extraction of oil must be part of the production overheads to be allocated to the cost of inventory. The 90% of costs that relate to the removal of the oil rig and restoration of damage caused by building it would be recognised as part of the cost of the oil rig.

3.2.4 Costs excluded from inventories

Section 13 states the following: [FRS 102.13.13]

Extract from Section 13

- 13** Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:
- (a) abnormal amounts of wasted materials, labour or other production costs;
 - (b) storage costs, unless those costs are necessary in the production process before a further production stage;
 - (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and
 - (d) selling costs.

3.2.5 Storage and distribution costs

Storage costs are excluded from the cost of inventories unless they are necessary in the production process. This appears to prohibit including the costs of the warehouse and the overheads of a retail outlet as part of inventory, as neither of these is a prelude to a further production stage.

However, where it is necessary to store raw materials or work in progress prior to a further processing or manufacturing stage (e.g., maturing stocks such as cheese, wine and whiskey), the cost of such storage must be included in production overheads.

Although distribution costs are a cost of bringing an item to its present location, company law prohibits them from being added to the cost of stock. However, the Regulations do not define distribution costs. [1 Sch 27(4)]. The question therefore arises as to whether costs of transporting inventory from one location to another are eligible.

Costs of distribution to the customer are not allowed; they are selling costs and FRS 102 prohibits their inclusion in the carrying value of inventory. [FRS 102.13.13(d)].

How we see it

Distribution costs of inventory whose production process is complete should not normally be included in its carrying value.

However, judgement may need to be applied in identifying which costs are necessarily incurred to bring inventories to their present location.

For example, in the context of large retailers with distribution centres (e.g., supermarkets), the transport and logistics involved are essential to their ability to put goods on sale at a particular location in an appropriate condition. In these circumstances, costs to receive, repackage and transport goods from central or regional warehouses to retail outlets are considered a cost of bringing the asset to the point of sale and hence capitalised in the cost of inventories. [FRS 102.13.5]. Conversely:

- The cost of moving inventories from one retail outlet to another cannot be included in the carrying value of inventory.
- Entities may incur additional costs to store inventories due to lower-than-expected demand. Such costs need to be expensed when incurred as storage costs can only be capitalised when they are necessary to the production process before further processing.
- The cost of storing goods at central warehouses before they are shipped to customers upon receipt of an order (for example, for internet sales) or until they are moved to retail outlets for local storage, display or collection by customers cannot be included in the carrying value of inventory.
- Costs of distribution to the customer are excluded from the cost of inventory as they are not incurred to bring inventories to their point of sale.

3.2.6 General and administrative overheads

FRS 102 specifically prohibits administrative overheads that do not contribute to bringing inventories to their present location and condition from being included in the cost of inventories. [FRS 102.13.13(c)]. Costs and overheads that do contribute must be included in costs of conversion. There is a judgement to be made about such matters, as on a very wide interpretation, any department in an entity could be considered to make a contribution to inventories. For example, the accounts department will normally support the following functions:

- Production - by paying direct and indirect production wages and salaries, by controlling purchases and related payments, and by preparing periodic financial statements for the production units.
 - Marketing and distribution - by analysing sales and by controlling the sales ledger.
- And
- General administration - by preparing management accounts and annual financial statements and budgets, by controlling cash resources and by planning investments.

Only those costs of the accounts department that can be reasonably allocated to the production function can be included in the cost of conversion. Part of the management and overhead costs of a large retailer's logistical department may be included in cost if it relates to bringing the inventory to its present location and condition. These types of costs are unlikely to be material in the context of the total inventory held by organisations.

How we see it

In our view, an entity wishing to include a material amount of overhead of a borderline nature must ensure it can sensibly justify its inclusion under the provisions of FRS 102 by presenting an analysis of the function and its contribution to the production process similar to the bulleted guidance above.

3.2.7 Borrowing costs

In limited circumstances, borrowing costs may be included in the cost of inventories. Section 25 allows entities to adopt an accounting policy of capitalising borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. [FRS 102.25.2]. Qualifying assets are assets that necessarily take a substantial period of time to get ready for their intended use or sale and may include inventories. [FRS 102 Appendix I]. Inventories that are manufactured in large quantities on a repetitive basis are unlikely to meet the definition of qualifying assets. However, any manufacturer that produces small quantities of inventories over a long period of time (e.g., maturing stocks of wine or whisky) will have an accounting policy choice as to whether to include borrowing costs in the cost of these inventories. This is discussed further in Chapter 27.

3.2.8 Inventories acquired through a non-exchange transaction

Entities may sometimes enter into non-exchange transactions whereby the entity gives value to or receives value from another entity without directly receiving or giving approximately equal value in exchange.

[FRS 102 Appendix I].

Where inventories are acquired through a non-exchange transaction, their cost must be measured at their fair value as at the date of acquisition. [FRS 102.13.5A]. For entities other than public benefit entities, the fair value of inventories acquired through a non-exchange transaction must be determined by reference to the guidance Section 2A, which is discussed in Chapter 10.

For public benefit entities and entities within a public benefit entity group, Section 34 provides additional guidance on non-exchange transactions. As part of their normal business operations, public benefit entities may receive donations of cash, goods and services, and legacies which would meet the definition of non-exchange transactions. Public benefit entities and entities within a public benefit entity group must recognise inventories acquired through a non-exchange transaction at fair value only when required by Section 34. [FRS 102.13.5A]. Accounting for non-exchange transactions by public benefit entities and entities within a public benefit entity group is discussed further in Chapter 36 at 6.

3.2.9 Joint products and by-products

A production process may result in more than one product being produced simultaneously, for example when joint products are produced or where there is a main product and a by-product. If the costs of raw materials or converting each product are not separately identifiable, they must be allocated between the products on a rational and consistent basis. This may be, for example, based on the relative sales value of each of the products, either at the stage in the production process when the products become separately identifiable, or once production is complete. If the value of the by-product is immaterial, as is often the case, it must be measured at selling price less costs to complete and sell, with this amount then deducted from the cost of the main product. [FRS 102.13.10]. In the extractive industries, it is common for more than one product to be extracted from the same reserves therefore, joint and by-products are further discussed in the EY publication, International GAAP®.

3.2.10 Service providers

The February 2026 amendments to FRS 102, which are part of the 2024 Periodic Review, removed paragraph 13.114 which dealt specifically with the inventories of service providers - effectively their work in progress. This was replaced with the relevant requirements in Section 23 on costs to fulfil a contract. Section 23 divides contract fulfilment costs into two categories: (1) costs that give rise to an asset; and (2) costs that are expensed as incurred. When determining the appropriate accounting treatment for such service provider costs, Section 23 makes it clear that any other applicable sections of FRS 102 (e.g., Section 13, Section 17 and Section 18) are considered before Section 23. That is, if costs incurred in fulfilling a contract are within the scope of another section of FRS 102, an entity accounts for those costs in accordance with those other sections of FRS 102. [FRS 102.23.116, FRS 102.23.117]. Accordingly, if those other sections of FRS 102 preclude capitalisation of a particular cost, then an asset cannot be recognised under Section 23. If the costs incurred to fulfil a contract are not within the scope of another section of FRS 102, an entity capitalises such costs only if they meet all the criteria in Section 23 for the capitalisation of such costs (see Chapter 25 at 10.3.2).

3.2.11 Inventories held for distribution at no or nominal consideration

Inventories held for distribution at no or nominal consideration includes items such as advertising and promotional material, and also items that may be distributed to beneficiaries by public benefit entities. [FRS 102.A3.36].

FRS 102 requires inventories held for distribution at no or nominal consideration to be measured at the lower of cost adjusted, when applicable, for any loss of service potential and replacement cost. [FRS 102.13.4A]. Inventories held for distribution at no or nominal consideration could include advertising and promotional material.

FRS 102 provides no further guidance on how, or at what unit of account, service potential must be measured. It does not specify whether this must be at the individual asset level (e.g., the extent to which an individual catalogue is expected to generate future revenue for the entity) or based on a class of promotional material (e.g., the extent to which all catalogues printed for a particular year/season are expected to generate future revenue for the entity).

How we see it

In our view, an entity wishing to recognise a material inventory balance for advertising and promotional expenditure must ensure that it can sensibly justify how the entity will derive future benefit from the use of the materials.

The measurement basis described above (i.e., lower of cost adjusted for loss of service potential and replacement cost) is an application of fair value accounting as permitted by Schedule 1 to the Regulations, however for inventories held for distribution at no or nominal value (particularly items distributed to beneficiaries by public benefit entities) there is unlikely to be a significant difference between replacement cost and fair value. [FRS 102.A3.37].

The carrying amount of inventories held for distribution at no or nominal consideration must be recognised as an expense when the inventories are distributed. [FRS 102.13.20A].

3.2.12 Agricultural produce harvested from biological assets

Inventories comprising agricultural produce that an entity has harvested from its biological assets must be measured on initial recognition, at the point of harvest, at either: [FRS 102.13.15]

- Their fair value less costs to sell.

Or

- The lower of cost and estimated selling price less costs to complete and sell.

For the purposes of applying Section 13, this amount becomes the cost of the inventories at that date.

3.2.13 Cost measurement methods

FRS 102 allows the use of standard costing methods, the retail method or most recent purchase price for measuring the cost of inventories if the result approximates cost. [FRS 102.13.16].

Standard costs must take into account normal levels of materials and supplies, labour, efficiency and capital utilisation. They must be reviewed regularly and revised where necessary. [FRS 102.13.16].

The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin. This method is typically used in businesses with high volumes of various line items of inventory, where similar marks-ups are applied to ranges of inventory items or groups of items. In these circumstances, the cost of the inventory is determined by converting selling prices to cost by removing the normal mark-up.

A judgemental area in applying the retail method is in determining the margin to be removed from the selling price of inventory in order to convert it back to cost. The percentage has to take account of circumstances in which inventories have been marked down to below original selling price. Adjustments have to be made to eliminate the effect of these markdowns so as to prevent any item of inventory being valued at less than both its cost and its net realisable value. In practice, however, entities that use the retail method apply a gross profit margin computed on an average basis appropriate for departments and/or ranges, rather than applying specific mark-up percentages.

As noted above, FRS 102 also allows the use of the most recent purchase price as a cost measurement method. This method arrives at the cost of stock by applying the latest purchase price to the total number of units in stock. IAS 2 is silent on the use of this methodology. In practice, the use of the most recent purchase price is not a common method of measuring the cost of inventory. Where it is used, care must be taken to ensure that the result does approximate to the actual cost of inventories.

Items of inventory that are not interchangeable (i.e., where one item of inventory cannot easily be replaced with another item of inventory held by the entity) and goods or services produced and segregated for specific projects must have their costs specifically identified. [FRS 102.13.17]. These costs must be matched with the goods or services physically sold. Due to the clerical effort required, this is likely to be feasible only where there are relatively few high value items being bought or produced. Consequently, it would normally be used where inventory comprised items such as antiques, jewellery and vehicles in the hands of dealers.

When inventory comprises a large number of ordinarily interchangeable items, FRS 102 requires inventory to be measured using either a first-in, first-out (FIFO) or a weighted average cost formula. [FRS 102.13.18].

The FIFO method assumes that when inventories are sold or used in a production process, the oldest are sold or used first. Consequently, the balance of inventory on hand at any point represents the most recent purchases or production. The weighted average method involves the computation of an average unit cost by dividing the total cost of units by the total number of units. The average unit cost then has to be revised with every receipt of inventory, or at the end of predetermined periods. In practice, where it is not possible to value inventory on an actual costs basis, the FIFO method is generally used. However, the weighted average method is widely used in computerised inventory systems. In times of low inflation, or where inventory turnover is relatively quick, the FIFO and weighted average methods give similar results.

The last-in, first-out (LIFO) method of measuring the cost of inventory is not permitted by FRS 102. [FRS 102.13.18]. The LIFO method assumes that when inventories are sold or used in a production process, the most recent purchases are sold or used first. This method is an attempt to match current costs with current revenues so that the profit and loss account excludes the effects of holding gains. However, this results in inventories being stated on balance sheet at amounts which may bear little or no relationship to recent cost levels.

FRS 102 makes it clear that the same cost formula must be used for all inventories having a similar nature and use to the entity. However, different cost formulas may be justified for inventories with a different nature or use. [FRS 102.13.18].

3.2.14 Costs of real estate inventory

3.2.14.1 Allocation of costs to individual units in multi-unit developments

A real estate developer of a multi-unit complex will be able to track and record various costs that are specific to individual units, such as individual fit out costs. However, there will also be various costs that are incurred which are not specific to any individual unit, such as the costs of land and any shared facilities, and a methodology will be required to allocate these costs to the individual units. This will of course impact the profit that is recognised on the sale of each individual unit.

There are two general approaches to this allocation:

- The first approach is to allocate these non-unit specific costs based on some relative cost basis. A reasonable proxy of relative cost is likely to be the size of each unit and hence an appropriate methodology would be to allocate the non-unit specific cost per square metre to the individual units based upon the floor area of each unit. Another proxy of (total) relative cost may be the use of the specific cost of each unit. Marking up the specific cost that is attributable to each unit by a fixed percentage so as to cover and account for the non-unit specific costs would also seem reasonable. This relative cost approach is consistent with the guidance under Section 13 in respect of allocation of overheads which requires a “systematic allocation of fixed and variable production overheads”. [FRS 102.13.8].
- The second approach would be to allocate these non-unit specific costs based on the relative sales value of each unit. Although this methodology is specifically referred to by the standard in the context of a production process that results in more than one product being produced simultaneously. [FRS 102.13.10].

How we see it

In our view, both approaches discussed above are acceptable under IAS 2 when allocating non-unit specific costs to individual units in a multi-unit complex. Whichever approach is adopted it must be applied consistently. In addition, the developer must initially, as far as is practicable, segregate the non-unit specific costs between any commercial, retail and residential components before applying these methodologies.

3.2.14.2 Property demolition and lease costs

During the course of a property redevelopment project, an existing building may need to be demolished in order for the new development to take place. Must the cost of the building to be demolished be capitalised as part of the construction cost for the new building or must the cost be charged to profit or loss?

In all such cases an entity will need to exercise judgement in assessing the facts and circumstances. There are three distinct scenarios to consider:

- The entity is the owner-occupier, in which case the matter falls under IAS 16.
 - The entity holds the property to earn rentals or for capital appreciation, in which case the matter falls under IAS 40.
- Or
- The entity sells such properties in its ordinary course of business.

If it is the strategy of the developer to sell the developed property after construction, the new development falls within the scope of IAS 2, as it would be considered held for sale in the ordinary course of business by the developer. If the entity purchased the property in question consisting of land and an old building, it is our view that on initial recognition, the entity classifies the land and building as two separate items of property, plant and equipment under IAS 16, and measures the land and building based on cost, allocated to the land and building on a relative fair value basis, consistent with the measurement at initial recognition in IFRS 3.2(b). [IFRS 3.2(b)].

How we see it

In our view, the cost of the old building as well as demolition costs and costs of developing the new one would be treated as inventory if:

- At the time of purchase, it is the entity's intention to demolish the existing building.
- And
- The building will not be used or leased out prior to its demolition.

The cost of the new development will still be subject to the normal 'lower of cost and net realisable value' requirements.

If the property in question was purchased in a prior reporting period and subsequently occupied, the land and building would have been separately recognised in accordance with the requirements of IAS 16 in that period. Depending on the facts and circumstances, if the existing building was unusable, or likely to be demolished by any party acquiring it, the entity might have concluded that a large part of the purchase price related to the land. In such cases, the carrying amount of the existing building will likely be minimal. If the existing building is demolished in subsequent periods in order for the new development to take place, the carrying amount of the old building will be derecognised in accordance with IAS 16 (see Chapter 20 at 3.4.1.G).

How we see it

Whilst IAS 16 requires that land and buildings must be accounted for separately, even when they are acquired together, we believe that it may be appropriate for the acquirer to allocate a large proportion of the purchase price to the land if the existing building is unusable or likely to be demolished.

When the building is demolished under the circumstances described above, our view is that its carrying amount which is derecognised in accordance with IAS 16 cannot be capitalised as part of the cost of the new building.

If a new development within the scope of IAS 2 is being constructed on land that is leased, the entity needs to determine whether the depreciation charge relating to the right-of-use asset represents a cost of conversion in bringing the inventories to their present location and condition as specified in IAS 2.12. If the entity concludes that this is the case, a systematic allocation of the depreciation of the right-of-use asset relating to that leased land used in the development process is included in the cost of the inventories.

[IAS 2.12].

3.2.15 Additional company law considerations

As an alternative to the historical cost accounting rules set out above, the Regulations allow that where materials and consumables inventories are of a kind that are constantly being replaced, they may be recorded at a fixed quantity and value if: [1 Sch 26, 1 Sch 26 (LLP)]

- Their overall value is not material to the company.
- And
- Their quality, value and composition are not subject to material variation.

This treatment is not generally permitted by Section 13 and would be appropriate only if the result approximated the cost of inventories as determined by applying the measurement requirements of Section 13.

3.3 Impairment of inventories

In accordance with the requirements of Section 27 *Impairment of Assets*, entities must assess inventories for impairment at the end of each reporting period. Inventories are impaired if their carrying value exceeds their selling price less costs to complete and sell. Inventories may become impaired due to damage, obsolescence or declining selling prices. Where inventories are impaired, the carrying amount must be written down to selling price less costs to complete and sell. [FRS 102.13.19]. The reduction in carrying value is an impairment loss and must be recognised immediately in profit or loss. [FRS 102.27.2].

Assessing inventories for impairment must normally be done on an item-by-item basis. However, in many circumstances it will be impracticable to determine the selling price less costs to complete and sell on this basis. Where this is the case, items of inventory may be grouped. This may be the case for items of inventory relating to the same product line that have similar purposes, or end uses and are produced and marketed in the same geographical area. [FRS 102.27.3].

3.3.1 Selling price less costs to complete and sell

Section 32 *Events after the End of the Reporting Period* states that “the sale of inventories after the end of a reporting period may give evidence about their selling price at the end of the reporting period for the purpose of assessing impairment at that date.” [FRS 102.32.5(b)(ii)]. Events that have impacted selling prices after the end of the reporting period, such as damage to inventories as a result of a warehouse fire post year end, would not be relevant to the assessment of impairment at end of the reporting period. Other than this, FRS 102 gives no guidance on how to determine selling price or what costs must be included when assessing costs to complete and sell.

The requirement to measure inventories at the lower of cost and selling price less costs to complete and sell under FRS 102 is similar to the requirement under IFRS to carry inventories at the lower of cost and net realisable value. Entities may therefore choose to look to IFRS for further guidance in this area.

IFRS defines net realisable value as “the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.” [IAS 2.6].

IFRS is explicit that materials and other supplies held for use in the production of inventories are not written down below cost if the final product in which they are to be used is expected to be sold at or above cost. [IAS 2.32]. Whilst this is not explicit in FRS 102, we consider that this is consistent with the measurement principle of FRS 102. As such, we would not expect a whisky distiller, for example, to write down an inventory of grain because of a fall in the grain price, so long as it expected to sell the whisky at a price sufficient to recover cost. Conversely, if a provision is required in respect of finished goods, then work in progress and raw materials must also be reviewed to see if any further provision is required.

In estimating net realisable value, IFRS requires that entities must take into consideration the purpose for which inventory is held. For example, the net realisable value of inventory held to satisfy firm sales contracts is based on that contract price. [IAS 2.31]. This reflects the fact that net realisable value, unlike fair value, is an entity specific value.

How we see it

In our view, selling price less costs to complete and sell is also an entity specific measure intended to reflect the amount that the entity actually expects to make from selling particular inventories.

IAS 2 provides detailed guidance on determining net realisable value, however, the standard does not provide further guidance on how to determine “estimated costs necessary to make the sale”, a key component of the definition of net realisable value. Without detailed guidance on which costs to include when estimating net realisable value, entities need to apply judgement, which may include considering the nature of their products, sales channel (for example, in-store or online sales) and industry. This has led to diversity in practice. Incremental costs are often the starting point before considering whether additional costs need to be included and, in some cases, entities may have only considered those costs that are incremental.

The IFRS IC received a request for clarification on how to determine which costs must be included as part of the costs necessary to make the sale when determining the net realisable value in accordance with IAS 2. In June 2021, the IFRS IC decided not to add the matter to its standard-setting agenda. The IFRS IC observed that paragraph 28 of IAS 2 describes the objective of writing inventories down to their net realisable value which is to avoid inventories being carried “in excess of amounts expected to be realised from their sale”. [IAS 2.28]. The IFRS IC further observed that the requirement in paragraph 28 of IAS 2 does not allow an entity to limit such costs to only those that are incremental, thereby potentially excluding costs the entity must incur to sell its inventories but that are not incremental to a particular sale. Including only incremental costs could fail to achieve the objective set out in that paragraph of the standard. Judgement will be needed to determine which costs are necessary to make the sale considering each entity’s specific facts and circumstances, including the nature of the inventories.⁹⁶ There are a range of possibilities beyond the incremental cost approach: from direct costs at the point of sale (which might include, for example, a portion of the cost of internal sales staff or the cost of a special promotion campaign) to full costs (which might include costs such as depreciation or amortisation).

⁹⁶ [IFRIC Update](#), June 2021, Addendum. Available on the IFRS Foundation’s website.

Furthermore, within that range, direct costs at the point of sale may be quite similar to incremental costs. Which costs are considered necessary to sell inventories may vary by entity, depending on the nature of the inventories, the applicable industry, sales channel and cost structure.

How we see it

The incremental cost approach is no longer permitted if it excludes non-incremental costs that must be incurred to sell inventories. We do not believe it would be possible to limit which other approaches might be considered appropriate, depending on the specific facts and circumstances. This is because IAS 2 does not specify which costs to consider.

3.3.2 Reversal of impairment of inventory

As noted at 3.3 above, FRS 102 requires entities to assess inventories for impairment at the end of each reporting period. When the circumstances that previously caused inventories to be written down no longer exist, or when there is clear evidence of an increase in selling price less costs to complete and sell because of changed economic circumstances, the amount of the write down is reversed. The amount of the reversal cannot be greater than the amount of the original write down. This means that the new carrying amount of inventories following the reversal of an impairment will be the lower of its cost and the revised selling price less costs to complete and sell. [FRS 102.27.4].

3.4 Recognition of inventory in profit or loss

Section 13 states the following: [FRS 102.13.20]

Extract from Section 13

20 When inventories are sold, the entity shall recognise the carrying amount of those inventories as an expense in the period in which the related revenue is recognised.

However, some inventories go into the creation of another asset, such as self-constructed property, plant or equipment. In this case, the inventories form part of the cost of the other asset and are accounted for subsequently in accordance with the section of FRS 102 relevant to that asset type. [FRS 102.13.21].

Any impairment loss on inventory must be recognised immediately as an expense in profit or loss. [FRS 102.27.2].

The carrying amount of inventories held for distribution at no or nominal consideration (as discussed at 3.2.11 above) is recognised as an expense when the inventories are distributed. [FRS 102.13.20A].

3.5 Presentation and disclosure

3.5.1 Presentation of inventories

As discussed in Chapter 6 at 4.1, UK companies and qualifying partnerships applying Schedule 1 to the Regulations are permitted to use 'adapted formats' as an alternative to the statutory formats as set out in section B of Part 1 of Schedule 1. FRS 102's presentation requirements for adapted formats are similar but not identical to formats included in IAS 1 *Presentation of Financial Statements*. The two alternatives are set out below.

Where entities apply the statutory balance sheet formats, they are required by Schedule 1 to the Regulations to present inventories on the face of the balance sheet. Inventories must be further analysed, either on the face of the balance sheet or within the notes to the accounts, into:

- Raw materials and consumables.
- Work in progress.
- Finished goods and goods for resale.
- And
- Payments on account.

The classifications used in the disaggregation may be adapted dependent upon the nature of the company's business. [1 Sch 4(1)]. In practice, most companies present the disaggregation as a note to the financial statements.

Where 'adapted formats' are used, FRS 102 requires that inventories are shown on the face of the balance sheet. [FRS 102.4.2A]. Inventories must be further analysed, either in the statement of financial position or the notes, between amounts of inventories: [FRS 102.4.2B]

- Held for sale in the ordinary course of business.
 - In the process of production for such sale.
- And
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

3.5.2 Disclosure of inventories

FRS 102 requires an entity to disclose the following: [FRS 102.13.22]

Extract from Section 13

- 22 The entity shall disclose:
- (a) the accounting policies adopted in measuring inventories, including the cost formula used;
 - (b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
 - (c) [Deleted]
 - (d) impairment losses recognised or reversed in profit or loss in accordance with Section 27 Impairment of Assets; and
 - (e) the carrying amount of inventories pledged as security for liabilities.

The disclosure requirements of FRS 102 are similar to those required by IFRS, although IAS 2 also contains additional disclosure requirements not replicated in Section 13.

Where an entity has included borrowing costs in cost of inventories (see 3.2.7 above), the disclosure requirements of Section 25 will also be relevant. See Chapter 27 at 4.

3.5.2.A Additional company law disclosures

The Regulations includes the following additional disclosure requirements with respect to inventories:

- If finance costs are included in the cost of inventory, this fact, along with the amount included. [1 Sch 27(3)].
 - For large and medium companies where a costing method (such as FIFO, weighted average price or similar) has been applied, the difference between carrying value and replacement cost of inventories where this is material. [1 Sch 28(3)]. This may be determined by reference to the most recent purchase or production cost before the balance sheet date if this is considered by the directors of the company to give a more appropriate comparison. [1 Sch 28(5)].
- And
- Where there has been a departure from the historical cost convention, the fact that this is the case, the balances affected and the basis of valuation adopted. [1 Sch 34].

4 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Scope	Section 13 applies to inventories other than financial instruments and biological assets related to agricultural activity and agricultural produce at the point of harvest. The measurement rules of Section 13 also exclude inventories measured at fair value less costs to sell through profit or loss. See 3.1 above.	IAS 2 is similar to FRS 102 although there is a specific exclusion for commodity broker-dealers who measure inventories at fair value through profit or loss rather than a general exclusion for inventories measured in this way.
Measurement of inventory	Inventories are measured at the lower of cost and estimated selling price less costs to complete and sell. Section 13 provides prescriptive guidance on what may be and what must not be included in the cost of inventory. For inventories that meet the definition of qualifying assets, entities may choose to adopt an accounting policy of capitalising borrowing costs. See 3.2 above.	The measurement of inventory is similar to FRS 102, although borrowing costs must be capitalised if inventories meet the definition of qualifying assets.
Costs of inventories of a service provider	Section 13 provides specific guidance on the cost of inventories of a service provider. Inventories of a service provider are measured at the cost of their production. Costs consist primarily of the labour and other costs of personnel directly involved in providing the service, including supervisory personnel, and attributable overheads. See 3.2.10 above.	IAS 2 contains no guidance on cost of inventories of a service provider. IFRS 15 states that costs incurred in fulfilling a contract with a customer which are within the scope of another IFRS (e.g., IAS 2) must be accounted for under that standard. Otherwise, those costs are accounted for under IFRS 15 criteria. In practice, we believe any material GAAP difference is unlikely.
Impairment of inventory	FRS 102 provides limited guidance on assessing impairment of inventory. Inventory is impaired if its carrying amount exceeds its selling price less costs to complete and sell. See 3.3 above.	IAS 2 refers to 'net realisable value' rather than 'estimated selling price less costs to complete and sell' and provides substantial guidance on the identification of net realisable value. However, it is unlikely that a GAAP difference would arise in practice.
Inventory purchased on deferred payment terms	If the inventory is a qualifying asset and the entity adopts a policy of capitalising borrowing costs, the interest expense must be added to the cost of inventory. See 3.2.7 above.	If the inventory is a qualifying asset, the interest expense must be added to the cost of inventory.

FRS 102		IFRS
Inventories held for distribution at no or nominal consideration	These inventories, such as advertising and promotion items or items to be distributed to beneficiaries by public benefit entities, must be measured at cost adjusted, when applicable, for any loss of service potential and replacement cost. This is an application of fair value accounting. The carrying amount of those inventories must be recognised as an expense when they are distributed. See 3.2.11 above.	No guidance on inventories held for distribution at no or nominal consideration. IAS 38 - Intangible Assets - requires the cost of advertising and promotional material, such as mail order catalogues, to be recognised as an expense once the entity gains access to those materials (i.e., owns the goods). A GAAP difference may therefore arise.
Inventories acquired through non exchange transactions	Where an entity receives inventories without giving approximately equal value in exchange, the cost of the inventories must be measured as their fair value at the date of acquisition. See 3.2.8 above.	IFRS provides no specific guidance on inventories that are acquired through a non-exchange transaction.
Disclosures	FRS 102 requires fewer disclosures than IAS 2, although Company Law disclosures are also required. See 3.5.2 above.	IAS 2 requires some additional disclosures beyond those required by FRS 102. Company law disclosures are not required by entities reporting under IFRS.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

asset	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
fair value	The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in the Appendix to Section 2 Concepts and Pervasive Principles shall be used in determining fair value.
inventories	Assets: (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
inventories held for distribution at no or nominal consideration	Assets that are; (a) held for distribution at no or nominal consideration in the ordinary course of operations; (b) in the process of production for distribution at no or nominal consideration in the ordinary course of operations; or (c) in the form of material or supplies to be consumed in the production process or in the rendering of services at no or nominal consideration.
non-exchange transaction	A transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.
public benefit entity	An entity whose primary objective is to provide goods or services for general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives of rather than with a view to providing a financial return to equity providers, shareholders and members.
public benefit entity group	A public benefit entity parent and all of its wholly-owned subsidiaries.
qualifying asset	An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following might be qualifying assets: (a) inventories; (b) manufacturing plants; (c) power generation facilities; (d) intangible assets; and (e) investment properties. Financial assets, and inventories that are produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.
service potential	The capacity to provide services that contribute to achieving an entity's objectives. Service potential enables an entity to achieve its objectives without necessarily generating net cash inflows.

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Chapter 17

Investments in associates

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Overview

Section 14 *Investments in Associates* sets out the accounting for investments in associates and the equity method of accounting. An associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Joint ventures that are classified as jointly controlled entities are also generally accounted for using the equity method as described in Section 14.

The equity method of accounting involves a modified form of consolidation of the results and assets of the investees in the investor's financial statements. The essence of the equity method of accounting is that rather than full scale consolidation on a line-by-line basis, it requires incorporation of the investor's share (adjusted for basis differences, like fair value adjustments arising on initial acquisition of the interest in the associate or joint venture) of the investee's:

- Net assets, in one line in the investor's consolidated statement of financial position.
- Profit or loss, in one line in the investor's consolidated statement of profit or loss.
- Other comprehensive income, in one line in the investor's consolidated statement of other comprehensive income.

There has been debate about whether the equity method of accounting is primarily a method of consolidation or a method of valuing an investment as FRS 102 nor IFRS provide specific guidance either way. An investor that controls a subsidiary has control over the assets and liabilities of that subsidiary. While an investor that has significant influence over an associate or joint control of a joint venture controls its holding in the shares of the associate or joint venture, it does not control the assets and liabilities of that associate or joint venture. Therefore, the investor does not account for the assets and the liabilities of the associate or joint venture, but accounts only for its investment in the associate or joint venture as a whole. As there is no clear principle underlying the application of the equity method, different views on how to account for certain transactions for which the standard has no clear guidance might be taken, depending on which principle (i.e., consolidation or valuation of an investment) is deemed to take precedence.

What you need to know

- An investor has significant influence over an associate when it has the power to participate in the financial and operating policy decisions of the investee but does not have control or joint control of those policies.
- A holding of 20% or more of the voting power of the investee is presumed to give rise to significant influence, unless it can be clearly demonstrated that this is not the case.
- In its consolidated financial statements, an investor accounts for investments in associates using the equity method, unless the associate is held as part of an investment portfolio.
- Under the equity method, an associate is first recognised at its cost, including any directly attributable expenditures.
- The carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the associate after the date of acquisition adjusted for the effect of fair value adjustments on acquisition and goodwill amortisation. Distributions received from the associate reduce the carrying amount of the investment.
- Equity method losses are recognised until the investor's interest in the associate is reduced to zero.
- The equity method is discontinued when the investment ceases to be an associate.
- Section 14 permits entities that are not parents, and parent entities preparing separate financial statements, to account for their investment in associates at cost less impairment losses, at fair value with changes in fair value recognised through other comprehensive income (without recycling) or at fair value with changes in fair value recognised through profit or loss.

1 Introduction

Section 14 applies to investments in associates in:

- Consolidated financial statements
- And
- The individual financial statements of an investor that is not a parent

In its separate financial statements, an entity that is a parent accounts for investments in associates in accordance with paragraphs 9.26 and 9.26A of Section 14, i.e., at cost less impairment losses, fair value with changes in fair value recognised through other comprehensive income (without recycling) or at fair value with changes in fair value recognised through profit or loss. See Chapter 8 at 4 for further detail on individual and separate financial statements.

2 Comparison between Section 14 and IFRS

There are a number of differences between the accounting and disclosure requirements in Section 14 compared to IFRS accounting standards (IAS 28 *Investments in Associates and Joint Ventures*). The key differences are discussed below and summarised at 5 below.

2.1 Measurement - individual and separate entity financial statements

Section 14 permits entities that are not parents to account for their investment in associates at cost less impairment, at fair value with changes in fair value recognised through other comprehensive income (unless reporting gains and losses on revaluations in accordance with paragraphs 17.15E and 17.15F) or at fair value with changes in fair value recognised through profit or loss (see 3.2.1.A below). [FRS 102.14.4]. The same accounting policy choice is available for an investor preparing separate financial statements in accordance with Section 9 *Consolidated and Separate Financial Statements*. [FRS 102.9.26].

Under IFRS, an entity that is not a parent must prepare financial statements whereby its investments in associates are accounted for under the equity method accounting unless it meets the criteria for exemption. [IAS 28.16, IAS 28.17]. An election is available for investments in associates held by, or indirectly through, a venture capital organisation, mutual fund, unit trust or similar entities including investment-linked insurance funds, to measure their investment in an associate at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*. [IAS 28.18]. This election extends to portions of an investment held indirectly through venture capital and similar organisations, whereby the investor may elect to measure the portion of the investment so held at fair value through profit and loss in accordance with IFRS 9, regardless of whether the vehicle the investment is held through has significant influence over that portion of the investment. If this election is made, the equity method must be applied to the remaining portion of the investment in an associate that is not held through such a vehicle. [IAS 28.19]. This election also applies in the investor's individual financial statements, but in any case, an investor preparing separate financial statements under IFRS, has an accounting policy choice of measuring investments in associates at cost, fair value in accordance with IFRS 9 or the equity method of accounting. [IAS 27.10].

2.2 Investment portfolios/funds

Under Section 14, an investor that is a parent and has investments in associates that are held as part of an investment portfolio is required to measure those investments at fair value with changes in fair value recognised in profit or loss in the consolidated financial statements. [FRS 102.14.4B].

Under IAS 28, the measurement of investments in associates at fair value through profit or loss in consolidated financial statements is an option that is available only for an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds or one which holds its investments indirectly through such an entity. [IAS 28.18].

2.3 Accounting for the acquisition of an associate

Section 14 requires the use of Section 19 *Business Combinations and Goodwill* to determine the implicit goodwill on the acquisition of an associate. This goodwill is then amortised over its useful life.

[FRS 102.14.8(c), FRS 102.19.23].

Under IAS 28, the implicit goodwill is not amortised. [IAS 28.32(a)].

2.4 Loss of significant influence

Section 14 requires that where loss of significant influence is a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds and the carrying amount relating to the proportion disposed of. The carrying value of the equity interest retained at the date significant influence is lost becomes the cost of the retained investment and there is no re-measurement of the retained interest at fair value.

[FRS 102.14.8(i)(i)].

If the loss of significant influence is for reasons other than a partial disposal, for example as a result of a changes to the board of directors or equivalent governing body that results in a loss of significant influence, no gain or loss is recognised and the carrying value of the equity-accounted investment at the date significant influence is lost becomes the cost of the retained investment. [FRS 102.14.8(i)(ii)].

Under IFRS, where loss of significant influence is a result of a partial disposal, a gain or loss is recognised based on any difference between the disposal proceeds together with the fair value of any retained interest and the carrying amount of the total interest in the associate. Similarly, if the loss of significant influence is for reasons other than a partial disposal, a gain or loss is recognised based on the fair value of the retained interest and the carrying amount of the interest in the associate at that date. [IAS 28.22].

2.5 Transactions to create an associate

Section 9 sets out the requirements when an investor exchanges a business or other non-monetary asset for an interest in an associate. If the fair value of the consideration received by the investor exceeds the carrying value of the assets exchanged, any related goodwill and any cash given up, the investor recognises a gain. Any unrealised gain arising on the exchange is recognised in other comprehensive income. If the fair value of the consideration received is less than the carrying value of what has been exchanged, together with any related goodwill and cash given up, a loss is recognised in profit or loss (see 3.2.2.K below).

[FRS 102.9.31].

IFRS does not distinguish between realised and unrealised gains for equivalent transactions and requires that any gain or loss, realised or unrealised, is recognised in profit or loss. [IFRS 10 Appendix B.98].

3 Requirements of Section 14 for investments in associates

3.1 Definitions of an associate, and related terms

3.1.1 Associate

Section 14 defines an associate as an entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. *[FRS 102.14.2].*

- A similar definition is contained in UK Company law which defines an 'associated undertaking' as an undertaking in which an undertaking included in the consolidation has a participating interest and over whose operating and financial policy it exercises a significant influence, and which is not:
- A subsidiary undertaking of the parent company.

Or

A joint venture dealt with in accordance with the paragraph on joint ventures. *[6 Sch 19(1)].*

- A 'participating interest' is an interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest. The interest in shares includes interests which are convertible into shares or options to acquire shares, regardless of whether they are currently exercisable. Additionally, interests held on behalf of an undertaking are to be treated as held by it. *[10 Sch 11(1), 10 Sch (3), 10 Sch (4)].*

3.1.2 Significant influence

Fundamental to the definition of an associate is the concept of significant influence. This is defined as "the power to participate in the financial and operating policy decisions of the associate but is not control or joint control over those policies". *[FRS 102.14.3].*

Under Section 14, a holding of 20% or more of the voting power of the investee (held directly or indirectly, through subsidiaries) is presumed to give rise to significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, a holding of less than 20% of the voting power is presumed not to give rise to significant influence, unless it can be clearly demonstrated that significant influence does exist. The existence of a substantial or majority interest of another investor does not necessarily preclude the investor from having significant influence. *[FRS 102.14.3].* UK company law also contains a rebuttable presumption of significant influence when an undertaking holds 20% or more of the voting rights of another undertaking unless the contrary is shown. *[6 Sch 19(2)].*

How we see it

In our view, an entity considers both ordinary shares and other categories of shares in determining its voting rights, because Section 14 focuses on 'voting power'.

Other factors need to be considered to determine whether significant influence exists or not and to potentially rebut any presumptions above regarding voting power. The existence of significant influence can also be evidenced in the following ways:

- Representation on the board of directors or equivalent governing body of the investee.
- Participation in policy-making processes, including participation in decisions about dividends and other distributions.
- Material transactions between the entity and the investee.
- Interchange of managerial personnel.

Or

- Provision of essential technical information. *[FRS 102.14.3A].*

Significant influence may also exist over another entity through potential voting rights (see 3.1.2.D below).

An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, as a result of a contractual agreement or when an associate becomes subject to the control of a government, court, administrator or regulator.

An entity with an interest in an associate will need to evaluate the facts and circumstances, whenever a change to those facts and circumstances is identified, to assess whether it is still able to exercise significant influence over the financial and operating policies of the investee.

The accounting for loss of significant influence over an associate is discussed at 3.2.2.J below.

3.1.2.A Lack of significant influence

The presumption of significant influence due to the existence of 20% or more of the voting power can sometimes be rebutted, for example when:

- The investor has tried and failed to obtain representation on the investee's board of directors.
 - The investee, other shareholders or regulatory authorities are opposing the investor's attempts to exercise significant influence.
 - The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder, such as a standstill agreement.
 - The investor is unable to obtain timely or adequate financial information required to apply the equity method.
- Or
- A group of shareholders that holds the majority ownership of the investee operates without regard to the views of the investor.

How we see it

Determining whether the presumption of significant influence has been overcome requires considerable judgement. In our experience, many regulators take a keen interest in these decisions.

3.1.2.B Holdings of less than 20% of the voting power

Although there is a presumption that an investor that holds less than 20% of the voting power in an investee does not have significant influence, [FRS 102.14.3(b)], where investments give rise to less than 20% of the voting power careful judgement is needed to assess whether there are other indicators that significant influence exists.

For example, an investor might be able to exercise significant influence in the following circumstances:

- The investor's voting power is much larger than that of any other shareholder of the investee.
 - The corporate governance arrangements are such that the investor can appoint members to the board, supervisory board or significant committees of the investee. The investor will need to apply judgement to the facts and circumstances to determine whether representation in the respective boards or committees is enough to provide significant influence.
- Or
- The investor has the power to veto significant financial and operating decisions.

How we see it

Determining whether the indicators above result in an investor having significant influence despite a holding of less than 20% of the voting power requires considerable judgement.

3.1.2.C Voting rights in UK company law

The provisions of paragraphs 5 to 11 of Schedule 7 to the 2006 Act (parent and subsidiary undertakings: rights to be taken into account and attribution of rights) apply in determining whether an undertaking holds 20% or more of the voting rights in another undertaking. [6 Sch 19(4)].

The 'voting rights' in an undertaking are the rights conferred on shareholders in respect of their shares or, in the case of an undertaking not having a share capital, on members, to vote at general meetings of the undertaking on all, or substantially all, matters. [6 Sch 19(3)].

Voting rights on shares held as security remain the rights of the provider of the security and are not considered if the rights are only exercisable in accordance with instructions from the provider of the security or in his interest. [7 Sch 8]. Similarly, voting rights that are held in a fiduciary capacity by the entity are treated as not held by the entity. [7 Sch 6]. Voting rights held by a nominee on behalf of the entity must be treated as held by the entity. Rights are regarded as held as nominee for another if the rights are only exercisable on the other's instruction or with the other's consent. [7 Sch 7].

The voting rights referred to above must be reduced by any rights held by the undertaking itself. [7 Sch 10].

3.1.2.D Potential voting rights

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights).

Section 14 requires that an entity must consider the existence and effect of potential voting rights in deciding whether significant influence exists. [FRS 102.14.8(b)]. Potential voting rights must only be considered if they are currently exercisable or convertible. [FRS 102.14.3A].

Potential voting rights are not currently exercisable or convertible when they cannot be exercised or converted until a future date or until the occurrence of a future event. [FRS 102.14.3A]. The meaning of currently exercisable or convertible is discussed further in Chapter 8 at 3.2.1.

Consistent with that discussion, IAS 28 (on which the requirements of Section 14 are based) states that in assessing whether potential voting rights contribute to significant influence, an entity must examine:

- All facts and circumstances (including the terms of exercise of the potential voting rights) both of the reporting entity and of other parties.

And

- Any other contractual arrangements (whether considered individually or in combination) that affect potential voting rights, except the intention of management and the financial ability to exercise or convert those potential voting rights. [IAS 28.8].

3.1.2.E Voting rights held in a fiduciary capacity

Voting rights on shares held as security by an entity remain the rights of the provider of the security and are generally not taken into account if the rights are only exercisable in accordance with instructions from the provider of the security or in his interest. Similarly, voting rights that are held in a fiduciary capacity may not be those of the entity itself. If voting rights are held by a nominee on behalf of the entity, they must be taken into account. [7 Sch 6, 7 Sch 7, 7 Sch 8].

3.2 Measurement

3.2.1 Accounting policy options

3.2.1.A Investor not a parent

An entity that is not a parent accounts for investments in associates in its individual financial statements either:

- Using the cost model (see 3.2.3 below).
- Fair value with changes in fair value recognised in OCI (or profit or loss) in accordance with paragraphs 15E and 15F of Section 17 *Property, Plant and Equipment*

Or

- At fair value with changes in fair value recognised in profit or loss (see 3.2.4 below and Chapter 4). [FRS 102.14.4].

The measurement options are an accounting policy choice. Section 14 does not contain the additional guidance in Section 9 that requires a parent to apply the same accounting policy to all investments in a single class. [FRS 102.9.26]. A class is a grouping of assets of a similar nature and use in an entity's operations. [FRS 102 Appendix I]. However, applying the GAAP hierarchy in Section 10 as discussed in Chapter 9 at 3.2, it is logical to apply the same accounting policy to a single class of associates. A discussion of the meaning of class of investment in this context is in Chapter 8 at 4.2.

How we see it

As discussed in Chapter 8 at 4.2, in our view, associates or jointly controlled entities held as part of an investment portfolio could be considered as a separate class from other associates or jointly controlled entities in the separate financial statements of a parent. While Sections 14 and 15 do not specifically refer to different classes of associates and jointly controlled entities, we believe that an entity that is not a parent may similarly adopt a different accounting policy in accounting for associates and jointly controlled entities held as part of an investment portfolio to that applied to other associates and jointly controlled entities in its individual financial statements.

There is no option in Section 14 to use the equity method of accounting in individual financial statements even though permitted by Regulations. *[FRS 102.BC.A.28, 1 Sch 29A]*. However, the individual financial statements of an investor that is not a parent must disclose summarised financial information about its investments in associates, along with the effect of including those investments as if they had been accounted for using the equity method. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement. *[FRS 102.14.15A]*.

3.2.1.B Investor that is a parent

In its consolidated financial statements, an investor that is a parent accounts for its investments in associates using the equity method of accounting (see 3.2.2 below), subject to the exception below. *[FRS 102.14.4A]*.

When an associate is held as part of an investment portfolio it is measured at fair value with changes in fair value recognised in profit or loss in the consolidated financial statements. *[FRS 102.14.4B]*.

An investment is held as part of an investment portfolio if its value to the investor is through fair value as part of a directly or indirectly held basket of investments rather than as a media through which the investor carries out business. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments. (see Chapter 8 at 3.4.2.A). *[FRS 102 Appendix I]*.

An entity that is a parent accounts for its investments in associates in its separate financial statements in accordance with paragraphs 9.26 and 9.26A of Section 9 (see Chapter 8 at 4.2). *[FRS 102.14.1]*.

3.2.2 Equity method

Under the equity method, an investment is initially recognised at the transaction price (including transaction costs) and is subsequently adjusted to reflect the investor's share of: *[FRS 102.14.8]*

- Profit or loss
- Other comprehensive income
- And
- Equity of the associate

The investor's share of the associate's profit or loss is recognised in the investor's profit or loss. *[FRS 102.5.5, FRS 102.5.5B, 6 Sch 20(3)]*. The investor's share of the associate's other comprehensive income is recognised in the investor's statement of comprehensive income. *[FRS 102.5.5A(b)]*.

Transaction costs are defined in FRS 102 in the context of financial instruments as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial asset or liability. *[FRS 102 Appendix I]*. In the context of fair value measurement, transactions costs are considered to be the costs to sell an asset or transfer a liability in the principal or most advantageous market and are directly attributable to the disposal of the asset or transfer of the liability and result directly from and are essential to that transaction and would not have been incurred had the decision to sell the asset or transfer the liability not been made. *[FRS 102 Appendix I]*.

In the context of Section 14, transaction costs comprise any costs directly attributable to the acquisition of the interest in the associate.

Illustration 3-1 below demonstrates basic application of the equity method.

Illustration 3-1: Application of the equity method

On the first day of its financial year, Entity A acquires a 35% interest in Entity B, over which it exercises significant influence. A paid £475,000 for its interest in B. The carrying value of B's net identifiable assets at acquisition date was £900,000, and the fair value was £1,100,000. The difference of £200,000 relates to an item of property, plant and equipment with a remaining useful life of 10 years. During the year, B made a profit of £80,000 and paid a dividend of £120,000. B also had a gain in other comprehensive income of £20,000 during the year. Goodwill is assumed to have a 10 year useful life. For the purposes of the example, any deferred tax implications have been ignored.

A accounts for its investment in B under the equity method as follows:

	£	£
Acquisition of investment in B		
Share in carrying value of B's net assets: 35% of £900,000	315,000	
Share in fair valuation of B's net assets: 35% of (£1,100,000 - £900,000) *	70,000	
Goodwill on investment in B: £475,000 - £315,000 - £70,000 *	90,000	
Cost of investment		475,000
Profit during the year		
Share in the profit reported by B: 35% of £80,000	28,000	
Adjustment to reflect additional depreciation on fair value adjustment* 35% of ((£1,100,000 - £900,000) ÷ 10 years)	(7,000)	
Goodwill amortisation (£90,000 ÷ 10 years)*	(9,000)	
Share of profit in B recognised in income by A (equity method income)		12,000
Share of other comprehensive income recognised by A: 35% of £20,000		7,000
Dividend received by A during the year		
35% of £120,000 (debit cash, credit investment)		(42,000)
End of the financial year		
Share in carrying value of B's net assets:		
£315,000 + 35% (£80,000 - £120,000 + £20,000)	308,000	
Share in fair valuation of B's net assets: £70,000 - £7,000*	63,000	
Goodwill on investment in B: £90,000 - £9,000*	81,000	
Closing balance of A's investment in B		452,000

* These line items are often referred to as 'basis differences' and are combined with the ones immediately above.

3.2.2.A Date of commencement of equity accounting

An investor begins equity accounting for an associate from the date on which it obtains significant influence (and is not otherwise exempt from equity accounting). In most situations, this is when the investor purchases the investment in the associate. However, it may be that the investor obtains significant influence as a result of a piecemeal acquisition. These are discussed at 3.3.1.B below.

3.2.2.B Date of associate's financial statements

In applying the equity method, the investor must use the financial statements of the associate as of the same date as the financial statements of the investor unless it is impracticable to do so. [FRS 102.14.8(f)]. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. [FRS 102 Appendix I].

Otherwise, an investor must use the most recently available financial statements of the associate. Adjustments are then made for the effects of significant transactions or events, for example a sale of a significant asset or a major loss on a contract, that occurred between that date and the date of the investor's financial statements. [FRS 102.14.8(f)].

3.2.2.C Associate's accounting policies

If an associate uses accounting policies different from those of the investor for like transactions and events in similar circumstances, adjustments must be made to conform the associate's accounting policies to those of the investor when the associate's financial statements are used by the investor in applying the equity method unless it is impracticable to do so. *[FRS 102.14.8(g)]*.

In practice, this may be difficult, since an investor's influence over an associate, although significant, may still not be sufficient to ensure access to the relevant underlying information in sufficient detail to make such adjustments with certainty. Restating the financial statements of an overseas associate to FRS 102 may require extensive detailed information that might not be required under the associate's local GAAP (for example, in respect of business combinations, share-based payments, financial instruments and revenue recognition).

3.2.2.D Implicit goodwill and fair value adjustments

Section 14 states that on acquisition of an investment in an associate, any difference between the cost of acquisition and the investor's share of the net fair values of the investee's identifiable assets and liabilities are to be accounted for in accordance with Section 19 as implicit goodwill (see Chapter 22 at 3.9), as follows: *[FRS 102.14.8(c)]*

- Any goodwill relating to an associate is included in the carrying amount of the investment. After initial recognition, the acquirer measures goodwill included in the carrying amount of the investment at cost less accumulated amortisation (but not impairment, see 3.2.2.I below). Goodwill is considered to have a finite useful life and must be amortised on a systematic basis over its life. If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life must not exceed 10 years. Any amortisation is recognised against the investor's share of the associate's profit or loss. *[FRS 102.19.23]*
- If the acquirer's interest in the net amount of the associate's identifiable assets, liabilities and provisions for contingent liabilities exceeds the cost of the investment (also referred to as negative goodwill), the acquirer must (after reassessing the identification and measurement of the acquiree's assets and liabilities and the measurement of the cost of the combination) recognise the excess up to the fair value of the non-monetary assets acquired in the associate's profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of the non-monetary assets acquired is recognised in profit or loss in the periods expected to be benefited (see Chapter 22 at 3.9.3). *[FRS 102.19.24]*.

Section 14 also states that an investor adjusts its share of the associate's profits or losses after acquisition in order to account, for example, for additional depreciation or amortisation of the depreciable assets or amortisable assets (including goodwill) on the basis of the excess of their fair values over their carrying amounts at the time the investment was acquired. *[FRS 102.14.8(c)]*.

3.2.2.E Potential voting rights and share of the investee

In applying the equity method, the proportionate share of the associate to be accounted for, in many cases, will be based on the investor's ownership interest in the ordinary shares of the investee.

Although potential voting rights need to be considered in determining whether significant influence exists (see 3.1.2.D above) an investor measures its share of profit or loss and other comprehensive income of the associate as well as its share of changes in the associate's equity based on present ownership interests.

Those measurements do not reflect the possible exercise or conversion of potential voting rights.

[FRS 102.14.8(b)].

If an associate has outstanding cumulative preference shares that are held by parties other than the investor and that are classified as equity, the investor computes its share of profits or losses after adjusting for the dividends on such shares, whether or not the dividends have been declared.

Illustration 3-2: Cumulative preference shares issued by an associate

An entity holds an investment of 30% in the ordinary shares of an associate that has net assets of £200,000 and net profit for the year of £24,500. The associate has issued 5,000 cumulative preference shares with a nominal value of £10 which entitle its holders to a 9% cumulative preference dividend. The cumulative preference shares are classified by the associate as equity in accordance with the requirements of Section 22 *Liabilities and Equity*. The associate has not declared dividends on the cumulative preference shares in the past two years.

The investor calculates its share of the associate's net assets and net profit as follows:

	£
Net assets	200,000
9% Cumulative preference shares	(50,000)
Undeclared dividend on cumulative preference shares 2 years × 9% × £50,000 =	(9,000)
Net assets value attributable to ordinary shareholders	<u>141,000</u>
Investor's 30% share of the net assets	<u>42,300</u>
Net profit for the year	24,500
Share of profit of holders of cumulative preference shares 9% of £50,000 =	(4,500)
Net profit attributable to ordinary shareholders	<u>20,000</u>
Investor's 30% share of the net profit	<u>6,000</u>

If the investor also owned all of the cumulative preference shares, it would assess whether those preference shares are accounted for under the equity method or as a long-term interest. If accounted for using the equity method, its share in the net assets of the associate would be £42,300 + £50,000 + £9,000 = £101,300. Its share in the net profit would be £6,000 + £4,500 = £10,500.

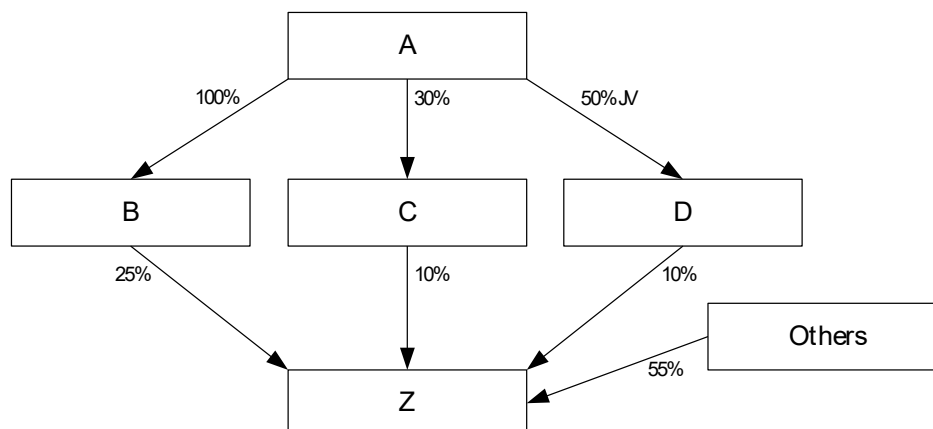
When an associate has a complicated equity structure with several classes of equity shares that have varying entitlements to net profits and equity, the investor needs to assess carefully the rights attaching to each class of equity share in determining the appropriate % of ownership interest.

An investor that holds ordinary shares in an entity which also has preference shares where the preference shareholders are entitled to a cumulative dividend on the net profits and have a liquidation preference in respect of the nominal value of the shares will need to carefully assess what its appropriate share in the profits and equity of that entity are. The investor would take the liquidation preference into account in calculating its interest in the associate or joint venture to the extent that there is economic substance to that right.

Section 14 does not address the situation of a group, in which the parent and its subsidiaries hold shares in the associate. However, based on the requirements of IAS 28, a group's share in an associate is the aggregate of the holdings in that associate by the parent and its subsidiaries. Holdings in the associate by the group's other associates or joint ventures are ignored for this purpose. [IAS 28.27].

Illustration 3-3: Share in an associate

Parent A holds a 100% investment in Subsidiary B, which in turn holds a 25% investment in Associate Z. In addition, Parent A also holds a 30% investment in Associate C and a 50% investment in Joint Venture D, each of which holds a 10% investment in Associate Z.



In its consolidated financial statements Parent A accounts for a 25% investment in Associate Z under the equity method because:

- The investments in associate Z held by associate C and joint venture D are not taken into account.
- Parent A consolidates the assets of Subsidiary B, which include a 25% investment in Associate Z.

Section 14 does not address the situation where an associate itself has subsidiaries, associates or jointly controlled entities. However, based on the CA 2006 and the requirements of IAS 28, the profits or losses, other comprehensive income and net assets taken into account when the investor applies the equity method are those recognised in the associate's consolidated financial statements, but after any adjustments necessary to give effect to uniform accounting policies (see 3.2.2.C above). [6 Sch 21(2), IAS 28.27].

It may be that the associate does not own all the shares in some of its subsidiaries, in which case its consolidated financial statements will include non-controlling interests. Under the CA 2006, any non-controlling interests are presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent. Profit or loss and each component of other comprehensive income are attributed to the owners of the parent and to the non-controlling interests. [FRS 102.6.3(a)].

The profit or loss and other comprehensive income reported in the associate's consolidated financial statements will include 100% of the amounts relating to the subsidiaries, but the overall profit or loss and total comprehensive income will be split between the amounts attributable to the owners of the parent (i.e., the associate) and those attributable to the non-controlling interests. The net assets in the associate's consolidated statement of financial position will also include 100% of the amounts relating to the subsidiaries, with any non-controlling interests in the net assets presented in the consolidated statement of financial position within equity, separately from the equity of the owners of the parent.

Section 14 does not address whether the investor's share, for equity accounting purposes, of the associate's profits, other comprehensive income and net assets must be based on the amounts before or after any non-controlling interests in the associate's consolidated financial statements. However, as the investor's interest in the associate is as an owner of that associate (which is itself a parent), it is appropriate that the share is based on the profit or loss, other comprehensive income and equity (net assets) that are reported as being attributable to the owners of the parent in the associate's consolidated financial statements, i.e., after any amounts attributable to the non-controlling interests.

How we see it

In our view, when an investee does not wholly own its subsidiaries, since the investor's interest in the associate is as an owner of the parent, its share of its associate's or joint venture's profits is based on the amounts that are reported as attributable to the owners of the parent (controlling interest) in the associate's consolidated financial statements, i.e., after any amounts attributable to the NCI.

3.2.2.F Distributions and other adjustments to carrying amount

Distributions received from an associate reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary due to changes in the associate's equity from items of its other comprehensive income. [FRS 102.14.8(a)].

Such changes could include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of the investee's other comprehensive income is recognised in the investor's statement of comprehensive income. [FRS 102.5.5A]. Distributions received in excess of the carrying amount of the associate are dealt with at 3.3.2 below.

3.2.2.G Investor's transactions with associates

Section 14 requires unrealised profits and losses resulting from what it refers to as 'upstream' (associate to investor) and 'downstream' (investor to associate) transactions between an investor (including its consolidated subsidiaries) and an associate to be eliminated from the investor's financial statements to the extent of investor's interest in the associate. Unrealised losses on such transactions may provide evidence of an impairment of the asset transferred. [FRS 102.14.8(e)].

'Upstream' transactions are, for example, sales of assets from an associate to the investor. 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate.

Section 14 provides no further guidance as to how this broadly expressed requirement translates into accounting entries.

How we see it

We believe that an appropriate approach for presenting these entries is as follows:

- In the income statement, the adjustment is taken against either the investor's profit or the share of the associate's profit, according to whether the investor or the associate recorded the profit on the transaction, respectively.
- In the statement of financial position:
 - If the asset subject to the transaction is held by the associate, the adjustment is made against the carrying amount for the associate (see Illustration 3-6 below).
 - Or
 - If the asset subject to the transaction is held by the investor, entities have an accounting policy choice as to where the adjustment is made. It is acceptable to make the adjustment either against the carrying amount of the associate or against the asset which was the subject of the transaction. This latter approach is shown in Illustration 3-7 below.

Illustration 3-6 and Illustration 3-7 below show the adjustment against the asset which is the subject of the transaction. Both Illustrations deal with the reporting Entity H and its 40% Associate A. The journal entries are based on the premise that H's financial statements are initially prepared as a simple aggregation of H and the relevant share of its associate. The entries below would then be applied to the numbers at that stage of the process.

Illustration 3-4: Elimination of profit on sale by investor to associate ('downstream transaction')

One month before its reporting date, Entity H sells inventory costing £750,000 to Associate A for £1 million, all of which remains in A's inventory at the reporting date.

H recorded revenue of £1 million and cost of sales of £750,000. However since, at the reporting date, the inventory is still held by A, only 60% of this transaction is regarded by FRS 102 as having taken place (in effect with the other shareholders of A). This is reflected by the elimination accounting entry:

	£	£
Dr Revenue	400,000	
Cr Cost of sales		300,000
Cr Investment in A		100,000

This entry effectively defers recognition of 40% of the profit on sale (£250,000 x 40%) and offsets the deferred profit against the carrying amount of H's investment in A.

After the reporting date, when the inventory is sold to a third party for £1.2 million, this deferred profit can be released by H, reflected by the following equity accounting entry:

	£	£
Dr Investment in A	100,000	
Dr Cost of sales	300,000	
Cr Revenue		400,000

An alternative approach would be to eliminate the profit on 40% of the sale against the cost of sales. Before the reporting date, this is reflected by the equity accounting entry:

	£	£
Dr Cost of sales	100,000	
Cr Investment in A		100,000

After the reporting date, when the inventory is sold to a third party for £1.2m by A, this deferred profit can be released by H, reflected by the following equity accounting entry:

	£	£
Dr Investment in A	100,000	
Cr Cost of sales		100,000

An argument in favour of the alternative approach is that the revenue figures are not adjusted because the sales to associates are disclosed as related party transactions. However, this approach causes volatility in H's reported gross margin as revenue and the related net margin are not recognised in the same accounting period.

Illustration 3-5: Elimination of profit on sale by associate to reporting entity ('upstream transaction')

This is the mirror image of the transaction in Illustration 3-6 above. Before H's reporting date, A sells inventory costing £750,000 to H for £1 million.

A recognised a profit of £250,000 (£1 million - £750,000), 40% of which (£100,000) is regarded under FRS 102 as unrealised by H, and is therefore deferred and offset against inventory:

	£	£
Dr Equity method earnings in A	100,000	
Cr Inventory		100,000

In the following period, when the inventory is sold to a third party for £1.2 million by H, the entry is reversed:

	£	£
Dr Inventory	100,000	
Cr Equity method earnings in A		100,000

Under this approach, at the reporting date, the investment in A will have increased by £100,000 more than the share of profit of associates as reported in the group profit or loss (and in the following period by £100,000 less). This is because the adjustment to the statement of financial position at the reporting date is to inventory rather than the carrying value of the investment in A, reflecting the fact that A has, indeed, made a profit. It might therefore be necessary to disclose the reasons for this difference in the notes to the financial statements.

Note that unrealised losses on upstream and downstream transactions might provide evidence of an impairment in the asset transferred. [FRS 102.14.8(e)].

The effect of these requirements is illustrated in Illustration 3-8 and Illustration 3-9 below.

Illustration 3-6: Sale of asset from an investor to associate at a loss

Entity A holds 40% of Entity B, giving it significant influence. B acquires a property from A for £8 million cash and the property was recorded in the financial statements of A at £10 million. £8 million is agreed to be the fair market value of the property. How must A account for these transactions?

The required accounting entry by A is as follows:

	£m	£m
Dr Cash ⁽¹⁾	8	
Dr Loss on sale ⁽²⁾	2	
Cr Property ⁽³⁾		10

(1) £8 million received from B.

(2) Loss on sale of property £2 million (£8 million received from B less £10 million carrying value = £2 million) not adjusted since the transaction indicated an impairment of the property. In effect, it is the result that would have been obtained if A had recognised an impairment charge immediately prior to the sale and then recognised no gain or loss on the sale.

(3) Derecognition of A's original property

Illustration 3-7: Sale of asset from associate to an investor at a loss

Entity A holds 40% of Entity B giving it significant influence. B acquires a property for £8 million from an independent third-party C. The property is then sold to A for £7 million, which is agreed to be its market value. How must A account for these transactions?

The required accounting entry by A is as follows:

	£m	£m
Dr Property ⁽¹⁾	7.0	
Dr Share of loss of B ⁽²⁾	0.4	
Cr Investment in B		0.4
Cr Cash ⁽³⁾		7.0

(1) £7 million paid to B not adjusted since the transaction indicated an impairment of B's asset.

(2) Loss in B's books is £1 million (£8 million cost of property less £7 million proceeds of sale). A recognises its 40% share because the transaction indicates an impairment of the asset. In effect, it is the result that would have been obtained if B had recognised an impairment charge immediately prior to the sale and then recognised no gain or loss on the sale.

(3) £7 million consideration for the property.

Elimination of 'downstream' unrealised profits in excess of the investment

Occasionally an investor's share of the unrealised profit on the sale of an asset to an associate exceeds the carrying value of the investment held. In that case, to what extent is any profit in excess of the carrying value of the investment eliminated?

Section 14 provides no guidance on the elimination of 'downstream' unrealised gains in excess of the investment.

How we see it

in our view, an investor needs to determine an appropriate policy for dealing with the elimination of excess downstream unrealised gains. We believe the investor could either recognise the excess as 'deferred income' or restrict the elimination to the amount required to reduce the investment to zero. The treatment chosen is based on the investor's accounting policy choice for dealing with other situations when Section 14 is unclear, reflecting whether the investor considers the equity method of accounting to be primarily a method of consolidation (which would be consistent with recognition of the excess as deferred income) or a method of valuing an investment (which would be consistent with restricting the elimination to the amount that reduces the investment to zero). The investor applies a consistent policy to such situations.

Loans and borrowings between the reporting entity and its associates

The requirement in Section 14 to eliminate partially unrealised profits or losses on transactions with associates is expressed in terms of transactions involving the transfer of assets. The requirement for partial elimination of profits could be read to not apply to items such as interest paid on loans and borrowings between the reporting entity and its associates, since such loans and borrowings do not involve the transfer of assets giving rise to gains or losses. Moreover, they are not normally regarded as part of the investor's share of the net assets of the associate, but as separate transactions (except in the case of loss-making associates, where interests in long-term loans and borrowings may be required to be accounted for as if they were part of the reporting entity's equity investment in determining the carrying value of the associate against which losses may be offset, see 3.3.2.H below).

How we see it

We believe that loans and borrowings between the reporting entity and its associates generally are not eliminated in the reporting entity's consolidated financial statements when the interest income and expense are recognised by both parties.

However, if the associate has capitalised the borrowing costs, then the investor would need to eliminate a relevant share of its interest income and realise it as the associate depreciates the qualifying asset. The same principle applies to eliminate a share of capitalised management or advisory fees charged to an associate.

Cash flow statement

FRS 102 is silent on how cash flows relating to transactions with an associate must be presented in the consolidated cash flow statement. It is generally accepted that no adjustment must be made in respect of these cash flows, as the associate is not a member of the group and hence is not subject to the requirements on elimination of intragroup transactions as set out in Section 9. [FRS 102.9.15]. This contrasts with the requirement, in any consolidated statement of cash flows, to eliminate the cash flows between members of the group in the same way that intragroup transactions are eliminated in the profit and loss account and statement of financial position.

3.2.2.H Losses in excess of investment

An investor in an associate recognises its share of the losses of the associate until its share of losses equals or exceeds the carrying amount of its interest in the associate, at which point the investor discontinues recognising its share of further losses. [FRS 102.14.8(h)].

Once the investor's interest is reduced to zero, additional losses are provided for, and a liability is recognised in accordance with Section 21 *Provisions and Contingencies* (see Chapter 24), only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised. [FRS 102.14.8(h)]. Practically, an entity needs to track the off balance sheet losses of its associates in order to calculate subsequent income to be recognised from that associate.

In addition to the recognition of losses arising from application of the equity method, an investor in an associate must consider the requirements of Section 27 *Impairment of Assets* in respect of impairment losses. An investor also needs to consider Section 11 *Basic Financial Instruments* in order to determine whether it is necessary to recognise any additional impairment loss with respect to that part of the investor's interest in the associate that does not comprise its net investment in the associate (see 3.2.2.I below).

Section 14 states that the interest in an associate is the carrying amount of the investment determined using the equity method together with any financial instruments that in substance form part of the investor's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future might be regarded as being, in substance, an extension of the entity's investment in that associate. An investor would need to consider whether these interests are recoverable in accordance with Section 27. Examples of such financial instruments include:

- Preference shares
- Long-term receivables or loans (unless supported by adequate collateral)
- But do not include:
- Trade receivables
- Trade payables
- Any long-term receivables for which adequate collateral exists, such as secured loans. [FRS 102.14.8(h), FRS 102.14.8A].

Illustration 3-8: Accounting for a loss-making associate

At the beginning of the year entity H invests £5 million to acquire a 30% equity interest in Associate A. In addition, H lends £9 million to A, but does not provide any guarantees or commit itself to provide further funding. How must H account for the £20 million loss that A made during the year?

H's share in A's loss is £20 million $\times$ 30% = £6 million. If H's loan to A is considered part of the net investment in the A then the carrying amount of the associate is reduced by £6 million, from £14 million (= £5 million + £9 million) to £8 million. That is, the equity interest is reduced to nil and the loan is reduced to £8 million.

Conversely, if the loan is not part of the net investment in A, then H accounts for the loss as follows:

- The equity interest in the associate is reduced from £5 million to zero.
- A loss of £1 million remains unrecognised because H did not provide any guarantees and has no commitments to provide further funding.
- If in the second year, A were to make a profit of £10 million then H would recognise a profit of £2 million (= £10 million $\times$ 30% - £1 million).
- Alternatively, if, in the second year H were to provide a £1.5 million guarantee to A and A's net profit were nil, then H would need to recognise an immediate loss of £1 million (i.e., the lower of the unrecognised loss of £1 million and the guarantee of £1.5 million) because it now has a legal obligation in respect of A's debts.
- As there are several indicators of impairment, the loan from H to A is tested for impairment in accordance with Section 11.

3.2.2.1 Impairment

An entity tests the carrying value of its investment in an associate for impairment only if an event has occurred that indicates that it will not recover the carrying value. [FRS 102.27.7].

Determining whether an investment in an associate is impaired may be more complicated because it involves carrying out several separate impairment assessments:

- Underlying assets of the associate
It is generally not appropriate for the investor simply to multiply the amount of the impairment charge recognised in the investee's own books by the investor's % of ownership when recognising its share of the investee's profit or loss. This is because the investor measures its interest in an associate's identifiable net assets at fair value at the date of acquisition of an associate (see 3.2.2.D above). Therefore, if the value that the investor attributes to the associate's net assets differs from the carrying amount of those net assets in the associate's own books, the investor adjusts any impairment losses recognised by the associate for the effect of those fair value differences.
Any goodwill recognised by an associate, needs to be separated into two elements.
 - Goodwill that existed at the date the investor acquired its interest in the associate.
 - And
 - Goodwill that arises on subsequent acquisitions by the associate or joint venture.
 - Goodwill that existed at the date investor acquired its interest is not an identifiable asset of the associate from the perspective of the investor. It is combined with the investor's goodwill on the acquisition of its interest in the associate.
Goodwill that arises on subsequent acquisitions by the associate is accounted for as such in the books of the associate and tested for impairment in accordance with Section 27 by the associate. The investor does not make any adjustments to the associate's accounting for that goodwill.
- Investment in the associate
As well as reflecting any impairment in the underlying assets of the associate using the equity method as discussed above, Section 14 requires an investor to test the entire carrying amount of the interest, including financial instruments that in substance form part of the investor's net investment in the associate, for impairment as a single asset in accordance with Section 27. Any goodwill included as part of the carrying amount of the investment in the associate is not tested separately for impairment but is tested as part of the overall investment as a whole. [FRS 102.14.8A].

- Other interests that are not part of the equity interest in the associate

The investor must also apply Section 11 in order to determine whether it is necessary to recognise any additional impairment loss with respect to that part of the investor's interest in the associate that does not comprise its net investment in the associate. This could include, for example, trade receivables and payables, and collateralised long-term receivables, but might also include preference shares or loans (see 3.3.2.H above). In this case, however, the impairment is calculated in accordance with Section 11, and not Section 27.

How we see it

It is unlikely that any impairment charge recognised in respect of an associate will simply be the investor's share of any impairment charge recognised by the associate itself, even when the associate complies with FRS 102, considering the factors described above.

When the carrying amount of an investment in an associate is tested for impairment in accordance with Section 27, an impairment loss is recognised against the entire investment and is not allocated to any individual asset, including goodwill, which forms part of the carrying amount of the associate. In addition, any reversal of that impairment loss is recognised to the extent that the recoverable amount of the investment exceeds the carrying amount, subject to the reversal not exceeding the carrying amount that would have been determined had no impairment loss been recognised in previous years. [FRS 102.27.30, FRS 102.14.8A].

Illustration 3-9: Impairment losses recognised by an associate

Investor A acquires a 25% equity interest in Associate B. The cost of the investment was £95,000 including transaction costs. To simplify this Illustration, assume that the only assets held by B are PP&E and there is no equity method goodwill. At the acquisition date, the fair value of the PP&E is £380,000 and A's share of this is £95,000 (25% of £380,000). On that date, the carrying value of the PP&E of B is £300,000 and A's share of this is £75,000 (25% of £300,000). The £20,000 difference between A's cost of £95,000 and its share of the carrying value of net assets of B of £75,000 relates entirely to the fair value uplift of the PP&E. Depreciation, transactions between A and B and the effect of income taxes have been ignored to simplify this example.

	B's carrying value	A's 25% share of B's carrying value	Fair value of B's net assets	Difference between carrying value and fair value (basis difference)	A's 25% of basis difference
	£'000	£'000	£'000	£'000	£'000
PP&E	300	75	380	80	20

Subsequently, B determines that the PP&E is impaired and the recoverable amount of the PP&E at the date of impairment is £280,000. Therefore, B recognises an impairment charge of £20,000 to reduce the carrying value of the PP&E to its recoverable amount. A's share of the revised carrying value of the PP&E is £70,000 (25% of £280,000).

In the ordinary course of recording its share of B's profits under the equity method, A records its share of the impairment charge £5,000 (25% of £20,000). That is, the impairment charge recorded by B is included in its profit or loss, which is the basis for A to determine its share of B's profits.

In addition, A assesses the effect of the impairment on the fair value adjustment recorded on acquisition of its investment in B. Because A's share of the fixed assets of £90,000 (£95,000 less the impairment charge of £5,000) exceeds its share of the recoverable amount of the PP&E (£70,000), A recognises an additional impairment charge of £20,000. Therefore, the total impairment charge recognised by A is £25,000 (£5,000 that was included in A's share of B's profit plus £20,000 additional loss related to the fair value adjustment). While A does not assess individual underlying assets for impairment, when B recognises an impairment, A adjusts the impairment charge to reflect its share in the underlying assets. After recording the impairment charge, A's share in the PP&E of B is as follows:

	B's carrying value (after impairment)	A's 25% share of B's carrying value	Fair value of B's net assets	Difference between carrying value and fair value (basis difference)	A's 25% of basis difference
	£'000	£'000	£'000	£'000	£'000
PP&E (after impairment)	280	70	280	-	-
					£'000
Cost of original 25% equity method investment					95
A's equity method loss from B (25% of £20,000)					(5)
Additional equity method loss for impairment [(£95,000 - £5000) - (25% of £280,000)]					(20)
A's equity method carrying amount of B					70

3.2.2.J Discontinuing the equity method

An investor discontinues the use of the equity method from the date that significant influence ceases. The subsequent accounting depends upon the nature of the retained investment.

If the associate becomes a subsidiary (because control is obtained), it will be accounted for in accordance with Section 19 (i.e., a step-acquisition, see Chapter 22 at 2.10).

If an investment in an associate becomes an investment in a joint venture it will account for its investment in accordance with Section 15 *Investments in Joint Ventures* (i.e., it will continue to be accounted for under the equity method, see Chapter 18).

Otherwise, the retained investment is accounted for as a financial asset in accordance with Section 11 or Section 12 *Other Financial Instruments* as discussed below. [FRS 102.14.8(i)].

If an investor disposes of some or all of its investment, such that it no longer has significant influence over the investee, it will discontinue the use of the equity method. In such situations, the entity derecognises the associate and recognises in profit or loss any difference between the:

- The proceeds from the disposal.
- And
- The carrying amount of the investment in the associate relating to the proportion disposed of or lost at the date significant influence is lost. [FRS 102.14.8(i)(i)].

The investor accounts for any retained interest as a financial asset in accordance with Section 11 or Section 12 as appropriate. The carrying amount of the proportion retained in the investment at the date that it ceases to be an associate is regarded as its cost on initial measurement as a financial asset.

Where an investor ceases to have significant influence due to a change in circumstances other than by partial disposal, for example, as a result of changes to the board of directors or equivalent governing body of the associate that results in a loss of significant influence, the investor will discontinue the use of the equity method. In that case, the investor does not recognise a profit or loss but regards the carrying amount of the investment at that date as the new cost basis in accordance with Sections 11 or 12.

[FRS 102.14.8(i)(ii)].

If an investor loses significant influence as a result of a disposal, the gain or loss arising on that disposal includes amounts recognised in other comprehensive income in relation to that associate where those amounts are required to be reclassified to profit or loss on disposal. [FRS 102.14.8(i)]. Under FRS 102 this includes cash flow hedges which have not yet been reclassified to profit or loss. Amounts that are not required to be reclassified to profit or loss upon disposal are transferred directly to retained earnings.

[FRS 102.14.8(i)].

A deemed disposal, for example, where the associate has issued shares to a new investor, is accounted for as a regular disposal and hence a profit or loss is recognised as set out above. The original investor considers whether any profit resulting from the transaction is realised or unrealised. If unrealised, it is taken to other comprehensive income and not to profit or loss.

3.2.2.K Transactions to create an associate

An investor may exchange a business, or other non-monetary asset, for an interest in another entity, and that other entity becomes an associate of the investor. Questions arise regarding the use of fair values or previous carrying values and reporting any gain on the transaction.

The requirements in respect of such transactions are set out in Section 9 (see Chapter 8 at 3.8).

[FRS 102.9.31]. Fair values are used except in rare circumstances where the transaction is artificial and has no substance. Any unrealised gains are not reported in profit or loss.

Accordingly, the following accounting treatment is applied in the consolidated financial statements of the investor:

- The retained interest in the assets exchanged is not remeasured and included at its pre-transaction carrying amount. The investor retains an ownership interest in the business or other non-monetary assets exchanged, held through the associate. That retained interest, including any related goodwill, is treated as having been owned by the investor throughout the transaction and included at its pre-transaction carrying amount.
- Goodwill is recognised as the difference between:
 - The fair value of the consideration given.
 - And
 - The fair value of the investor's share of the pre-transaction identifiable net assets of the associate.

The consideration given for the interest acquired in the associate includes that part of the business or other non-monetary assets exchanged and no longer owned by the investor, i.e., the part effectively sold to the other investors in the associate. The consideration might also include cash or monetary assets to achieve equalisation of values. For example, where all investing parties in the associate have contributed assets of values not precisely commensurate with each party's ultimate ownership interest in the associate. When it is difficult to value the consideration given, the best estimate of its value may be obtained by valuing what is acquired.

- To the extent that the fair value of the consideration received by the investor exceeds the carrying value of assets given up, the investor recognises a gain. The assets given up include the part of the business or other non-monetary assets exchanged and no longer owned by the investor, as well as any related goodwill and cash transferred. Any unrealised gain arising on the exchange is recognised in other comprehensive income.
- And
- To the extent that the fair value of the consideration received by the investor is less than the carrying value of assets given up, the investor recognises a loss. The assets given up include the part of the business or other non-monetary assets exchanged and no longer owned by the investor, as well as any related goodwill and cash transferred. The loss is recognised either as an impairment in accordance with Section 27 (i.e., in other comprehensive income or profit and loss as appropriate) or, for any loss remaining after an impairment review of the relevant assets, in profit or loss. [FRS 102.9.31].

The most common situation for these transactions in practice is the contribution of a business for equity in an associate (or joint venture). Examples 3-7 and 3-8 in Chapter 18 illustrate the required accounting for such transactions.

Section 9 does not explain how a realised gain can be distinguished from an unrealised gain. Example 3-7 in Chapter 18 adopts a 'top slicing' approach whereby as much of the total gain as is backed by cash is treated as realised (i.e., £10m). 'Top slicing' is the recommended approach in determining realised profits for exchanges of assets in paragraph 3.18 of the ICAEW/ICAS TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006*. Paragraph 3.18A of the guidance states that when the consideration received comprises a combination of assets and liabilities, the profit will be realised only to the extent of any net balance (i.e., cash less liabilities) of qualifying consideration received.

No gain or loss is recognised in those rare cases where the transaction is artificial or lacks substance. In that case, a gain or loss on the exchange is not justified. In these circumstances, disclosure is required. [FRS 102.9.32]. The standard gives no example of when a transaction is artificial or lacks substance.

3.2.3 Cost model

An investor that is not a parent that adopts the cost model measures its investments in associates at cost less any accumulated impairment losses. Section 27 applies to the recognition and measurement of impairment losses. [FRS 102.14.5].

Section 14 does not define 'cost' of investment. However, Section 2 *Concepts and Pervasive Principles* defines 'historical cost' as the value of costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. [FRS 102.2.69]. The Regulations state that the purchase price of an asset is determined by adding to the actual price paid any expenses incidental to its acquisition and then subtracting any incidental reductions in the cost of the acquisition. [1 Sch 27(1)]. Consistent with this, Section 17 *Property, Plant and Equipment*, states that cost is normally either the purchase price paid (including directly attributable costs) or the fair value of non-monetary assets exchanged. [FRS 102.17.10, FRS 102.17.14]. The purchase price would generally represent the fair value of the consideration given to purchase the investment consistent with the guidance in respect of exchanges of businesses or other non-monetary items assets (see Chapter 8 at 3.8) and the requirements in respect of measuring the cost of a business combination (see Chapter 22 at 3.6).

An investor will recognise distributions received from its investments in associates as income irrespective of whether the distributions are from accumulated profits of the associate arising before or after the date of acquisition. [FRS 102.14.6].

3.2.4 Fair value model

An investor that is not a parent that accounts for its associate at fair value through other comprehensive income, initially recognises its investment at the transaction price. [FRS 102.14.9]. 'Transaction price' is not defined but is considered to be the same as its cost.

At each subsequent reporting date, the investor measures its investments in associates at fair value using the fair value guidance in Section 2A *Fair Value Measurement*. [FRS.102.14.10].

When the fair value through other comprehensive income model is used, increases in the carrying amount as a result of a revaluation to fair value are recognised in other comprehensive income and accumulated in equity, i.e., a revaluation reserve. However, if a revaluation increase reverses a previous revaluation decrease of the same investment that was recognised as an expense, it is recognised in profit or loss. [FRS 102.17.15E]. Decreases as a result of revaluation are recognised in other comprehensive income to the extent of any previously recognised revaluation increase accumulated in revaluation reserve in respect of the same investment. If a revaluation decrease exceeds the revaluation gains accumulated in revaluation reserve in respect of that investment, the excess is recognised in profit or loss. [FRS 102.17.15F]. This means that it is not permissible to carry a negative revaluation reserve in respect of each investment in associate carried at fair value.

An investor recognises distributions received from its investments in associates accounted for at fair value through other comprehensive income as income irrespective of whether the distributions are from accumulated profits of the associate arising before or after the date of acquisition. [FRS 102.14.10A].

When the fair value through profit or loss model is used, increases and decreases in the carrying amount of the investment as a result of a revaluation to fair value are recognised in profit or loss.

3.3 Practical Issues

3.3.1 Changes in ownership interest

3.3.1.A Initial carrying amount of an associate following loss of control of an entity

Under Section 9, when a parent loses control of a subsidiary and retains an interest in it, that retained interest is measured at the carrying amount of the net assets (and goodwill) attributable to the investment at the date that the entity ceases to be a subsidiary. That carrying amount is regarded as the cost on initial measurement of the financial asset or investment in the associate, as appropriate. In applying the equity method to a retained investment in an associate, there is no need to determine the implicit goodwill and fair values of the associate's assets and liabilities at the date it becomes an associate. [FRS 102.9.19].

Illustration 3-10: Accounting for retained interest in an associate following loss of control of an entity

Entity A owns 100% of the shares of Entity B. The interest was originally purchased for £500,000 and £40,000 of directly attributable costs relating to the acquisition were incurred. During the year, Entity A sells 60% of the shares to Entity C for £1,300,000. As a result of the sale, Entity C obtains control over Entity B. Entity A determines that its 40% interest gives it significant influence over Entity B.

At the date of disposal, the carrying amount of the net assets of Entity B in Entity A's consolidated financial statements is £1,200,000 and there is also goodwill of £200,000 relating to the acquisition of Entity B. The fair value of the identifiable assets and liabilities of Entity B is £1,600,000. The fair value of Entity A's retained interest of 40% of the shares of Entity B is £800,000.

Upon Entity A's sale of 60% of the shares of Entity B, it deconsolidates Entity B and accounts for its investment in Entity B as an associate using the equity method of accounting.

Entity A's initial carrying amount of the associate is based on the carrying value of the net assets (and goodwill) of the retained interest, i.e., £560,000 or 40% of the carrying amount of the net assets and goodwill totalling £1,400,000.

3.3.1.B Piecemeal acquisition of an associate

There is no guidance in FRS 102 on how to account for the piecemeal acquisition of an associate and so different approaches could be applied in practice.

Existing investment becomes an associate

An entity may gain significant influence over an existing investment upon acquisition of a further interest or due to a change in circumstances. Section 14 gives no guidance on how an investor must account for an existing investment that subsequently becomes an associate.

It is clear under Section 19 that in a business combination where control over an acquiree is achieved in stages following a series of transactions, the cost of the business combination is the aggregate of the fair values of the assets given, liabilities assumed and equity instruments issued by the acquirer at the date of each transaction in the series. [FRS 102.19.11A]. It might be argued that a similar approach should be adopted when an associate is acquired in stages.

3.3.1.C Step increase in existing associate

An entity may acquire an additional interest in an existing associate that continues to be an associate accounted for under the equity method. FRS 102 does not explicitly deal with such transactions.

How we see it

When an investor acquires an additional interest in an existing associate that continues to be accounted for under the equity method, we believe that the purchase price paid for the additional interest is added to the existing carrying amount of the associate and the existing interest in the associate or joint venture is not remeasured.

This increase in the investment is still notionally split between goodwill and the additional interest in the fair value of the net assets of the associate. This split is based on the fair value of the net assets at the date of the increase in the associate. However, no remeasurement is made for previously unrecognised changes in the fair values of identifiable net assets.

Paragraph 14.8(c) of FRS 102 establishes the requirement that the cost of an investment in an associate is allocated between the purchase of a share of the fair value of net assets and the goodwill. This requirement is not limited to the initial application of equity accounting but applies to each acquisition of an investment. However, this does not result in any revaluation of the existing share of net assets.

Rather, the existing ownership interests are accounted for under paragraph 14.8 of FRS 102, whereby the carrying value is adjusted only for the investor's share of the associate's profits or losses and other recognised equity transactions. No entry is recognised to reflect changes in the fair value of assets and liabilities that are not recognised under the accounting policies applied for the associate.

Illustration 3-11 below illustrates an increase in ownership of an associate that continues to be an associate.

Illustration 3-11: Accounting for an increase in the ownership of an associate

Entity A obtains significant influence over Entity B by acquiring an investment of 25% at a cost of £3,000. At the date of the acquisition, the fair value of the associate's net identifiable assets is £10,000, which equals their carrying amounts. Therefore, the difference between the amount paid of £3,000 and A's share of the fair value of B's net assets of £2,500 is attributable entirely to goodwill. The investment is accounted for under the equity method in the consolidated financial statements of A.

Two years later, Entity A acquires an additional investment of 20% in Entity B at a cost of £4,000, increasing its total investment in Entity B to 45%. The investment is still an associate and accounted for using the equity method of accounting.

For the purposes of the example, directly attributable costs have been ignored and it is assumed that no profit or loss arose during the period since the acquisition of the first 25%. The implicit goodwill on the initial acquisition of the associate of £500 is assumed to have a 10 year useful life, therefore goodwill amortisation of £100 has been recognised over the two year period between the initial investment of 25% and the purchase of the additional interest of 20%. Therefore, the carrying amount of the investment immediately prior to the additional investment is £2,900 (£3,000 - £100). However, an asset held by the associate has increased in value by £5,000 so that the fair value of the associate's net identifiable assets is now £15,000.

To summarise, amounts are as follows:

	£
Fair value of net assets of Entity B at acquisition	10,000
Increase in fair value	<u>5,000</u>
Fair value of net assets of Entity B two years later	<u>15,000</u>

Because of the additional investment, the equity-accounted amount for the associate increases by £4,000. The notional goodwill applicable to the second tranche of the acquisition is £1,000 [$£4,000 - (20\% \times £15,000)$].

The impact of the additional investment on Entity A's equity-accounted amount for Entity B is summarised as follows:

	% held	Carrying amount	Share of net assets	Goodwill included in investment
		£	£	£
Existing investment	25	2,900	2,500	400
Additional investment	<u>20</u>	<u>4,000</u>	<u>3,000</u>	<u>1,000</u>
Total investment	<u>45</u>	<u>6,900</u>	<u>5,500</u>	<u>1,400</u>

The accounting described above applies when the additional interest in an existing associate continues to be accounted for as an associate under the equity method. The accounting for an increase in an associate that becomes a subsidiary is discussed in Chapter 22.

3.3.1.D Step increase in existing associate that becomes a joint venture

In the situation discussed at 3.3.1.C above, the acquisition of the additional interest did not result in a change in status of the investee, i.e., the associate remained an associate. However, an entity might acquire an additional interest in an existing associate that becomes a joint venture. In this situation, although FRS 102 refers to an associate that becomes a joint venture, it contains no specific guidance as to what must be done. [FRS 102.14.8(i)]. However, as a joint venture is also accounted under the equity method, the accounting described in Illustration 3-11 above applies.

3.3.2 Distributions received in excess of the carrying amount

When an associate makes dividend distributions to the investor in excess of the investor's carrying amount it is not clear how the excess must be accounted for.

How we see it

A liability under Section 21 is recognised only if the investor is obliged to refund the dividend, has incurred a legal or constructive obligation or made payments on behalf of the associate. In our view, in the absence of such obligations, it is appropriate that the investor recognises the excess of the distribution over the investor's carrying amount in profit or loss. When the associate subsequently makes profits, the investor resumes recognising its share of those profits only when they exceed the excess distributions recognised previously in profit or loss plus any previously unrecognised losses (see 3.2.2.H above).

3.3.3 Equity transactions in an associate's financial statements

The financial statements of an associate that are used for the purposes of equity accounting by the investor may include items within its statement of changes in equity that are not reflected in the profit or loss or components of other comprehensive income, for example, dividends or other forms of distributions, issues of equity instruments and equity-settled share-based payment transactions. Where the associate has subsidiaries and consolidated financial statements are prepared, those financial statements may include the effects of changes in the parent's (i.e., the associate's) ownership interest and non-controlling interest in a subsidiary that did not arise from a transaction that resulted in loss of control of that subsidiary.

Although the description of the equity method in Section 14 together with the requirements in Section 5 *Statement of Comprehensive Income and Income Statement* requires that the investor's share of the profit or loss of the associate is recognised in the investor's profit or loss, and the investor's share of changes in items of other comprehensive income of the associate is recognised in other comprehensive income of the investor. [FRS 102.14.8]. No explicit reference is made to other items that the associate may have in its statement of changes in equity.

Investors will therefore need to determine an appropriate accounting treatment for these different types of transactions that may be accounted for by the associate in its statement of changes in equity.

4 Presentation and disclosures

4.1 Presentation

Under the Companies Act formats, investments in participating interests are classified under fixed asset investments in the balance sheet (see Chapter 6 at 4.3.4). When 'adapted formats' (see Chapter 6 at 4.1) are used, investments in associates are shown as a separate balance sheet item and distinguished between current and non-current items. *[FRS 102.4.2A]*.

Goodwill relating to an associate is included in the carrying amount of the investment. *[FRS 102.14.8(c)]*.

There is no guidance in FRS 102 as to how long-term interests (such as long-term loans for which no payment is intended in the foreseeable future) in associates must be presented and therefore an entity must make an accounting policy choice as to the presentation of such interests. Entities frequently make loans to associates, the terms of which are repayable on demand, but there is no intention of repayment in the foreseeable future. In these circumstances, for entities applying the Companies Act formats, management exercises judgement in determining whether such a loan is a debtor or a fixed asset investment in nature (see Chapter 6 at 4.3.4). For entities applying the adapted formats, such loans need to be classified as appropriate between current or non-current assets (see Chapter 6 at 5.1.1).

In the profit and loss account, for entities applying the Companies Act formats, income from interests in associates is shown as one line item in the profit and loss account. *[6 Sch 20]*. For entities applying the adapted formats, the share of the profit or loss of associates and jointly controlled entities accounted for using the equity method must be included as one line item in the profit and loss account. *[FRS 102.5.5B]*.

4.2 Disclosures

The disclosures required under Section 14 in respect of investments in associates are set out below. Additional disclosures required by the CA 2006 are discussed at 4.2.4 and 4.2.5 below.

4.2.1 General requirements

In both consolidated and individual financial statements where an entity holds an investment in an associate the following is disclosed:

- The accounting policy for investments in associates.
- The carrying amount of investments in associates.
- And
- The fair value of each investment in an associate accounted for using the equity method if a market price for the investment is quoted. *[FRS 102.14.12]*.

4.2.2 Consolidated financial statements

An investor discloses separately:

- Its share of the profit or loss of associates accounted for in accordance with the equity method.
- And
- Its share of any discontinued operations of such associates. *[FRS 102.14.14]*.

4.2.3 Individual financial statements

The individual financial statements of an investor that is not a parent discloses:

- Summarised financial information about the investments in associates.
- And
- The effect of including those investments as if they had been accounted for using the equity method.

Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if the entity had subsidiaries, are exempt from this requirement. *[FRS 102.14.15A]*.

Summarised financial information is not defined in FRS 102, but using the GAAP hierarchy to refer to IFRS 12 *Disclosure of Interests in Other Entities*, it would be appropriate to include: current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss from continuing operations, post-tax profit or loss from discontinued operations, other comprehensive income, total comprehensive income. This list is not exhaustive, and other items may need to be considered if deemed material.

[IFRS 12 Appendix B.12].

For investments accounted for in accordance with the cost model, an investor is required to disclose the amount of dividends and any other distributions recognised as income. *[FRS 102.14.13]*.

For investments in associates accounted for in accordance with fair value through other comprehensive income, an investor must make the disclosures required by Section 11 paragraphs 43 and 44 (this is notwithstanding the fact that paragraph 44 refers to fair value through profit or loss, but the intention is clearly to make these disclosures for fair value through other comprehensive income): *[FRS 102.14.15]*

- The basis for determining fair value (e.g., quoted market price in an active market or a valuation technique. If the latter is used, the assumptions applied in determining fair value for each class of financial assets or liabilities must be disclosed).

And

- If a reliable measure of fair value is no longer available for financial instruments that would otherwise be required to be measured at fair value through profit or loss this fact must be disclosed and the carrying amount of those financial instruments.

For investments in associates accounted for at fair value through profit or loss, the above disclosures will also apply.

4.2.4 Additional company law disclosures - consolidated financial statements

The Regulations also require that the following information must be given where an undertaking included in the consolidation has an interest in an associated undertaking:

- The name of the associate
 - The country in which the associate is incorporated for those incorporated outside the United Kingdom
 - The address of the registered office of the associate
 - The identity and proportion of the nominal value of each class of share held disclosing separately those held by the:
 - Parent company
- And
- Group *[4 Sch 19]*

4.2.5 Additional company law disclosures - individual financial statements

In individual financial statements the Regulations require additional disclosures in respect of significant holdings in undertakings, other than subsidiary entities. A holding is deemed significant if:

- It amounts to 20% or more of the nominal value of any class of shares in the undertaking.
- Or
- The amount of the holding as stated in the company's individual accounts exceeds 20% of the stated net assets of the company. *[4 Sch 4]*.

In practice, this definition will capture most investments in associates. The resulting disclosures in individual financial statements are:

- The name of each associate.
- The address of the registered office of each associate.
- The address of each associate's principal place of business if unincorporated.

And

- The identity and proportion of the nominal value of each class of share held. *[4 Sch 5]*.

For each associate detailed above there must also be disclosed the aggregate amount of the capital and reserves as at the end of its relevant financial year of each entity and its profit or loss for that year (unless the associate is not required to publish its balance sheet anywhere in the world and the holding is less than 50% of the nominal value of the shares, or the information is not material). *[4 Sch 6]*.

A parent that is exempt under Sections 400 or 401 of the Act from the requirement to prepare group accounts is not required to give the additional disclosures listed above in its separate financial statements if it discloses, in the notes to its accounts, the aggregate investment in all significant holdings in undertakings (including its associates) determined by way of the equity method of valuation. *[4 Sch 13]*.

A parent that prepares consolidated financial statements and discloses the information described at 4.2.4 above in respect of its associates is not required to give the disclosures otherwise required by paragraphs 5 and 6 of Schedule 4 of the Regulations in its individual financial statements. *[4 Sch 4]*.

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for associates are set out below.

	FRS 102	IFRS
Individual and separate entity financial statements	An entity that is not a parent (i.e., has no subsidiaries) or is a parent that prepares separate financial statements, has the option to account for its investments in associates using either the cost model, at fair value through other comprehensive income (movements follow the PP&E revaluation model and there is no recycling) or at fair value through profit or loss. Under FRS 102, there is no option to use equity accounting in the separate financial statements of an investor that is a parent or the individual financial statements of an investor that is not a parent.	An entity that is not a parent (i.e., has no subsidiaries) accounts for its investments in associates under the equity accounting method unless it meets criteria for exemption. An entity that is a parent and prepares separate financial statements accounts for its investments at cost, in accordance with IFRS 9 (at fair value through other comprehensive income without recycling) or using the equity method.
Investment portfolios/funds	Investments in associates held as part of an investment portfolio must be measured at fair value through profit or loss in the consolidated financial statements of an investor that is a parent.	Venture capital organisations and similar entities can choose to measure investments in associates at fair value through profit or loss. Investment entities must apply this option.
Implicit goodwill and fair value adjustments on acquisition of an associate	Follows the requirements of Section 19. Goodwill is amortised over its finite useful life, but if, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life must not exceed 10 years.	Generally, follows the IFRS requirements regarding business combinations. Implicit goodwill is not amortised.
Loss of significant influence of an equity-accounted associate that does not become a subsidiary or a jointly controlled entity	If significant influence is lost as a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds and the carrying amount relating to the proportion disposed of. The carrying value of the equity interest retained at the date significant influence was lost becomes the cost of the retained investment. If significant influence is lost for reasons other than a partial disposal, no gain or loss is recognised and the carrying value of the equity-accounted investment at the date significant influence is lost becomes the cost of the retained investment.	If significant influence is lost as a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds together with the fair value of any retained interest and the carrying amount of the total interest in the associate. If significant influence is lost for reasons other than a partial disposal, a gain or loss is recognised based on the fair value of the retained interest and the carrying amount of the interest in the associate at that date.

FRS 102		IFRS
Exchange of business or other non-monetary assets for an interest in an associate in the consolidated financial statement.	Gains that are not realised are reported in other comprehensive income.	No distinction between realised and unrealised gains and all gains/losses are reported in profit or loss.
Disclosures in financial statements (key differences)		
Summarised financial information	Only the individual financial statements of an associate that is not a parent must disclose summarised financial information about its investments in the jointly controlled entities, along with the effect of including those investments as if they had been accounted for using the equity method.	Summarised financial information of material associate and individually material associates (in aggregate) required in the consolidated accounts of a venturer.
Restrictions	Not Applicable	The nature and extent of any significant restrictions on the ability of associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity is required to be disclosed.
Non-coterminous financial statements of an associate	Not Applicable	When the financial statements of an associate used in applying the equity method are as of a date or for a period that is different from that of the entity the following are disclosed: (i) The date of the end of the reporting period of the financial statements of that joint venture or associate. And (ii) The reason for using a different date or period.
Unrecognised share of losses	Not Applicable	Disclosure of the unrecognised share of losses of an associate, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the associate when applying the equity method.

Appendix A - Defined terms

Extract from FRS 102 Appendix 1 Glossary

Definitions

associate	An entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture .
consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
held as part of an investment portfolio	An interest is held as part of an investment portfolio if its value to the investor is through fair value as part of a directly or indirectly held basket of investments rather than as media through which the investor carries out business . A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund it first being established and is expected to acquire additional investments.
impracticable	Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term.
parent	An entity that has one or more subsidiaries .
separate financial statements	Those presented by a parent in which the investments in subsidiaries , associates or jointly controlled entities are accounted for either at cost or fair value rather than on the basis of the reported results and net assets of the investees. Separate financial statements are included within the meaning of individual financial statements .
significant influence	Significant influence is the power to participate in the financial and operating policy decision of the associate but is not control or joint control over those policies.
subsidiary	An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

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Chapter 18 Investments in joint ventures

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Overview

This chapter addresses the requirements of Section 15 *Investments in Joint Ventures* which applies to investments in joint ventures in consolidated financial statements and the individual financial statements of a venturer that is not a parent. Section 15 also applies to investments in jointly controlled operations and jointly controlled assets in the separate financial statements of a venturer that is a parent. In its separate financial statements, a venturer that is a parent accounts for investments in jointly controlled entities in accordance with Section 9 *Consolidated and Separate Financial Statements*.

What you need to know

- A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. A joint venture is classified as a jointly controlled entity, jointly controlled operation or jointly controlled asset.
- Investments in jointly controlled entities in the scope of Section 15 are accounted for using the equity method as described in Section 14 *Investments in Associates*.
- In respect of its interest in a jointly controlled operation, a venturer recognises the assets that it controls and the liabilities that it incurs, and the expenses that it incurs and its share of the revenue that it earns from the sale of goods or services by the jointly controlled operation.
- In respect of its interest in a jointly controlled asset, a venturer recognises:
 - Its share of the jointly controlled assets.
 - Any liabilities it has incurred and its share of any incurred jointly.
 - Any revenue from the sale or use of its share of the output of the jointly controlled asset and its share of expenses incurred by the jointly controlled asset.
 - And
 - Any expenses it has incurred in respect of its interest in the jointly controlled asset.
- A venturer that is not a parent but has one or more interests in jointly controlled entities measures all such interests using either the cost model, at fair value with changes recognised in other comprehensive income, without recycling, or at fair value with movements recognised in profit or loss.

1 Introduction

Section 15 sets out the accounting and disclosure requirements for joint ventures in consolidated financial statements, separate financial statements of a venturer that is a parent and individual financial statements of a venturer that is not a parent. *[FRS 102.15.1]*.

A 'joint venture' is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. The exact form of the strategic investment can vary and Section 15 addresses that variation by classifying joint ventures into three categories: jointly controlled assets, jointly controlled operations and jointly controlled entities. *[FRS 102.15.3]*.

Joint ventures are commonplace in many industry sectors, often as a means of pooling resources or expertise, risk sharing or new product development. The term is sometimes used loosely to describe any commercial partnership type arrangement, but it is important to emphasise that only those where contractually based joint control exists will fall within the scope of Section 15.

2 Comparison between Section 15 and IFRS

There are differences between the accounting and disclosure requirements in Section 15 compared with IFRS 11 *Joint Arrangements*. The key differences are discussed below and summarised at 5 below.

2.1 Scope and classification

As noted above, Section 15 classifies joint ventures as either jointly controlled operations, jointly controlled assets or jointly controlled entities.

IFRS 11 addresses joint arrangements and only makes the distinction between joint operations and joint ventures. This distinction is based on the rights and obligations under the arrangement, rather than focussing on the legal form of the entity. [IFRS 11.14]. Where the parties with joint control have an interest in the net assets of the arrangement then the arrangement will be a joint venture, [IFRS 11.16], which is the equivalent of a jointly controlled entity under Section 15. Otherwise, where the parties with joint control have rights to underlying assets and obligations for liabilities the arrangement will be a joint operation. [IFRS 11.15]. Determining the appropriate classification under IFRS 11 involves an assessment of a venturer's rights and obligations under the arrangement, based on the detailed guidance within the standard.

Generally, arrangements that are jointly controlled operations or jointly controlled assets under Section 15 would be joint operations under IFRS 11. Although many arrangements that are jointly controlled entities under Section 15 would be classified as joint ventures under IFRS 11, some would have to be classified as joint operations due to the requirement to assess rights and obligations rather than focussing on the legal form of the entity.

2.2 Individual and separate entity financial statements

Section 15 permits entities that are not parents to account for their investment in jointly controlled entities using either cost less impairment, at fair value with changes in fair value recognised through other comprehensive income (unless reversing a revaluation decrease of the same investment previously recognised in profit or loss, in which case the revaluation increase is recognised in profit or loss, or where a revaluation decrease exceeds increases previously recognised in respect of the same investment, in which case the excess is recognised in profit or loss) or at fair value with changes in fair value recognised through profit or loss (see 3.5.2.B below). [FRS 102.15.9]. The same accounting policy choice is available for a venturer accounting for their investment in jointly controlled entities that is preparing separate financial statements in accordance with Section 9. [FRS 102.9.26].

Under IFRS, an entity that is not a parent must prepare individual financial statements in which its investments in jointly controlled entities are accounted for under the equity accounting method unless it meets the criteria for exemption. [IAS 28.16, IAS 28.17]. An entity preparing separate financial statements under IFRS has an accounting policy choice of measuring investments in jointly controlled entities at cost, in accordance with IFRS 9 *Financial Instruments*, or using the equity method of accounting. [IAS 27.10].

2.3 Investment portfolios/funds

Under Section 15, a venturer that is a parent and has investments in jointly controlled entities that are held as part of an investment portfolio is required to measure those investments at fair value through profit or loss in the consolidated financial statements (see 3.5.3.B below). [FRS 102.15.9B].

Under IFRS, the measurement of investments in joint ventures at fair value through profit or loss is an option that is only available for an entity which is a venture capital organisation or a mutual fund, unit trust and similar entities including investment-linked insurance funds or one which holds its investments indirectly through such an entity. [IAS 28.18].

2.4 Implicit goodwill and fair value adjustments on acquisition of an equity-accounted jointly controlled entity

Section 15 (via Section 14) requires the use of Section 19 *Business Combinations and Goodwill* to determine the implicit goodwill on the acquisition of a jointly controlled entity. The implicit goodwill is then amortised over its useful life. If an entity is unable to make a reliable estimate of the useful life of goodwill, the life must not exceed 10 years. [FRS 102.14.8(c), FRS 102.19.23]. Under IFRS, implicit goodwill is not amortised.

2.5 Loss of joint control of an equity-accounted jointly controlled entity that does not become a subsidiary or an associate

Section 15 (via Section 14) requires that where loss of joint control is as a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds and the carrying amount relating to the proportion disposed of. The carrying value of the equity interest retained at the date joint control is lost becomes the cost of the retained investment and there is no measurement of the retained interest at fair value.

If the loss of joint control is for reasons other than a partial disposal, for example a change in circumstances such as the joint venture issuing shares to third parties, no gain or loss is recognised and the carrying value of the equity-accounted investment as at the date at which joint control is lost becomes the cost of the retained investment. *[FRS 102.14.8(i)].*

Under IFRS, where loss of joint control is as a result of a partial disposal, a gain or loss is recognised based on any difference between the disposal proceeds together with the fair value of any retained interest and the carrying amount of the total interest in the joint venture.

If the loss of joint control is for reasons other than a partial disposal, a gain or loss is recognised based on the fair value of the retained interest and the carrying amount of the interest in the joint venture at that date. *[IAS 28.22].*

2.6 Transactions to create a jointly controlled entity

Section 9 sets out the requirements in respect of transactions where a venturer may exchange a business, or other non-monetary asset, for an interest in another entity, and that other entity becomes a jointly controlled entity of the venturer. To the extent that the fair value of the consideration received by the venturer exceeds the carrying value of the part of the business, or other non-monetary assets exchanged and no longer owned by the venturer, and any related goodwill together with any cash given up, the venturer recognises a gain. Any unrealised gain arising on the exchange is recognised in other comprehensive income. To the extent that the fair value of the consideration received is less than the carrying value of what has been exchanged, together with any related goodwill and cash given up, a loss is recognised (see 3.8 below).

IFRS, does not distinguish between realised and unrealised gains for equivalent transactions and requires that gain or loss, realised or unrealised, to be recognised in profit or loss. *[IFRS 10.B98].*

3 Requirements of Section 15 for investments in joint ventures

3.1 Scope

Section 15 applies to investments in:

- Joint ventures in consolidated financial statements
 - Joint ventures in the individual financial statements of a venturer that is not a parent (see 3.5.2 below)
- And
- Jointly controlled operations and jointly controlled assets in the separate financial statements of a venturer that is a parent (see 3.5.3.A below)

A venturer that is a parent accounts for interests in jointly controlled entities in its separate financial statements in accordance with paragraphs 9.26 and 9.26A of FRS 102, as appropriate (see Chapter 8 at 4.2). [FRS 102.15.1].

3.2 Definition of a joint venture and related terms

Section 15 defines joint venture as follows: [FRS 102.15.3]

Extract from FRS 102

15.2 A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets or jointly controlled entities.

An economic activity is not defined in FRS 102 but is intended to be broadly based given that joint ventures can take many forms (see 3.2.5 below).

Joint control is defined as “the contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers)”. [FRS 102.15.2].

How we see it

Although FRS 102 does not define what strategic, financial and operating decisions would cover, these are generally understood to include areas such as budgeting, capital expenditure, treasury management, dividend policy, production, marketing, sales and human resources.

FRS 102 defines control (of an entity) as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities”. [FRS 102 Appendix I]. The concept of control is discussed further in Chapter 8 at 2.3.

A venturer is defined as “a party to a joint venture that has joint control over that joint venture”.

[FRS 102 Appendix I].

Section 15 offers no further guidance on the following:

- Parties to a joint venture that are not venturers
- And
- The nature of the contractual arrangements or joint control (in particular the concept of unanimous consent) which are key to an understanding of a joint venture

These aspects are discussed in the following sections making reference to additional guidance in IFRS 11 when relevant. As Section 10 *Accounting Policies, Estimates and Errors*, requires management to use its judgement in developing and applying an accounting policy when a transaction is not specifically addressed by the standard, management may consider the requirements and guidance in IFRS dealing with similar and related issues. [FRS 102.10.5, FRS 102.10.6].

3.2.1 'Venturer' versus 'investor'

In addition to 'venturers', there may well be other investors in the joint venture. In the absence of a definition of an 'investor' in FRS 102, it is clear from the definition of a 'venturer' that an investor in a joint venture must be a party to a joint venture that does not have joint control over the joint venture. This is illustrated by Illustration 3-1.

Illustration 3-1: 'Venturer' versus 'investor'

A, B and C establish a fourth entity D, of which A owns 40%, B 11% and C 49%. A and B enter into a contractual arrangement whereby any financial and operating decisions taken by A and B relating to the activity of D require the unanimous consent of A and B. A simple majority of D's shareholders only is required for all major decisions. An analysis based on the relevant definitions would regard A and B as being 'venturers', and C as an 'investor', in D.

The interest of an 'investor' in a jointly controlled entity is treated as either:

- An associate within the scope of Section 14 if the investor has significant influence over the entity (see Chapter 17)
- Or
- Otherwise as a financial asset within the scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues* (see Chapter 13) [FRS 102.15.18].

3.2.2 Contractual arrangement

Contractual arrangements can be evidenced in several ways. An enforceable contractual arrangement is often, but not always, in writing (we expect unwritten agreements to be rare in practice). Statutory mechanisms can create enforceable arrangements, either on their own or in conjunction with contracts between the parties. [IFRS 11.B2]. A contractual arrangement may be incorporated into the articles or other formation documents of the entity. [IFRS 11.B3].

The contractual arrangement sets out the terms upon which the parties agree to share control over the activity that is the subject of the arrangement. IFRS 11 provides some relevant guidance on the aspects generally specified in the contractual arrangement for a joint arrangement which could equally be applied to a joint venture under FRS 102 using the GAAP hierarchy in Section 10.

Contractual arrangements generally specify the following: [IFRS 11.B.4]

- Purpose, activity and duration of the joint arrangement
- Appointment of members of the board of directors (or equivalent governing body)
- Decision-making processes
 - Matters requiring decisions from the parties
 - Voting rights of the parties

And

 - Required level of agreement for those matters
- Capital or other contribution requirements
- Sharing of assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement

3.2.3 Joint control and unanimous consent

In order to establish whether joint control of an arrangement exists, it is necessary to establish whether the contractual arrangement gives all the parties to that arrangement (or a group of the parties) control of the arrangement in the collective sense. That means the parties (or a group thereof) must need to act together to direct the strategic, financial and operating policies of the arrangement. It follows that there must be at least two parties for there to be joint control.

Section 15 includes the specific requirement for 'unanimous consent' in the definition of joint control. Unanimous consent means that any party to the arrangement can prevent any of the other parties, or group of the other parties, from making decisions of a strategic, financial or operating nature without its consent. This ensures that no single party can control the arrangement. This means, for example, that none of the parties to the contractual arrangement must have a casting vote that enables it to resolve a deadlock, as that would constitute a form of unilateral control. [FRS 102.15.2].

Care is required in situations where a contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture if it acts within the

financial and operating policies agreed by the venturers in accordance with the contractual arrangement and delegated to the operator. If, however, the operator does have the power to govern (i.e., not merely to execute) the financial and operating policies of the economic activity, the operator controls the venture, and the venture is a subsidiary of the operator and not a joint venture.

3.2.4 Potential voting rights

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party's voting power over the financial and operating policies of another entity (potential voting rights).

How we see it

Potential voting rights are not addressed directly in Section 15. Nevertheless, the existence of potential voting rights may be relevant to an assessment of joint control, as explained in Section 9, since control can be achieved by having options or convertible instruments that are currently exercisable. However, the contractual arrangement giving rise to joint control will tend to override relative ownership interests (voting and potential voting rights). This is an issue that will need to be addressed in the light of individual facts and circumstances. [FRS 102.9.6].

3.2.5 Types of joint venture

Section 15 explains that joint ventures can take one of three forms, all sharing the common characteristics of an underlying contractual arrangement and joint control. The three forms are:

- Jointly controlled operations (see 3.3 below)
- Jointly controlled assets (see 3.4 below)
- Jointly controlled entities (see 3.5 below)

3.3 Jointly controlled operations

3.3.1 Definition

Jointly controlled operations arise when a joint venture is established that does not involve the formation of a separate corporation, partnership or other entity or financial structure that exists separately from the venturers. Instead, the joint venture uses assets and other resources of the venturers. In such a case each venturer will use its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale of the joint product and any expenses incurred in common are shared among the venturers. [FRS 102.15.4].

An example of a jointly controlled operation might be where two or more venturers combine their operations, resources and expertise in order to jointly manufacture, market and distribute a particular product. Each venturer undertakes a different part of the manufacturing process and bears its own costs. Revenue from the sale of the product is then shared on the basis of the contractual arrangement. There is no separate entity conducting the business of manufacturing and selling the product. It is merely an extension of the venturers' existing businesses.

3.3.2 Accounting requirements for jointly controlled operations

In respect of its interests in jointly controlled operations, a venturer recognises in its financial statements:

- The assets that it controls and the liabilities that it incurs.
- And
- The expenses that it incurs and its share of the revenue that it earns from the sale of goods or services by the joint venture. [FRS 102.15.5].

As the assets, liabilities, income and expenses will already be reflected in the individual financial statements of the venturer (including the separate financial statements of a venturer that is a parent) then no adjustments or other consolidation procedures are required in respect of these items if the venturer presents consolidated financial statements.

When venturers are funding the operations of a jointly controlled operation they may need to account for a receivable or payable from other venturers, as illustrated in Illustration 3-2 below.

Illustration 3-2: Loans to jointly controlled operations

Two entities, A and B, each own half of a jointly controlled operation. In the joint venture agreement, revenue from the sale of the joint product and expenses incurred in common are shared equally between the A and B. A has lent £400 to the jointly controlled operation, while B has lent £300. How must A account for its loan?

The jointly controlled operation has total borrowings of £400 + £300 = £700. A's share in the borrowings of £350 (=50% of £700) must be offset against its receivable of £400. A must, therefore, account for a net receivable from its joint venture partner of £50 (=£400 - £350).

The jointly controlled operation is not a separate legal entity and under the joint venture agreement A has a business relationship only with B. Gross presentation of a receivable of £200 (=£400 - 50% of £400) and a liability of £150 (=50% of £300) would therefore not be appropriate.

3.4 Jointly controlled assets

3.4.1 Definition

Jointly controlled assets arise in circumstances where one or more assets are contributed to or acquired for the purpose of the joint venture and those assets are jointly controlled and often jointly owned.

[FRS 102.15.6].

The assets are used to obtain benefits for the venturers, who may each take a share of the output from the assets and bear an agreed share of the expenses incurred. Such ventures do not involve the establishment of an entity or financial structure separate from the venturers themselves, so that each venturer has control over its share of future economic benefits through its share in the jointly controlled assets.

Joint ventures of this type are particularly common in extractive industries. For example, a number of oil companies may jointly control and operate an oil pipeline. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the operating expenses of the pipeline. Another example of a jointly controlled asset could be that two entities jointly control a commercial property, each taking a share of the rents received and bearing a share of the expenses.

3.4.2 Accounting requirements for jointly controlled assets

In respect of its interest in a jointly controlled asset, a venturer recognises in its financial statements:

- Its share of the jointly controlled assets, classified according to their nature (i.e., a share in a jointly controlled pipeline to be shown within property, plant and equipment rather than as an investment)
 - Any liabilities that it has incurred (e.g., those it has incurred in financing its share of the assets)
 - Its share of any liabilities incurred jointly with the other venturers in relation to the joint venture
 - Any revenue from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture
- And
- Any expenses that it has incurred in respect of its interest in the joint venture (e.g., those relating to financing the venturer's interest in the assets and selling its share of the output) [FRS 102.15.7]

As with jointly controlled operations, the assets, liabilities, income and expenses will already be reflected in the individual financial statements of the venturer (including the separate financial statements of a venturer that is a parent), therefore no adjustments or other consolidation procedures are required in respect of these items if the venturer presents consolidated financial statements. Separate accounting records may be limited to a record of the expenses incurred in common and ultimately borne by the venturers according to their agreed shares. Similarly, financial statements may not be prepared for the joint venture itself, although the venturers may prepare management accounts in order to assess the performance of the joint venture.

3.5 Jointly controlled entities

3.5.1 Definition

Section 15 defines a jointly controlled entity as “a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest”. The entity would operate in the same way as other entities except that the venturers would have joint control over the entity and its economic activities by virtue of the existence of a contractual arrangement between them. [FRS 102.15.8].

A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns income. It manages the joint venture and may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the results of the jointly controlled entity based on the requirements in the joint venture agreement.

There are a number of different considerations for the accounting for interests in jointly controlled entities depending on whether the venturer is a parent or not, and if a parent, the financial statements being prepared. These are discussed below.

3.5.2 Venturer that is not a parent

Where a venturer is an entity that is not a parent and hence only prepares individual financial statements, in those financial statements it has a choice of how to account for its interests in jointly controlled entities. It can apply either:

- The cost model (see 3.5.2.A below).
- Fair value with changes in fair value recognised in OCI (or profit or loss) in accordance with paragraphs 15E and 15F of Section 17 *Property, Plant and Equipment* (see 3.5.2.B below).

Or

- Fair value with changes in fair value recognised in profit or loss. [FRS 102.15.9].

In terms of the option to carry interests in jointly controlled entities at fair value through profit or loss or fair value through other comprehensive income, fair value in that context is determined by reference to the guidance in Section 2A *Fair Value Measurement* (see Chapter 4 at 3.7.1.B). [FRS 102.15.9].

There is no option in Section 15 to use the equity method of accounting in individual financial statements (this option exists under IFRS) even though permitted by the Regulations (see 3.10 below). However, the individual financial statements of a venturer that is not a parent must disclose summarised financial information about its investments in jointly controlled entities, along with the effect of including those investments as if they had been accounted for using the equity method. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement. [FRS 102.15.21A].

3.5.2.A Cost model

A venturer that is not a parent and adopts the cost model, measures its investments in jointly controlled entities at cost less any accumulated impairment losses. Section 27 *Impairment of Assets* applies to the recognition and measurement of impairment losses. [FRS 102.15.10].

Section 15 does not define ‘cost’ of investment. However, Section 2 defines ‘historical cost’ as the value of costs incurred in acquiring or creating the asset, comprising the consideration paid to acquire or create the asset plus transaction costs. [FRS 102.2.69]. The Regulations state that the purchase price of an asset is determined by adding to the actual price paid any expenses incidental to its acquisition and then subtracting any incidental reductions in the cost of the acquisition. [1 Sch.27(1)]. Consistent with this, Section 17 *Property, Plant and Equipment* states that cost is normally either the purchase price paid (including directly attributable costs) or the fair value of non-monetary assets exchanged. [FRS 102.17.10, FRS 102.17.14]. The purchase price would generally represent the fair value of the consideration given to purchase the investment consistent with the guidance in respect of exchanges of businesses or other non-monetary assets (see Chapter 8 at 3.8) and the requirements in respect of measuring the cost of a business combination (see Chapter 22 at 3.6).

A venturer will recognise distributions received from its investments in jointly controlled entities as income irrespective of whether the distributions are from accumulated profits of the jointly controlled entity arising before or after the date of acquisition. [FRS 102.15.11].

3.5.2.B Fair value model

A venturer that is not a parent that accounts for its jointly controlled entity at fair value through other comprehensive income or fair value through profit or loss, initially recognises its investment at the transaction price. [FRS 102.15.14]. 'Transaction price' is not defined but is considered the same as its cost (see 3.6.2.A above).

At each subsequent reporting date, the venturer measures its investments in jointly controlled entities at fair value using the fair value guidance in Section 2A. [FRS 102.15.15].

When the fair value through other comprehensive income model is used, increases in the carrying amount as a result of a revaluation to fair value are recognised in other comprehensive income and accumulated in equity, i.e., revaluation reserve. However, if a revaluation increase reverses a previous revaluation decrease of the same investment that was recognised as an expense, it is recognised in profit or loss. [FRS 102.17.15E]. Decreases as a result of revaluation are recognised in other comprehensive income to the extent of any previously recognised revaluation increase accumulated in revaluation reserve in respect of the same investment. If a revaluation decrease exceeds the revaluation gains accumulated in revaluation reserve in respect of that investment, the excess is recognised in profit or loss. [FRS 102.17.15F]. This means that it is not permissible to carry a negative revaluation reserve in respect of each investment in jointly controlled entities held at fair value (see Chapter 20 at 3.6.3).

Where the fair value through profit or loss model is used, increases and decreases in the carrying amount of the investment as a result of a revaluation to fair value are recognised in profit or loss.

A venturer will recognise distributions received from its investments in jointly controlled entities as income irrespective of whether the distributions are from accumulated profits of the jointly controlled entity arising before or after the date of acquisition. [FRS 102.15.15A].

3.5.3 Venturer that is a parent

3.5.3.A Separate financial statements

A venturer that is a parent accounts for interests in jointly controlled entities in its separate financial statements in accordance with the requirements of Section 9 (see also Chapter 8 at 4.2). [FRS 102.15.1].

The parent is required to apply a policy of accounting for its investments in jointly controlled entities either:

- At cost less impairment (i.e., a cost model).
 - Fair value with changes in fair value recognised in OCI (or profit or loss) in accordance with paragraphs 15E and 15F of Section 17 *Property, Plant and Equipment*
- Or
- At fair value with changes in fair value recognised in profit or loss (guidance on fair value is provided in Section 2). [FRS 102.9.26].

The discussion at 3.5.2.A and 3.5.2.B above with respect to the cost model and the fair value model will be relevant for a parent applying either of these models.

The same choices apply to a parent that is exempt in accordance with Section 9 paragraph 9.3 from the requirement to present consolidated financial statements and therefore presents separate financial statements as its only financial statements. [FRS 102.9.26A].

Section 9 states that a parent must apply the same accounting policy for all investments in a single class (for example investments in subsidiaries that are held as part of an investment portfolio, those that are not so held, associates or jointly controlled entities) but it can elect different policies for different classes. [FRS 102.9.26].

How we see it

As discussed in Chapter 8 at 4.2, in our view, associates or jointly controlled entities held as part of an investment portfolio could be considered as a separate class from other associates or jointly controlled entities in the separate financial statements of a parent. While Sections 14 and 15 do not specifically refer to different classes of associates and jointly controlled entities, we believe that an entity that is not a parent may similarly adopt a different accounting policy in accounting for associates and jointly controlled entities held as part of an investment portfolio to that applied to other associates and jointly controlled entities in its individual financial statements.

3.5.3.B Consolidated financial statements

In its consolidated financial statements, a venturer that is a parent accounts for its investments in jointly controlled entities using the equity method, except where its investments in jointly controlled entities are held as part of an investment portfolio. In the latter case such investments in jointly controlled entities are required to be measured at fair value in its consolidated financial statements with the changes in fair value recognised in profit or loss. [FRS 102.15.9A, FRS 102.9B].

Investments in jointly controlled entities are held as part of an investment portfolio if their value to the venturer is through fair value changes in a directly or indirectly held basket of investments rather than as a means through which the venturer carries out business. A basket of investments is held indirectly if a venturer holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments (see Chapter 8 at 3.4.2.A). [FRS 102 Appendix I].

3.6 Equity method

3.6.1 Overview

Under the equity method, an investment is initially recognised at the transaction price (including transaction costs) and is subsequently adjusted to reflect the investor's share of:

- Profit or loss
- Other comprehensive income
- And
- Equity of the associate [FRS 102.14.8]

The investor's share of the jointly controlled entity's profit or loss is recognised in the investor's profit or loss. [FRS 102.5.5, 6 Sch 20(3)]. The investor's share of the jointly controlled entity's other comprehensive income is recognised in the investor's statement of comprehensive income. [FRS 102.5.5A(b)].

The requirements of the equity method are applied to jointly controlled entities, substituting 'joint control' for 'significant influence' and 'jointly controlled entity' for 'associate'. [FRS 102.15.13].

3.6.2 Summary of the equity method

The equity method is discussed in detail in Chapter 17. The key aspects of the equity method as applicable to an investment in a jointly controlled entity are therefore as follows: [FRS 102.14.8]

- A venturer commences equity accounting for a jointly controlled entity from the date it obtains joint control over the entity (see Chapter 17 at 3.3.1).
- Distributions received from the jointly controlled entity reduce the carrying amount of the investment. Adjustments to the carrying amount may also be required as a consequence of changes in the jointly controlled entity's equity arising from items of other comprehensive income (see Chapter 17 at 3.3.2).
- In applying the equity method, the proportionate share of the jointly controlled entity to be accounted for, in many cases, will be based on the venturer's ownership interest in the ordinary shares of the entity. A venturer measures its share of profit or loss and other comprehensive income of the jointly controlled entity as well as its share of changes in the jointly controlled entities' equity based on present ownership interests. Those measurements do not reflect the possible exercise or conversion of potential voting rights (see Chapter 17 at 3.2.2.E).
- On acquisition of the investment in a jointly controlled entity a venturer accounts for any difference (whether positive or negative) between the cost of acquisition and its share of the fair values of the net identifiable assets of the jointly controlled entity in accordance with Section 19, as implicit goodwill (see Chapter 22 at 3.9). A venturer adjusts its share of the jointly controlled entity's profits or losses after acquisition to account for additional depreciation or amortisation of the jointly controlled entity's depreciable or amortisable assets (including goodwill) on the basis of the excess of their fair values over their carrying amounts at the time the investment was acquired (see Chapter 17 at 3.2.2.D). If negative goodwill arises (the acquirer's interest in the net amount of the associate's identifiable assets, liabilities and provisions for contingent liabilities exceeds the cost of the investment), the acquirer must (after reassessing the identification and measurement of the acquiree's assets and liabilities and the measurement of the cost of the combination) recognise the excess up to the fair value of the non-monetary assets acquired in the jointly controlled entity's profit or loss in the periods in which the non-

monetary assets are recovered. Any excess exceeding the fair value of the non-monetary assets acquired is recognised in profit or loss in the periods expected to be benefited. [FRS 102.19.24]. If the interest in the jointly controlled entity is acquired on a piecemeal basis then the approach to such acquisitions is discussed, in the context of equity accounting, in Chapter 17 at 4.2.

- If there is an indication that an investment in a jointly controlled entity may be impaired a venturer tests the entire carrying amount of the investment for impairment in accordance with Section 27 (see Chapter 29) as a single asset. Any goodwill included as part of the carrying amount of the investment in the jointly controlled entity is not tested separately for impairment but, rather, as part of the test for impairment of the investment as a whole (see Chapter 17 at 3.2.2.H and Chapter 17 at 3.2.2.I).
- The venturer eliminates unrealised profits and losses resulting from upstream (jointly controlled entity to investor) and downstream (investor to jointly controlled entity) transactions to the extent of the venturer's interest in the jointly controlled entity. Unrealised losses on such transactions may provide evidence of an impairment of the asset transferred (see Chapter 17 at 3.2.2.G).
- In applying the equity method, the investor uses the financial statements of the jointly controlled entity as of the same date as the financial statements of the investor unless it is impracticable to do so. If it is impracticable, the investor uses the most recent available financial statements of the jointly controlled entity, with adjustments made for the effects of any significant transactions or events occurring between the accounting period ends (see Chapter 17 at 3.2.2.B).
- If the jointly controlled entity uses accounting policies that differ from those of the investor, the investor adjusts the jointly controlled entity's financial statements to reflect the investor's accounting policies for the purpose of applying the equity method unless it is impracticable to do so (see Chapter 17 at 3.2.2.C).
- If a venturer's share of losses of a jointly controlled entity equals or exceeds the carrying amount of its investment in the jointly controlled entity, the venturer discontinues recognising its share of further losses. After the venturer's interest is reduced to zero, the venturer recognises a provision for additional losses (see Section 21 *Provisions and Contingencies*) only to the extent that the venturer has incurred legal or constructive obligations or has made payments on behalf of the jointly controlled entity. If the jointly controlled entity subsequently reports profits, the venturer resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised (see Chapter 17 at 3.2.2.H).

And

- A venturer discontinues the use of the equity method from the date that joint control ceases. The subsequent accounting depends on the nature of any retained investment. If the investment becomes a subsidiary (because control is obtained), it will be accounted for in accordance with Section 19 (i.e., a step-acquisition, see Chapter 22 at 3.11). If the investment becomes an associate, it will be accounted for in accordance with Section 14 (i.e., it will continue to be accounted for under the equity method, see Chapter 17). Otherwise, on a full or partial disposal, a profit or loss will be recognised based on the difference between the disposal proceeds and the carrying amount relating to the proportion of the jointly controlled entity disposed of. Any retained investment is accounted for as a financial asset in accordance with Section 11 or Section 12 (see Chapter 17 at 3.2.2.J for further discussion).

3.7 Transactions between a venturer and joint venture

3.7.1 Background

It is common for venturers to transact with the joint venture, in particular on the formation of the venture. Typical transactions include:

- The venturers contribute cash to the venture in proportion to their agreed relative shares. The venture then uses some or all of the cash to acquire assets from the venturers for use in the venture.
- The venturers contribute other assets (or a mixture of cash and other assets) to the joint venture with fair values in proportion to the venturers' agreed relative shares in the venture.

And

- The venturers contribute other assets to the joint venture with fair values not in proportion to the venturers' agreed relative shares. Cash 'equalisation' payments are then made between the venturers so that the overall financial position of the venturers corresponds to their agreed relative shares in the venture.

3.7.2 Requirements of Section 15

When a venturer contributes or sells assets to a joint venture, Section 15 requires that the recognition of any portion of a gain or loss from the transaction reflects the substance of the transaction. While the assets are retained by the joint venture and provided the venturer has transferred the significant risks and rewards of ownership, the venturer only recognises that portion of the gain or loss that is attributable to the interests of the other venturers in its consolidated financial statements. However, the venturer recognises the full amount of any loss when the contribution or sale provides evidence of an impairment loss. [FRS 102.15.16].

These requirements are shown in the following Illustrations:

Illustration 3-3: Sale of asset from venturer to joint venture at a profit

Two entities, A and B, establish a joint venture involving the creation of a jointly controlled entity C in which A and B each hold 50%. A and B each contribute £5m in cash to the joint venture in exchange for equity shares. C then uses £8m of its £10m cash to acquire a property from A recorded in the financial statements of A at £6m. It is agreed that £8m is the fair value of the property.

The required accounting entry for A is as follows:

	£m	£m
Dr Cash ⁽¹⁾	3	
Dr Investment in C ⁽²⁾	4	
Cr Property ⁽³⁾		6
Cr Gain on sale ⁽⁴⁾		1

(1) £8m received from C less £5m contributed to C.

(2) £5m initial investment in C, less £1m (share of profit eliminated - see (4) below. In effect, this treatment represents that A still holds 50% of the property at its original carrying value to A (50% of £6m = £3m) plus 50% of the cash held by the joint venture (50% of £2m = £1m)

(3) Derecognition of A's original property.

(4) Gain on sale of property £2m (£8m received from C less £6m carrying value = £2m), less 50% eliminated (so as to reflect only profit attributable to interest of the other venturer B) = £1m.

In Illustration 3-3 above, the elimination of A's share of the profit has been made against the asset that was the subject of the transaction and now held by A. This is based on our suggested approach for the elimination of unrealised profits and losses resulting from downstream transactions (investor to jointly controlled entity) under Section 14, discussed in Chapter 17 at 3.2.2.G. It is also consistent with the treatment where a venture exchanges a non-monetary asset for an interest in another entity that becomes a jointly controlled entity of a venture (see 3.8 below).

Illustration 3-4: Sale of asset from venturer to joint venture at a loss

Two entities, A and B, establish a joint venture involving the creation of a jointly controlled entity C in which A and B each hold 50%. A and B each contribute £5m in cash to the joint venture in exchange for equity shares. C then uses £8m of its £10m cash to acquire a property from A recorded in the financial statements of A at £10m. £8m is agreed to be the fair market value of the property.

The required accounting entry for A is as follows:

	£m	£m
Dr Cash ⁽¹⁾	3	
Dr Investment in C ⁽²⁾	5	
Dr Loss on sale ⁽³⁾	2	
Cr Property ⁽⁴⁾		10

(1) £8m received from C less £5m contributed to C.

(2) Represented by 50% of C's cash of £2m (£10 m from A and B minus £8m to A), plus 50% of £8m (carrying value of the property in books of C).

(3) Loss on sale of property £2m (£8m received from C less £10m carrying value = £2m) not adjusted since the transaction indicated an impairment of the property. In effect, it is the result that would have been obtained if A had recognised an impairment charge immediately prior to the sale and then recognised no gain or loss on the sale.

(4) Derecognition of A's original property.

When a venturer purchases an asset from a joint venture, the venturer does not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party or otherwise realises its carrying amount. For example on an item of property, plant and equipment, this will occur as the asset is depreciated or written down for impairment; therefore, the appropriate proportion of the previously unrecognised profit can be recognised as the asset's carrying value is reduced. A venturer recognises its share of the losses resulting from these transactions in the same way as profits except that losses are to be recognised immediately when they represent an impairment loss. [FRS 102.15.17].

These requirements are shown in the following illustrations:

Illustration 3-5: Sale of asset from joint venture to venturer at a profit

Two entities A and B establish a joint venture involving the creation of a jointly controlled entity C in which A and B each hold 50%. A and B each contribute £5m in cash to the joint venture in exchange for equity shares. C then uses £8m of its £10m cash to acquire a property from an independent third-party D. The property is later sold to A for £12m, which is agreed to be its market value. How must A account for these transactions?

The required accounting entry for A is:

	£m	£m
Dr Property ⁽¹⁾	10	
Dr Investment in C ⁽²⁾	7	
Cr Cash ⁽³⁾		17

- (1) £12m paid to C less elimination of A's share of the profit made by C £2m (50% of £12m sales proceeds less £8m cost to C).
- (2) £5m initial investment in C plus profit on sale of property by C that is attributable to B. In effect, this treatment represents A's 50% interest in the cash held by the joint venture (50% of £14m).
- (3) £5m cash contributed to C plus £12m consideration paid for property.

In Illustration 3-5 above, the elimination of A's share of the profit made by C has been made against the asset that was the subject of the transaction and now held by A. This is based on our suggested approach for the elimination of unrealised profits and losses resulting from upstream transactions (jointly controlled entity to investor) under Section 14, discussed in Chapter 17 at 3.2.2.G.

Illustration 3-6: Sale of asset from joint venture to venturer at a loss

Two entities A and B establish a joint venture involving the creation of a jointly controlled entity C in which A and B each hold 50%. A and B each contribute £5m in cash to the joint venture in exchange for equity shares. C then uses £8m of its £10m cash to acquire a property from an independent third-party D. The property is then sold to A for £7m, which is agreed to be its market value. How must A account for these transactions?

The accounting entry for A is:

	£m	£m
Dr Property ⁽¹⁾	7.0	
Dr Investment in C ⁽²⁾	4.5	
Dr Share of loss of C ⁽³⁾	0.5	
Cr Cash ⁽⁴⁾		12.0

- (1) £7 million paid to C.
- (2) Represented by 50% of C's cash of £9m (£10m from A and B minus £8m to D plus £7m received from A).
- (3) Loss in C's books is £1 million (£8m cost of property less £7m proceeds of sale). A recognises its 50% share because the transaction indicates an impairment of the asset, which is recognised by C as an impairment charge immediately prior to the sale.
- (4) £5m cash contributed to C plus £7m consideration for property.

It may be that transactions occur between a venturer and a joint venture in assets, such as inventories, which are destined for onward sale in the normal course of business by the buying party. The accounting adjustments required are the same as for similar transactions between an investor and its associate - see Illustrations 12.6 and 12.7 in Chapter 17 at 3.2.2.G.

3.7.3 Loans and borrowings between the venturer and joint ventures

The requirement in Section 15 to eliminate partially unrealised profits or losses on transactions with joint ventures is expressed in terms of transactions involving the transfer of assets. The requirement for partial elimination of profits could be read to not apply to items such as interest paid on loans and borrowings between the reporting entity and its joint ventures, since such loans and borrowings do not involve the transfer of assets giving rise to gains or losses. Moreover, they are not normally regarded as part of the investor's share of the net assets of the joint venture, but as separate transactions (except in the case of loss-making joint ventures, where interests in long-term loans and borrowings may be required to be accounted for as if they were part of the reporting entity's equity investment in determining the carrying value of the joint venture against which losses may be offset).

How we see it

We believe that loans and borrowings between the reporting entity and its joint ventures generally are not eliminated in the reporting entity's consolidated financial statements when the interest income and expense are recognised by both parties.

However, if the joint venture has capitalised the borrowing costs, then the investor would need to eliminate a relevant share of its interest income and realise it as the associate depreciates the qualifying asset. The same principle applies to eliminate a share of capitalised management or advisory fees charged to a joint venture.

3.8 Transactions to create a jointly controlled entity

A venturer may exchange a business, or other non-monetary asset, for an interest in another entity, and that other entity becomes a jointly controlled entity of the venturer. Questions arise regarding the use of fair value or previous carrying values and reporting any gain on the transaction.

The requirements in respect of such transactions are set out in Section 9 (see also Chapter 8 at 3.8). The principles are that the only exception to the use of fair values must be in rare circumstances where the transaction is artificial and has no substance and that any unrealised gains are not reported in profit or loss.

Accordingly, the following accounting treatment is applied in the consolidated financial statements of the investor:

- The retained interest in the assets exchanged is not remeasured and included at its pre-transaction carrying amount. The investor retains an ownership interest in the business or other non-monetary assets exchanged, held through the jointly controlled entity. That retained interest, including any related goodwill, is treated as having been owned by the investor throughout the transaction and included at its pre-transaction carrying amount.
- Goodwill is recognised as the difference between:
 - The fair value of the consideration given.
 - And
 - The fair value of the investor's share of the pre-transaction identifiable net assets of the joint venture.

The consideration given for the interest acquired in the jointly controlled entity includes that part of the business or other non-monetary assets exchanged and no longer owned by the investor. I.e., the part effectively sold to the other investors in the associate. The consideration might also include cash or monetary assets to achieve equalisation of values. For example, where all investing parties in the joint venture have contributed assets of values not precisely commensurate with each party's ultimate ownership interest in the joint venture. When it is difficult to value the consideration given, the best estimate of its value may be obtained by valuing what is acquired.

- To the extent that the fair value of the consideration received by the investor exceeds the assets given up, the investor recognises a gain. The assets given up include the part of the business or other non-monetary assets exchanged and no longer owned by the investor, as well as any related goodwill and cash transferred. Any unrealised gain arising on the exchange is recognised in other comprehensive income.
- And

- To the extent that the fair value of the consideration received by the investor is less than the carrying value of assets given up, the investor must recognise a loss. The assets given up include the part of the business or other non-monetary assets exchanged and no longer owned by the investor, as well as any related goodwill and cash transferred. The loss is recognised either as an impairment in accordance with Section 27 or, for any loss remaining after an impairment review of the relevant assets, in profit or loss. [FRS 102.9.31].

The most common situation for these transactions in practice is the contribution of a business for equity in a joint venture (or associate), and such a transaction forms the basis of illustrating the above accounting requirements in Illustration 3-7 below.

Illustration 3-7: Creation of a jointly controlled entity by the transfer of non - monetary assets (1)

A and B are two companies which agree to form a jointly controlled entity (JV Co) in respect of a particular part of each of their businesses. A will own 40% of the JV Co, and B 60%. The parties agree that the total value of the new business is £250m.

A's contribution to the venture is one of its subsidiaries, the net assets of which are included in A's consolidated balance sheet at £60m (including remaining unamortised goodwill of £10m). The fair value of the separable net assets of the subsidiary contributed by A is considered to be £80m. The implicit fair value of the business contributed is £100m (40% of total fair value £250m).

B also contributes a subsidiary, the net assets of which have a carrying amount of £85m (including remaining unamortised goodwill of £15m). The fair value of the separable net assets is considered to be £120m. The implicit fair value of the business contributed is £150m (60% of total fair value £250m).

The carrying and fair values of the businesses contributed by A and B are summarised as follows:

(in £m)	A		B	
	Carrying value	Fair value	Carrying value	Fair value
Separable net assets	50	80	70	120
Goodwill	10	20	15	30
Total	60	100	85	150

How must A account for the set-up of the jointly controlled entity?

The required entries in A would be:

	£m	£m
Dr Share of net assets of JV Co ⁽¹⁾	68	
Dr Goodwill ⁽²⁾	16	
Cr Net assets contributed to JV Co ⁽³⁾		60
Cr Other comprehensive income (gain on disposal) ⁽⁴⁾		24

(1) 40% of (carrying value of A's separable net assets + fair value of B's separable net assets), i.e., 40% × (£50m + £120m) = £68m.

(2) Fair value of consideration given by A less fair value of separable net assets of B's business acquired, i.e., 60% of £100m less 40% of £120m = £12m (which can also be 'proved' as being 40% of B's inherent goodwill of £30m), plus 40% of A's original goodwill of £10m retained (£4m) = £16m. This goodwill will be included in the total carrying value of JV Co.

(3) Previous carrying amount of net assets contributed by A, now deconsolidated. In reality there would be a number of entries to deconsolidate these on a line-by-line basis.

(4) Fair value of consideration received, less carrying value of assets disposed of, i.e., 40% of £150m - 60% of £60m = £24m (which can also be 'proved' as being 60% of the £40m difference between the carrying value and fair value of A's business).

The gain on the transaction in Illustration 3-7 is unrealised because qualifying consideration has not been received. Therefore, the gain is accounted for in other comprehensive income as only realised profits can be recognised in profit or loss. [FRS 102.9.31(c)]. Where part or all of the gain is realised then that portion can be taken to profit or loss. This is illustrated in Illustration 3-8 below:

Illustration 3-8: Creation of a jointly controlled entity by the transfer of non - monetary assets (2)

Assume the same fact pattern as in Illustration 3-7 above, except that A was to receive a stake of only 36% in JV Co. In that case it would be expected that A, having contributed assets worth 40% of the combined entity, would receive a cash payment of £10m (4% of £250m) directly from B in compensation for the reduction in the stake from 40% to 36%.

How must A account for the set-up of the jointly controlled entity?

The required entries in A would be:

	£m	£m
Dr Share of net assets of JV Co ⁽¹⁾	61.2	
Dr Cash	10.0	
Dr Goodwill ⁽²⁾	14.4	
Cr Net assets contributed to JV Co ⁽³⁾		60.0
Cr Profit and loss (gain on disposal)		10.0
Cr Other comprehensive income (gain on disposal) ⁽⁴⁾		15.6

(1) 36% of (carrying value of A's separable net assets + fair value of B's separable net assets), i.e., $36\% \times (£50m + £120m) = £61.2m$.

(2) Fair value of consideration given by A (net of £10m cash received from B) less fair value of separable net assets of B's business acquired, i.e., 64% of £100m (£64m) less £10m = £54m, less 36% of £120m = £10.8m (which can also be 'proved' as being 36% of B's goodwill of £30m), plus 36% of A's goodwill of £10m retained (£3.6m) = £14.4m. This goodwill will be included in the total carrying value of JV Co.

(3) Previous carrying amount of net assets contributed by A, now deconsolidated. In reality there would be a number of entries to deconsolidate these on a line-by-line basis.

(4) Fair value of consideration received (including £10m cash received from B), less carrying value of assets disposed of, i.e., 36% of £150m = £54m plus £10m cash = £64m - 64% of £60m = £25.6m (which can also be 'proved' as being 64% of the £40m difference between the carrying value and fair value of A's business). The gain on disposal of £25.6m has been split based on an allocation between 'realised' and 'unrealised' profit. It has been assumed that no liabilities were transferred to A as part of the consideration, and therefore all the profit backed by cash is treated as realised. This approach is further explained below.

Section 9 does not explain how a realised gain can be distinguished from an unrealised gain. Illustration 3-7 above, adopts a 'top slicing' approach whereby as much of the total gain as is backed by cash is treated as realised (i.e., £10m). 'Top slicing' is the recommended approach to determining realised profits for exchanges of assets in paragraph 3.18 of the ICAEW/ICAS TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006*. Paragraph 3.18A of the guidance states that when the consideration received comprise a combination of assets and liabilities, the profit will be realised only to the extent of any net balance (i.e., cash less liabilities) of qualifying consideration received.

No gain or loss is recognised in those rare cases where the transaction is artificial or lacks substance. In that case, a gain or loss on the exchange is not justified. In these circumstances, disclosure is required. [FRS 102.9.32]. The standard gives no examples of when a transaction is artificial or lacks substance.

3.9 Variable profit share

Venturers may not always be entitled to a fixed proportion of the profit of a jointly controlled entity. Venturers that each have a 50% interest in a joint venture may, for example, agree that:

- In the initial three years of operation one of the venturers will be entitled to 75% of the profits in order to recover its investment quicker.
 - The venturers are entitled to a fixed proportion of cash flows 'as defined in the joint venture agreement'.
- Or
- The profit of the joint venture will be distributed based on an alternative measure of profitability such as earnings before interest, tax, depreciation and amortisation (EBITDA).

It may not be appropriate in those cases for the venturers to account for 50% of the profit of the joint venture. Instead, they would need to take into account the substance of the profit-sharing arrangements that apply in each reporting period, in determining their share of the profits and net assets of the joint venture. A venturer's profit share may therefore differ from its share in the net assets of the joint venture. This situation is not unlike the situation that arises in the case of an investment in an associate that has different classes of equity (see Chapter 17 at 3.2.2.E).

3.10 Company law matters

3.10.1 Jointly controlled entities

The Companies Act does not define a 'joint venture', but paragraph 18 of Schedule 6 of the Regulations refers to a 'joint venture' as an undertaking that is managed "jointly with one or more undertakings not included in the consolidation" in its description of non-corporate joint ventures that are permitted to be dealt with in consolidated financial statements by way of proportional consolidation. [6 Sch 18]. The disclosure requirements for 'joint ventures' are framed in the context of such joint ventures that are proportionally consolidated, [4 Sch 18], and hence under FRS 102, these requirements will not be relevant. However, jointly controlled entities that are equity accounted will be captured by the accounting and disclosure requirements in paragraph 19 of Schedule 6 of the Regulations which refer to 'associated undertakings'.

An '*associated undertaking*' is defined in the Regulations as "an undertaking in which an undertaking included in the consolidation has a participating interest and over whose operating and financial policy it exercises a significant influence, and which is not:

- (a) a subsidiary undertaking of the parent company, or
- (b) a joint venture dealt with in accordance with paragraph 18". [6 Sch 19(1)].

A '*participating interest*' is defined as "an interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest". The interest in shares includes interests which are convertible into shares or options to acquire shares, regardless of whether or not they are currently exercisable. Additionally, interests held on behalf of an undertaking are to be treated as held by it. [10 Sch 11(1), 10 Sch 11(3), 10 Sch 11(4)].

Hence an equity interest in a jointly controlled entity, given the nature of the joint control, will meet the definition of an associated undertaking for the purposes of the Regulations.

3.10.2 Measurement in individual entity accounts

Schedule 1 to the Regulations permits the equity method of accounting to be applied in respect of participating interests in the individual entity accounts of a venturer. [1 Sch 29A]. However, since FRS 102 already includes a number of options for accounting for such investments, this option was not introduced to FRS 102. Consequently, this option cannot be applied by a venturer in preparing their individual entity accounts in accordance with FRS 102 (see 3.5.2 above). [FRS 102.BC.A.28].

3.10.3 Presentation and disclosure

3.10.3.A Consolidated financial statements

The Regulations require that equity accounted investments in jointly controlled entities are presented as fixed asset investments in the balance sheet. [6 Sch 20]. When 'adapted formats' (see Chapter 6 at 4.1) are used, investments in jointly controlled entities must be shown as a separate balance sheet item and distinguished between current and non-current items. [FRS 102.4.2A].

Goodwill relating to a jointly controlled entity is included in the carrying amount of the investment. [FRS 102.15.13].

There is no guidance in FRS 102 as to how long-term interests (such as long-term loans for which no payment is intended in the foreseeable future) in jointly controlled entities must be presented and therefore an entity must make an accounting policy choice as to how such interests are presented. Entities frequently make loans to jointly controlled entities, the terms of which mean they are repayable on demand, but there is no intention of repayment in the foreseeable future. In these circumstances, for entities applying Schedule 1 to the Regulations, management will need to exercise judgement in determining whether such a loan is a debtor or a fixed asset investment in nature (see Chapter 6 at 4.3.4.A). For entities applying the adapted formats, such loans will need to be classified as appropriate between current or non-current assets (see Chapter 6 at 4.1.1).

In the profit and loss account, for entities applying the formats of Schedule 1 to the Regulations, income from interests in joint controlled entities are to be shown as one line item in the profit and loss account. [6 Sch 20]. For entities applying the adapted formats, the share of the profit or loss of associates and jointly controlled entities accounted for using the equity method must be included as a single line item in the profit and loss account. [FRS 102.5.5B]. The format of the profit and loss account and balance sheet under FRS 102 are discussed further in Chapter 6.

The Regulations also require that the following information must be given where an undertaking included in the consolidation has an interest in an 'associated undertaking' (which, as discussed at 3.10 above, will also be relevant for equity accounted jointly controlled entities):

- The name of the jointly controlled entity.
- The country in which the jointly controlled entity is incorporated for those incorporated outside the United Kingdom.
- The address of the registered office of the jointly controlled entity.
- The identity and proportion of the nominal value of each class of share held, disclosing separately those held by the:
 - Parent company.
 - And
 - Group. [4 Sch 19].

3.10.3.B Individual financial statements

In individual financial statements the Regulations require additional disclosures in respect of significant holdings in undertakings, other than subsidiary entities. A holding is deemed significant if:

- It amounts to 20% or more of the nominal value of any class of shares in the undertaking.
- Or
- The amount of the holding as stated in the company's individual accounts exceeds 20% of the stated net assets of the company. [4 Sch 4].

In practice, this definition will capture most investments in jointly controlled entities. The resulting disclosures in individual accounts are:

- The name of each jointly controlled entity.
- The address of the registered office of each jointly controlled entity.
- The address of each jointly controlled entity's principal place of business if unincorporated.
- And
- The identity and proportion of the nominal value of each class of share held. [4 Sch 5].

Additional disclosure would also be required in respect of each jointly controlled entity detailed above of:

- The aggregate amount of the capital and reserves of each entity.
- And
- The profit or loss for the year of each entity. [4 Sch 6].

The additional disclosures immediately above are not required when the jointly controlled entity is not required to publish its balance sheet anywhere in the world and the holding is less than 50% of the nominal value of the shares (or the information is not material). [4 Sch 6].

A parent is not required to provide the additional disclosures of paragraph 6 of Schedule 4 in the Regulations in its individual financial statements if it is exempt under Sections 400 or 401 of the Act from the requirement to prepare group accounts and the company discloses, in the notes to its accounts, the aggregate investment in the relevant jointly controlled entities determined by way of the equity method of valuation. [4 Sch 13].

A parent that prepares consolidated financial statements and discloses the information described at 3.10.3.A above in respect of its jointly controlled entities is not required to give the above disclosures in its individual financial statements. [4 Sch 4].

4 Disclosures

Section 15 requires the following disclosures in individual and consolidated financial statements:

- The accounting policy for investments in jointly controlled entities.
- The carrying amount of investments in jointly controlled entities.
- The fair value of each investment in a jointly controlled entity accounted for using the equity method, if a market price for the investment is quoted.

And

- The aggregate amount of commitments relating to joint ventures, including the venturers share in the commitments that have been incurred jointly with other venturers. [FRS 102.15.19].

For jointly controlled entities accounted for using the equity method, a venturer discloses separately its share of the profit or loss of such investments and its share of any discontinued operations of such jointly controlled entities. [FRS 102.15.20].

For jointly controlled entities accounted for at fair value through other comprehensive income, a venturer must make the disclosures required by paragraphs Section 11 paragraphs 43 and 44 (this is notwithstanding the fact that paragraph 44 refers to fair value through profit or loss, but the intention is clearly to make these disclosures for fair value through other comprehensive income): [FRS 102.15.21]

- The basis for determining fair value (e.g., quoted market price in an active market or a valuation technique. If the latter is used, the assumptions applied in determining fair value for each class of financial assets or liabilities must be disclosed).

And

- If a reliable measure of fair value is no longer available for financial instruments that would otherwise be required to be measured at fair value through profit or loss this fact is disclosed and the carrying amount of those financial instruments.

The individual financial statements of a venturer that is not a parent must disclose summarised financial information about its investments in the jointly controlled entities, along with the effect of including those investments as if they had been accounted for using the equity method. Summarised financial information is not defined in FRS 102, but using the GAAP hierarchy to refer to IFRS 12 *Disclosure of Interests in Other Entities*, it would be appropriate to include: current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss from continuing operations, post-tax profit or loss from discontinued operations, other comprehensive income, total comprehensive income. This list is not exhaustive and other items may need to be considered if deemed material. [IFRS 12.B.12]. Investing entities that are exempt from preparing consolidated financial statements, or would be exempt if they had subsidiaries, are exempt from this requirement. [FRS 102.15.21A].

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for joint ventures are set out below.

FRS 102		IFRS
Scope and classification	Classifies joint ventures as either jointly controlled operations, jointly controlled assets or jointly controlled entities with different accounting considerations for each. Classification as jointly controlled entity requires existence of a separate legal entity.	Defines joint arrangements and classifies them between joint operations and joint ventures. Classification as a joint venture depends on assessment of the venturer's rights and obligations over the arrangement.
Accounting for jointly controlled operations	A venturer recognises in its financial statements: ▪ The assets that it controls and the liabilities that it incurs - And ▪ The expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture	A joint operator recognises: ▪ Assets, including any share of assets held jointly ▪ Liabilities, including its share of any liabilities incurred jointly ▪ Revenue from the sale of its share of the output by the joint operation ▪ Share of the revenue from the sale of the output by the joint operation - And ▪ Expenses, including its share of any expenses incurred jointly The accounting and measurement for each of these items is in accordance with the applicable IFRS.
Accounting for jointly controlled assets	A venturer recognises in its financial statements: ▪ Its share of the jointly controlled assets, classified according to their nature ▪ Any liabilities that it has incurred ▪ Its share of any liabilities incurred jointly with the other venturers in relation to the joint venture ▪ Any revenue from the sale or use of its share of the output of the joint venture together with its share of any expenses incurred by the joint venture - And ▪ Any expenses that it has incurred in respect of its interest in the joint venture	Although IFRS does not have a concept of jointly controlled assets, such assets would normally qualify as joint operations as defined by IFRS 11. The accounting for joint operations is, in substance, the same as the accounting for jointly controlled assets under FRS 102.

FRS 102		IFRS
Individual and separate entity financial statements	An entity that is not a parent or is a parent that prepares separate financial statements, has the option to account for its investments in jointly controlled entities using either the cost model, fair value through other comprehensive income (movements follow the PP&E revaluation model and there is no recycling) or at fair value through profit or loss. Under FRS 102, there is no option to use equity accounting in the separate financial statements of an investor that is a parent or the individual financial statements of an investor that is not a parent.	An entity that is not a parent (i.e., has no subsidiaries) accounts for its investments in associates under the equity accounting method unless it meets criteria for exemption. An entity that is a parent and prepares separate financial statements accounts for its investments at cost, in accordance with IFRS 9 or using the equity method.
Investment portfolios/funds	Investments in jointly controlled entities held as part of an investment portfolio are measured at fair value through profit or loss in the consolidated financial statements of a venturer that is a parent.	Venture capital organisations and similar entities can choose to measure investments in joint ventures at fair value through profit or loss. Investment entities would elect this option.
Implicit goodwill and fair value adjustments on acquisition of an equity-accounted jointly controlled entity	Follows the requirements of Section 19 of FRS 102. Goodwill is be amortised over its finite useful life, but if, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life must not exceed 10 years.	Follows the IFRS requirements regarding business combinations. Implicit goodwill is not amortised.
Loss of joint control of an equity-accounted jointly controlled entity that does not become a subsidiary or an associate	If loss of joint control is as a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds and the carrying amount relating to the proportion disposed of. The carrying value of the equity interest retained at the date joint control is lost becomes the cost of the retained investment. If the loss of joint control is for reasons other than a partial disposal, no gain or loss is recognised and the carrying value of the equity-accounted investment at the date joint control is lost becomes the cost of the retained investment.	If loss of joint control is as a result of a partial disposal, a gain or loss is recognised based on the disposal proceeds together with the fair value of any retained interest and the carrying amount of the total interest in the joint venture. If loss of joint control is for reasons other than a partial disposal, a gain or loss is recognised based on the fair value of the retained interest and the carrying amount of the interest in the joint venture at that date.
Exchange of business or other non-monetary assets for an interest in a joint venture in consolidated financial statement.	Gains that are not realised are reported in other comprehensive income.	No distinction between realised and unrealised gains and all gains/losses are reported in profit or loss.

FRS 102		IFRS
Disclosures in financial statements (key differences)		
Summarised financial information	Only the individual financial statements of a venturer that is not a parent must disclose summarised financial information about its investments in the jointly controlled entities, along with the effect of including those investments as if they had been accounted for using the equity method.	Summarised financial information of material Joint Ventures and individually material Joint Ventures (in aggregate) required in the consolidated accounts of a venturer.
Restrictions	Not applicable	The nature and extent of any significant restrictions on the ability of joint ventures to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity is required to be disclosed.
Non-coterminous financial statements of a Joint Venture	Not applicable	When the financial statements of a joint venture used in applying the equity method are as of a date or for a period that is different from that of the entity the following are disclosed: ▪ The date of the end of the reporting period of the financial statements of that joint venture or associate - And ▪ The reason for using a different date or period
Unrecognised share of losses	Not applicable	Disclosure of the unrecognised share of losses of a joint venture, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the joint venture when applying the equity method.

Appendix A - Defined terms

Extract from FRS 102 Appendix 1 Glossary

Definitions

consolidated financial statements	The financial statements of a parent and its subsidiaries presented as those of a single reporting entity.
control (of an entity)	The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
held as part of an investment portfolio	An interest is held as part of an investment portfolio if its value to the investor is through fair value as part of a directly or indirectly held basket of investments rather than as a media through which the investor carries out business. A basket of investments is indirectly held if an investment fund holds a single investment in a second investment fund which, in turn, holds a basket of investments. In some circumstances, it may be appropriate for a single investment to be considered an investment portfolio, for example when an investment fund is first being established and is expected to acquire additional investments.
individual financial statements	The accounts that are required to be prepared by an entity in accordance with the Act or relevant legislation, for example: (a) 'individual accounts', as set out in section 394 of the Act; (b) 'statement of accounts', as set out in section 132 of the Charities Act 2011; or (c) 'individual accounts', as set out in section 72A of the Building Societies Act 1986. Separate financial statements are included in the meaning of this term.
joint control	The contractually agreed sharing of control over an economic activity. It exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).
jointly controlled entity	A joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.
joint venture	A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures can take the form of jointly controlled operations, jointly controlled assets or jointly controlled entities.
parent	An entity that has one or more subsidiaries.
separate financial statements	Those presented by a parent in which the investments in subsidiaries, associates or jointly controlled entities are accounted for either at cost or fair value rather than on the basis of the reported results and net assets of the investees. Separate financial statements are included within the meaning of individual financial statements.
subsidiary	An entity, including an unincorporated entity such as a partnership, which is controlled by another entity (known as the parent).
venturer	A party to a joint venture that has joint control over that joint venture.

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Chapter 19

Investment property

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Overview

This chapter covers the requirements of Section 16 *Investment Property* which prescribes the accounting treatment and related disclosures for investment property, i.e., a property (land or a building - or part of a building - or both) held by the owner, or by the lessee as a right-of-use asset, to earn rentals or for capital appreciation or both. [FRS 102 Appendix I]. Accordingly, this section must be applied in the recognition, measurement and disclosure of investment property.

On initial recognition, investment properties are measured at cost. Subsequently, except for certain properties required or allowed to be measured using a cost model (see 3.1.2 and 3.1.7 below) or measured at cost amount less impairment (see 3.3.3 below), all investment properties are measured using a fair value model. Fair value is determined in accordance with Section 2A *Fair Value Measurement* and any gains and losses from periodic revaluation under the fair value model are recognised in profit or loss. The requirements of Section 2A are discussed in detail in Chapter 10.

A property is required to be transferred to, or from, investment property only when there is a change in use. This transfer occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use.

Accounting for properties in the scope of Section 17 *Property, Plant and Equipment* is covered in Chapter 20 and accounting for properties in the scope of Section 13 *Inventories* is covered in Chapter 16.

What you need to know

- Section 16 applies to any property that meets the investment property definition, irrespective of the nature of the business of the reporting entity.
- Judgement is required in determining whether a property qualifies as investment property; an entity must develop criteria so that it can exercise that judgement consistently, and, when classification is difficult, disclose these criteria.
- Investment properties are held at fair value, except for the following:
 - An investment property rented to another group entity may be transferred to property, plant and equipment ('PP&E') or to right-of-use assets and accounted for using the cost model in accordance with Section 17 (for owned properties) or Section 20 *Leases* (for investment property held by the entity as the lessee), respectively.
 - If the fair value of the investment property component of a mixed use property cannot be measured reliably, the entire property is accounted for as PP&E under Section 17 (for owned properties) or, as a right-of-use asset under Section 20 (for investment property held by the entity as the lessee).
 - If, in exceptional cases only, a reliable measure of fair value is no longer available for an investment property, it must remain to be classified as investment property but measured at a cost equal to the carrying amount at the last date when the property was reliably measurable, less impairment (if any), until a reliable measure of fair value becomes available.
 - A valuation technique other than using an unadjusted quoted price is likely to be the most common methodology used in estimating fair value for investment property due to the lack of an active market for identical assets.
 - The definition of 'fair value' in Section 2A is consistent with 'market value' as defined in International Valuation Standards (IVS). But, perhaps confusingly, it differs from the IVS definition of fair value. Management needs to be aware of the conceptual differences between Section 2A and IVS to ensure any values used for financial reporting that are obtained from appraisals, whether external or internal, are consistent with the objective of fair value measurement in accordance with Section 2A.

1 Introduction

What primarily distinguishes investment property from other types of property interests is that its cash flows (from rental or sale) are largely independent of those from other assets held by the entity. By contrast, property used by an entity for administrative purposes or for the production or supply of goods or services do not generate cash flows themselves but do so only in conjunction with other assets. Therefore, FRS 102 proposes a different model for investment properties than for PP&E under Section 17. However, for investment properties rented to another group entities, an entity has an accounting policy choice to transfer such property to PP&E or to right-of-use assets, if applicable (see 3.1.2 below).

Section 16 applies to accounting for investments in properties (i.e., land or buildings) and property interests held by a lessee under a lease (see 3.1.5 below) that meet the definition of investment property (see 3.1 below). This chapter discusses the version of Section 16 contained in the September 2024 edition of FRS 102, which incorporates the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS - Periodic Review 2024* ('Periodic Review 2024') issued by the FRC in March 2024.

The key Periodic Review 2024 amendments which affect Section 16 are mainly due to the new lease accounting requirements in Section 20, which is based on the on-balance sheet model from IFRS 16 *Leases*. While lessor accounting is substantially unchanged from previous accounting, Section 20 significantly changes the accounting for lessees, requiring them to recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets. Under Section 20, lessees apply a single model for most leases i.e., they no longer need to classify leases as finance leases or as operating leases.

Leases of property that meet the definition of investment property in Section 16 are included in the scope of Section 20. As a consequence, the scope of Section 16 was amended by defining investment property to include both owned investment property and property held by a lessee as a right-of-use asset (see 3.1 below). Further, a number of paragraphs in Section 16 were amended, added or deleted due to the new lease accounting requirements in Section 20. For example:

- In paragraph 4 of Section 16, for mixed use property, if the fair value of the investment property component cannot be measured reliably, then the entire property is accounted for under Section 17, where held by the owner, or Section 20, as a right-of-use asset, if held by the lessee (see 3.1.7 below).
- In paragraph 6 of Section 16, the measurement basis at initial recognition has been updated to state that an investment property held by a lessee as a right-of-use asset is measured initially at its cost in accordance with Section 20 (see 3.2.4 below).
- In paragraph 7 of Section 16, it has been clarified that if a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it measures the right-of-use asset, and not the underlying property, at fair value (see 3.3.1 below).

As mentioned above, Section 20 requires a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model of Section 16 if the leased property meets the definition of investment property. This represents a change from the previous requirements of Section 16. Under previous requirements, the classification of property held under an operating lease as an investment property was an accounting policy election that was available on a property-by-property basis (see 3.1.5 below).

The Periodic Review 2024 also added a revised definition of fair value and added a new Section 2A to provide guidance on fair value measurement, both were amended to align with the definition and guidance in IFRS 13 *Fair Value Measurement*. Section 16 refers to Section 2A in determining the fair value of investment property (see 3.3.1 below).

Other Periodic Review 2024 amendments are editorial in nature and/or intended to merely clarify rather than change the accounting treatment. For example, additional guidance is added when accounting for transfers of assets to or from investment property, i.e., there must be evidence of change in use (see 3.4 below), and clarifies that use of judgement is necessary when determining whether the acquisition of investment property is the acquisition of an asset or a group of assets, or a business combination (see 3.2.8 below).

Except for the new supplier finance arrangements disclosure requirements (effective 1 January 2025), the Periodic Review 2024 is effective for accounting periods beginning on or after 1 January 2026, with early application permitted provided all amendments are applied at the same time (see Chapter 3 at 1.3).

The amendments are applied retrospectively in accordance with paragraph 12 of Section 10 *Accounting Policies, Estimates and Errors* (see Chapter 9 at 3.3.2), except when a specific transitional provision allows or requires otherwise (see Chapter 3 at 1.3). [FRS 102.1.39]. For example, the requirements of the new Section 2A are applied prospectively from the date of initial application (in the same way as a change in accounting estimate). [FRS 102.1.41].

2 Comparison between Section 16 and IFRS

There are some key differences between accounting for investment properties under Section 16 compared to IFRS (IAS 40 *Investment Property*). These are discussed at 2.1 to 2.5 below. The summary at 5 below contains the major GAAP differences.

2.1 Measurement basis after initial recognition

Section 16 requires all property (either owned or held by a lessee as right-of-use assets) meeting the definition of investment property (whose fair value can be measured reliably on an on-going basis - see 2.3 below) to be measured at fair value (see 3.3 below). [FRS 102.16.7]. For investment properties rented to other group entities, an entity has an accounting policy choice (see 3.1.2 below).

IAS 40 permits entities an accounting policy choice to use either cost or fair value for investment properties. Once an entity chooses a measurement basis, it must apply that basis to all of its investment properties. However, there are some exceptions for insurers and similar entities. [IAS 40.30-32C]. IAS 40 does not identify a preferred alternative although the fair value model seems to be the more widely adopted model amongst entities in real estate sector.

Under IFRS, insurance companies and other entities that hold specified assets, including investment properties, whose fair value or return is directly linked to the return paid on specific liabilities (i.e., liabilities that are secured by such investment properties), can choose either the fair value or cost model for all such properties without it affecting the choice available for all the other investment properties that they may hold. However, for some entities that operate an investment fund that provides investors with benefits determined by units in the fund, all properties within such a fund must be measured on the same basis. A similar requirement applies for some entities that issue insurance contracts with direct participation features, for which the underlying items include investment property. This is because IAS 40 does not permit the entity to measure the property held by such a fund partly at cost and partly at fair value.

[IAS 40.32A, IAS 40.32B].

2.2 Mixed use property

Section 16 states that a property that has mixed use must be separated between investment property and other property if the resulting portions could be sold separately or leased out separately under a finance lease. Section 16 further requires consideration of whether the separate investment property component can be fair valued. That is, if the fair value of the investment property component cannot be reliably measured, the entire property is accounted for as PP&E (for owned properties) in accordance with Section 17 or, as a right-of-use asset (for investment property held by the entity as the lessee) in accordance with Section 20 (see 3.1.7 below). [FRS 102.16.4].

Similar to above, IAS 40 requires that a property that has mixed use must be separated between the owner-occupied element and the investment property element only if the two elements could be sold (or leased under a finance lease) separately. However, the entire property is accounted for as PP&E or right-of-use assets, if applicable, only in the event that no separation is possible and if a significant proportion is used for non-investment property purposes. If no separation is possible and if an insignificant proportion is used for non-investment property purposes, the entire property is an investment property. [IAS 40.10].

IAS 40 emphasises that it is only in exceptional cases and only on initial recognition (either by acquisition or change in use) that the entity will be able to conclude that it will not be able to reliably measure the investment property's fair value on a continuing basis. [IAS 40.53]. Accordingly, if separation is possible but on initial recognition the fair value of the investment property element cannot be reliably measured on a continuing basis, the property is still classified as investment property but is measured using the cost model in IAS 16 *Property, Plant and Equipment* for owned investment property or cost model in accordance with IFRS 16 for investment property held by a lessee as a right-of-use asset, until its disposal. The investment property element is assumed to have a nil residual value (see also 2.3 below). [IAS 40.53].

2.3 Inability to reliably measure fair value

Section 16 requires investment property to be measured at fair value at each reporting date. Section 2A provides guidance on determining fair value (see 3.3.1 and 3.3.2 below). [FRS 102.16.7]. If a reliable measure of fair value is no longer available for an asset measured at fair value, its carrying amount at the last date the asset was reliably measurable becomes its new cost. The entity measures the asset at this cost amount less impairment, if any, until a reliable measure of fair value becomes available (see 3.3.3 below).

[FRS 102.2A.23].

Although there is a choice under IAS 40 whether to apply either the fair value or cost model, where an entity adopts the fair value model, "there is a rebuttable presumption that an entity can reliably measure the fair value of an investment property on a continuing basis." Only in exceptional circumstances and only on initial recognition (either by acquisition or change in use) of an investment property may that presumption be rebutted. [IAS 40.53]. In such exceptional cases, the property is measured using the cost model in IAS 16 for owned investment property, or the cost model in accordance with IFRS 16 for investment property held by a lessee as a right-of-use asset, until its disposal. The property is assumed to have a nil residual value. [IAS 40.53]. Once a property is initially recognised at its fair value, it must always be so recognised until disposed of or reclassified for owner-occupation or development for subsequent sale in the ordinary course of the business, even if comparable market transactions become less frequent or market prices become less easily available. [IAS 40.55].

2.4 Investment property rented to another group entity

Section 16 states that if investment property (or part of such property) is rented to another group entity, that property (or the part of that property that is rented to another group entity) must be accounted for either at fair value in accordance with Section 16 or by transferring the property to PP&E and applying the cost model in accordance with Section 17 (for owned properties) or by transferring the property to right-of-use assets and applying the cost model in Section 20 (for investment property held by the entity as the lessee) (see 3.1.2 below). [FRS 102.16.1A, FRS 102.16.4A, FRS 102.16.4B]. Accordingly, the treatment of such property in the individual accounts and in the group accounts would be the same if an entity chooses to account for such property in its individual accounts as PP&E or, if applicable, as right-of-use asset.

Under IFRS, if an entity owns property (either as a freehold property or as a right-of-use asset) that is leased to, and occupied by, its parent or another subsidiary, that property meets the definition of an investment property from the perspective of the entity that owns it. There is no option to treat the property as PP&E, or a right-of-use asset, in the individual financial statements. In the consolidated financial statements the property does not qualify as investment property because the property is owner-occupied from the perspective of the group. Therefore, the lessor treats the property as investment property in its individual financial statements but the same property would be treated differently, i.e., as PP&E or, if applicable, as right-of-use asset, in the consolidated financial statements. [IAS 40.15].

2.5 Disclosures

The disclosure requirements of Section 16 (see 4 below) are less extensive than those of IFRS. For example, unlike IAS 40, Section 16 does not require comparative information to be presented in the reconciliation between the carrying amounts of investment property at the beginning and the end of the reporting period. In addition, IAS 40 and IFRS 13 require extensive amounts of information relating to fair value measurement compared to Section 2A and Section 16.

3 Requirements of Section 16 for investment property

3.1 Definition, scope and initial recognition of investment property

Only items that meet the definition of an 'asset' are recognised in the statement of financial position.

[FRS 102.2.50]. An asset is defined as a present economic resource, which is a right that has the potential to produce economic benefits, that is controlled by the entity as a result of past events. [FRS 102 Appendix I]. This is further discussed in Chapter 4 at 3.6.2.

Accordingly, an entity recognises an asset (e.g., investment property) in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. This is consistent with the recognition criteria for PP&E under Section 17. These recognition criteria apply for any costs incurred, whether initially or subsequently (see Chapter 20 at 3.3 and 3.3.3). [FRS 102.17.4].

Section 16 applies to investment property. [FRS 102.16.1]. Investment property is defined as property (land or a building, or part of a building, or both) held by the owner, or by the lessee as a right-of-use asset, to earn rentals or capital appreciation or both. [FRS 102 Appendix I].

This means that any entity, whatever the underlying nature of its business, can hold investment property assets if its intention on initial recognition (either by acquisition or by transfer - see 3.4 below) is to hold them for rent or for capital appreciation or both. Subsequent to initial recognition, reclassifications of assets into and from investment property are discussed at 3.4 below. A property interest held by a lessee under a lease as a right-of-use asset can also be an investment property (see 3.1.5 below).

How we see it

An entity's intention of holding a property plays an important role in determining whether it meets the definition of investment property or not. Such intention affects classification of the property at initial recognition, i.e., either when recognising an asset for the first time, or when an existing asset is to be transferred to, or from, investment property provided such change in intention is supported by evidence of change in use of that asset (see 3.4 below).

In contrast, property held by the owner, or by the lessee as a right-of-use asset, for use in the production or supply of goods or services or for administrative purposes (commonly referred to as 'owner-occupied property'), or property held or under construction for sale in the ordinary course of business is not investment property (see 3.1.11 below). [FRS 102 Appendix I]. Also, properties held primarily for the provision of social benefits are not classified as investment property (see 3.1.6 below). [FRS 102.16.3A]. In addition, a property which has mixed use must be separated between investment property and other property (see 3.1.7 below).

These, or the parts of these, properties that are not investment properties are accounted for either as PP&E under Section 17 (see Chapter 20), as right-of-use asset under Section 20 (see Chapter 23), or as inventories under Section 13 (see Chapter 16). The definition of investment property ensures that all property is covered by one, and only one, section in FRS 102, that is either Section 13, Section 16, Section 17 or Section 20.

Circumstances are not always straightforward particularly if at initial recognition the intention of holding a property is mixed or undetermined (except for land - see 3.1.4 below). For example, an entity could consider the Basis for Conclusions on IFRS 16 *Leases* where it states that "entities that are not in the property industry may not be within the scope of IAS 40 if they sublease a property under an operating lease with the intention of subsequently using the property within their own business. Such a property would not meet the definition of an investment property in IAS 40 because it would not be held solely for rentals, capital appreciation or both." [IFRS 16.BC179(b)]. In this example, the intended use of the property as an owner-occupied property would even be clearer if the sublease of the property would only be for a short period of time in relation to the remaining lease term of the head lease.

How we see it

Considering how an entity's principal activities and its business strategy for the property, including the length of the lease to a tenant, impact the determination of the intended use of the property (and therefore, whether the property meets the definition of an investment property) may require the exercise of judgement based on specific facts and circumstances. An entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and the related guidance in Section 16. If significant, disclosure of this judgement would be required by Section 8 *Notes to the Financial Statements*.

Further, as discussed in 1 above, what primarily distinguishes investment property from other types of property interest is that it generates cash flows (from rental or sale) that are largely independent of those from other assets held by the entity. By contrast, owner-occupied property used by an entity for administrative purposes or for the production or supply of goods or services does not generate cash flows that are attributable only to itself but does so only in conjunction with other assets used in the production or supply process. Section 17 applies to owned owner-occupied property and Section 20 applies to owner-occupied property held by a lessee as a right-of-use asset.

However, even with the distinction described above, it is sometimes difficult to distinguish investment property from owner-occupied property. This chapter therefore gives guidance to help determine whether or not an asset is an investment property (see 3.1.1 to 3.1.12 below).

Section 16 applies to the measurement in a lessor's financial statements of investment property provided to a third-party lessee under an operating lease (see 3.1.8 below). It also applies to the subsequent measurement in a lessee's financial statements of investment property interests held under a lease where the investment property is rented to a third party under an operating lease (see 3.1.5 below). For investment property rented to another group entity under an operating lease, Section 16 applies to the measurement of investment property in a lessor's financial statements, and/or to the subsequent measurement of investment property interests held under a lease in a lessee's financial statements, if the fair value model is selected to be applied to such investment property (see 3.1.2 below). However, Section 16 does not deal with other accounting matters that are dealt with in Section 20 (see Chapter 23), including:

- Classification of leases as finance or operating leases by a lessor.
- Recognition of lease income arising from the leasing of investment property.
- Initial measurement in a lessee's financial statements of property interests held under a lease.
- Measurement in a lessor's financial statements of its net investment in a finance lease.
- Accounting for sale and leaseback transactions.
- Disclosure of information about leases by lessors and lessees.

Section 16 does not apply to investment property rented to another group entity that is transferred to either PP&E or to right-of-use assets (see 3.1.2 below). [FRS 102.16.4A].

In some situations, there may be difficulties in determining whether or not an acquisition of a single investment property or a group of assets - notwithstanding that they may be held within a separate entity or entities - constitutes an acquired business within the scope of Section 19 *Business Combinations and Goodwill*, and judgement will need to be exercised based on the particular circumstances. [FRS 102.16.2A]. This is further discussed in 3.2.8 below.

3.1.1 Investment property under construction

Section 16 does not explicitly scope in investment property under construction. However, it states that an entity determines the cost of a self-constructed investment property in accordance with paragraphs 10 to 14 of Section 17 (see Chapter 20 at 3.4). [FRS 102.16.5].

How we see it

The above reference to Section 17 implies that investment property under construction is within the scope of Section 16 and that classification as an investment property is determined at initial recognition, instead of when construction is completed. Furthermore, it implies that the FRC believe that an investment property under construction is normally recognised and measured initially at cost under Section 17 on the grounds that the fair value cannot be reliably measurable until completion. However, in our view, if the fair value can be reliably measured during construction, then FRS 102 would require that investment property under construction to be held at fair value.

See 3.2.3 below for measurement of investment property under construction at initial recognition.

3.1.2 Investment property leased to other group entities

A property leased to other parties, which would include group entities, under an operating lease is within the scope of Section 16 as it meets the definition of an investment property (see 3.1.8 below).

[FRS 102 Appendix I, FRS 102.16.4A, FRS 102.16.4B].

Note that the treatment of inter-group leased property in the consolidated financial statements can be different from the treatment in standalone financial statements of individual group entities. For example, it may be the case that a property owned by one group company (either as a freehold property or as a right-of-use asset) is held for occupation by another group company. In consolidated financial statements transactions between group entities, including income and expenses in respect of inter-group leased property, are eliminated in accordance with Section 9 *Consolidated and Separate Financial Statements* (see Chapter 8 at 3.5.1). Accordingly, such a property owned by one group company but leased to another will be an owner-occupied property (see 3.1.11 below) from the perspective of the group as a whole but can be classified as an investment property in the financial statements of the individual entity that owns it, provided it meets the definition of an investment property and the owner does not elect the accounting policy choice to transfer such property to PP&E or to right-of-use assets, if applicable. This accounting policy choice is discussed further below. This classification in the lessor's individual financial statements will apply even if the rental is not at arm's length and the individual entity is not in a position to benefit from capital appreciation.

How we see it

A property, that meets the investment property definition (see 3.1 above), which is owned by a group entity (either as a freehold property or as right-of-use asset) but occupied by an associate or a joint venture would be accounted for as investment property in the consolidated financial statements. This is because associates and joint ventures are not part of the group.

A significant amount of feedback from stakeholders suggested that the cost of obtaining a fair value for an investment property that is rented to another group entity far outweighs the benefit, as the information is of little use when the investment property would be treated as PP&E in the consolidated financial statements. As a result, an accounting policy choice was introduced whereby entities that rent investment property to another group entity can choose to measure that investment property either at cost (less depreciation and impairment) or at fair value. [FRS 102.BC.B16.2, FRS 102.BC.B16.3].

Section 16 states that an entity that rents investment property (or part of such property) to another group entity must account for those properties as follows: [FRS 102.16.4A, FRS 102.16.4B]

Extract from Section 16

Investment property rented to another group entity

- 16.4A** An entity that rents investment property to another group entity shall choose to account for those properties either:
- (a) at fair value with changes in fair value recognised in profit or loss in accordance with this section (Section 2A provides guidance on determining fair value); or
 - (b) by transferring them, in the case of investment properties held by the entity as:
 - (i) the owner, to property, plant and equipment and applying the cost model in accordance with Section 17; or
 - (ii) the lessee, to right-of-use assets and applying the cost model in accordance with Section 20.

An entity choosing to apply (b) above shall provide all the disclosures required by the relevant section, other than those related to fair value measurement.
- 16.4B** When only part of a property is rented to another group entity and the remainder is used for other purposes (such as being rented to an external third party or owner-occupied), paragraph 16.4A only applies to the component of that property that is rented to another group entity.

Section 16 is not explicit on whether the accounting policy choice described above can be applied on a property-by-property basis.

How we see it

As currently written, it appears that an entity's accounting policy choice must be applied to all of its investment properties (or part of such property) rented to another group entities.

If an entity subsequently changes its previous choice of accounting policy, this represents a change in accounting policy and must be accounted for retrospectively (see Chapter 9 at 3.3). [FRS 102.10.10, FRS 102.10.12].

3.1.3 Property with the provision of ancillary services

Section 16 provides no guidance on the impact (if any) of ancillary services on the classification of a property as an investment property where such services (e.g., security and maintenance services) are provided by the owner to the user of the investment property.

However, the definition of an investment property requires that the property must be held for capital appreciation and/or rentals rather than for use in the production or supply of goods and services. Therefore, if an owner provides ancillary services to the user of the investment property, exercise of judgement will be required to determine whether or not the property is being held for capital appreciation/rentals or for the income generated by the supply of those ancillary goods and services.

How we see it

Section 16 is silent on this matter. In our view, it would be reasonable to consider the related guidance in adopted IFRS as allowed by Section 10. Paragraph 11 of IAS 40 states that if the owner supplies ancillary services to the user of the investment property, the property will not qualify as an investment property unless these services are an insignificant component of the arrangement as a whole. For example, security and maintenance services provided by the owner of an office building to the lessees who occupy that building are described as being insignificant.

The crucial issue is the extent to which the owner is involved with the underlying business and retains significant exposure to the risks of running a business. IAS 40 does not provide further guidance on when ancillary services are 'significant' (which would result in exclusion of the property from its scope). The IASB concluded that quantitative guidance would create arbitrary distinctions. [IAS 40.B39].

IAS 40, however, uses the example of an owner-managed hotel, which would be precluded from being an investment property as the services provided to guests are a significant component of the commercial arrangement as a whole. Therefore, an owner-managed hotel is owner-occupied property, rather than investment property. [IAS 40.12].

It may be difficult to determine whether ancillary services are so significant that a property does not qualify as an investment property. For example, the owner of a hotel sometimes transfers some responsibilities to third parties under a management contract and the terms of such contracts may vary widely. However, the nature of the asset in question is not the key factor; rather it is the nature of the owner's involvement and interest in the asset. If the owner's position is, in substance, that of a passive investor, a property would be treated as investment property. If, in contrast, the owner has outsourced day-to-day functions while retaining significant exposure to variation in the cash flows generated by the operations that are being executed in the property, such a property would rather be treated as owner-occupied property. [IAS 40.13].

How we see it

As discussed above, IAS 40 refers to owner-managed hotels as being precluded from being investment property. Hotel properties that are leased on arm's length terms to hotel operators may, however, fall to be accounted for as investment property. This is more likely to be the case when:

- The payments under the lease are not significantly determined by the results of the hotel operator (see 3.1.10 below), rather they reflect the general market for such properties.
- And
- The nature of the owner's rights in the arrangements with the operator is not divergent from those usually expected under a property lease.

IAS 40 acknowledges that this question of significance can require judgements to be made. It also specifies that an entity develops consistent criteria for use in such instances that reflect the provisions described above. [IAS 40.14]. If significant, disclosure of this judgement would be required by Section 8 *Notes to the Financial Statements*. [FRS 102.8.6].

3.1.4 Land

The definition of an investment property refers to land as well as buildings. Therefore, land is investment property if it is held to earn rentals or for capital appreciation or both. This is in contrast to land that is held for sale in the ordinary course of business (typically in the shorter term) or held for the production or supply of goods and services or for administrative purposes.

A situation may arise where an entity has land but has not yet decided what this land will be used for.

How we see it

Section 16 is silent on this matter. In our view, it would be reasonable to consider the related guidance in adopted IFRS as allowed by Section 10. IAS 40 provides guidance that if, on initial recognition, land is held for a currently undetermined future use, i.e., if an entity has not determined whether it will use the land as owner-occupied property, or for sale in the ordinary course of business, or to earn rentals or for capital appreciation, it is deemed to be held for capital appreciation and must be classified as investment property.

3.1.5 Property interest held under a lease

Leases of property are included in the scope of Section 20 (see Chapter 23). The Basis for Conclusions to FRS 102 explains that prior to the Periodic Review 2024 amendments, Section 16 applied to property held by a lessee under a finance lease and could be applied to property held under an operating lease, if certain criteria were met. As part of the Periodic Review 2024 amendments (see 1 above), the FRC introduced an on-balance sheet lease accounting model based on IFRS 16, which removed the distinction between finance leases and operating leases for a lessee, amongst other changes. Consequential amendments were made to Section 16 that bring all leases for which right-of-use assets are recognised in scope of Section 16 if the other criteria for accounting for the property as investment property are met. This approach is similar to the approach taken in IAS 40. [FRS 102.BC.B16.5]. Accordingly, properties held by lessees as right-of-use assets that meet the definition of investment property, as described in 3.1 above, are included in the scope of Section 16.

An investment property held by a lessee as a right-of-use asset is initially recognised in accordance with Section 20 (see 3.2.4 below). [FRS 102.16.6]. Subsequently, Section 20 requires a lessee to measure right-of-use assets arising from leased property in accordance with the fair value model in Section 16 if the leased property meets the definition of investment property. However, for investment property rented to another group entity held by the lessee as right-of-use asset, the lessee could elect to apply the fair value model in Section 16 (see 3.3 below) or the cost model in Section 20 (see Chapter 23 at 6.3.1.A) as an accounting policy choice (see 3.1.2 above). [FRS 102.16.4A, FRS 102.20.60].

When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it will measure the right-of-use asset, and not the underlying property, at fair value. Section 2A provides guidance on determining fair value (see 3.3.1 below). [FRS 102.16.7].

If the right-of-use assets meet the definition of investment property, these are presented in the statement of financial position as investment property (see Chapter 23 at 6.7). [FRS 102.20.75]. In addition to the relevant disclosure requirements in Section 20 (see Chapter 23 at 6.8), a lessee also applies the disclosure requirements in Section 16 for such right-of-use assets (see 4 below). [FRS 102.16.11, FRS 102.20.83].

Subsequent to initial recognition, the related lease liability would be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). For further discussion on subsequent measurements of lease liabilities and right-of-use assets, see Chapter 23 at 6.3.

3.1.6 Social benefit entities

Section 16 specifically excludes properties whose main purpose is to provide social benefits, from being accounted for as investment properties. For example, social housing held by a public benefit entity (i.e., an entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members).

[FRS 102 Appendix I]. Such properties held primarily for the provision of social benefits are properties held to supply services, which do not meet the definition of an investment property, and therefore, are accounted for as PP&E in accordance with Section 17 (see Chapter 20). [FRS 102.16.3A, FRS 102.BC.B17.3].

The requirements for property held for the provision of social benefits, as described above, apply to all entities applying FRS 102 and are not restricted to public benefit entities. [FRS 102.BC.B17.1]. On the other hand, public benefit entities may also hold investment properties, being those that are not held primarily to provide social benefits, but return market value rentals and/or are held for their capital appreciation. FRS 102 requires those properties to be accounted for as investment properties. [FRS 102.BC.B17.4].

Accordingly, Section 16 applies to a property acquired and let for social housing if it meets the definition of investment property (see 3.1 above). Grants associated with investment property are accounted for in accordance with Section 24 *Government Grants* (see Chapter 26).

3.1.7 Properties with mixed use

A property may have mixed use and could be partly owner-occupied and partly held for rental. For example, an entity may own a building and occupy some floors for its own use but also sub-lease other floors to tenants. Similarly with industrial/commercial property, an owner could sub-divide and subsequently sell or rent out some portions and retain other portions for own use.

Section 16 requires that mixed use property must be separated between investment property and other property if the resulting portions could be sold separately or leased out separately under a finance lease. [FRS 102.16.4].

How we see it

To meet the above requirements, we consider that a property must actually be in a state and condition to enable the owner to dispose of it or lease it out separately at the end of the reporting period.

The fact that a property could be divided in future periods if the owner so chose is insufficient to conclude that the portions can be accounted for separately. Consequently, if a property requires sub-division before the portions could be disposed of separately, then those parts are not accounted for as separate portions and the entire property must be accounted for as either an investment property or as a non-investment property (e.g., as an owner-occupied property or as an inventory property) until such sub-division occurs or unless sub-division is a non-substantive legal requirement.

In certain instances, portions of a property are leased out under operating leases rather than under finance leases.

How we see it

In our view, an intention to lease out, or the action of leasing out a portion of a property under an operating lease (rather than a finance lease) is *prima facie* evidence that, if it so wished, the entity could also lease out the property under a finance lease - the difference between the two commonly being just the length of the lease. Accordingly, this does not prohibit the application of Section 16 to that portion. If, however, there is evidence that the portion of the property could not be leased out under a finance lease, then Section 16 could not be applied to that portion and further assessment of the facts and circumstances may be needed.

It also seems clear that 'separately' needs to be assessed both in terms of the physical separation (e.g., mezzanine floors and partitioning walls) of the property and to legal separation (e.g., legally defined property boundaries and/or registered separately).

In the UK, as well as in many jurisdictions, properties that are physically sub-divided into different portions (for example, different floors) are registered in a Land or Property registry as one single property and need to be legally sub-divided before a portion can be leased out to another party or disposed of. Often, these legal proceedings are undertaken only at or near the point of sale of, or the assignment of a lease on, that portion of the property concerned. At the end of the reporting period the legal sub-division might not have occurred.

How we see it

For a property that is already physically sub-divided into different portions, we believe that judgement is required to determine whether the legal separation is a substantive requirement that will restrict the portion of the property concerned being currently separable or whether it is a non-substantive requirement where it is currently separable.

For example:

- If the entity owning the property could not be prevented from legally sub-dividing the property, then it is already in a condition to be sold separately and this would not prevent the portion of the property concerned being accounted for as investment property. This would be the case where, for example: the process of sub-dividing the property was entirely within the control of the entity and did not require permission from a third party (which would include the relevant authorities); or if permission from a third party was required, but this was no more than a formality.
- Conversely, if the entity was required to obtain the permission of third parties before legally sub-dividing the property, and such permission could realistically be withheld, the portions of the property concerned are not accounted for separately until such legal sub-division occurs.

Therefore, if the portion of the property concerned otherwise meets the definition of investment property at the end of the reporting period, judgement is required to assess the legal position of the property in determining whether it is appropriate to account for a portion separately under Section 16. Criteria used in the assessments described above must be applied consistently and if significant, disclosure of these judgements would be required by Section 8. [FRS 102.8.6].

In cases where the components of a mixed use property can be physically and legally separated but the fair value of the investment property component cannot be measured reliably, the entire property must be accounted for, in the case of property held by the owner, as PP&E in accordance with Section 17 or, in the case of property held by the lessee, as a right-of-use asset in accordance with Section 20. Section 2A provides guidance on determining fair value (see 3.3.1 below). [FRS 102.16.4].

However, there could also be cases where components of a mixed use property cannot be physically and legally separated but the fair value of the entire property can be measured reliably.

How we see it

Section 16 is silent on this matter. In our view, it would be reasonable to consider the related guidance in adopted IFRS as allowed by Section 10. Under paragraph 10 of IAS 40, in the event that no separation is possible (i.e., portions could not be sold or leased out separately under a finance lease), the property is an investment property only if an insignificant portion is used for non-investment property purposes.

However, IAS 40 does not provide further guidance to clarify what constitutes an 'insignificant portion' for this purpose. The IASB concluded that quantitative guidance would create arbitrary distinctions. [IAS 40.B39].

How we see it

If the portions could not be sold or leased out separately under a finance lease, classification and accounting of the entire property depends on the significance of the portions used for non-investment property purposes; but IAS 40 does not provide further guidance on this. Therefore, the setting of a threshold to evaluate whether or not something is 'significant' or 'insignificant' depends on judgement of facts and circumstances.

Criteria used in the assessments described above must be applied consistently and if significant, disclosure of these judgements would be required by Section 8. [FRS 102.8.6].

3.1.8 Property leased to others

Properties leased to other parties under one or more operating lease are generally investment properties, whether they are owned freehold by the reporting entity or are right-of-use assets relating to properties held by the reporting entity (see 3.1 and 3.1.5 above). Under adopted IFRS, this will also apply if the property is currently vacant while tenants are being sought. [IAS 40.8].

In the real estate industry, properties might have been held for sale in the ordinary course of business since their initial recognition (either by acquisition or transfer - see 3.4.2 below) but are leased out prior to sale in order to minimise cash outflows whilst the entity seeks a buyer; and because prospective buyers may view the existence of such lease contracts positively, especially those that wish to acquire property for investment purposes.

How we see it

In our view, such properties described above - notwithstanding that they are leased to tenants under operating leases - are accounted for as inventories under Section 13 as long as it remains the intention of the entity to hold such properties for sale in the ordinary course of business (see 3.1.9 below). The rent received would be recorded as operating lease income in profit or loss, and would not be treated as a reduction in the cost of inventory. See Chapter 16 at 3.2.2 for further discussion.

When an entity no longer intends to sell an inventory property, Section 16 requires the property to be transferred from inventories to investment properties when, and only when, there is a change in use evidenced, for example, by the commencement of an operating lease to another party (see 3.4 below).

Property that is leased to another party under a finance lease is not an investment property but is accounted for under Section 20 (see Chapter 23).

3.1.9 Property held or under construction for sale in the ordinary course of business

Property held, or being constructed, with the intention of sale in the ordinary course of business is not an investment property. This includes, for example, property acquired exclusively for sale in the near future or for development and resale. This is also irrespective of whether the property is let out or not, as discussed in section 3.1.8 above. Such property is accounted for as inventory under Section 13 (see Chapter 16).

An entity, whose principal business activity is to buy and sell property for short-term gains, may, in some circumstances, buy property (or reclassify existing property following a change in use - see 3.4 below) with the intention of holding it for long-term capital appreciation. Investment property is defined as property held to earn rentals or for capital appreciation or both, rather than for sale in the ordinary course of business (see 3.1 above). The fact that the entity's principal business activity is the buying and selling of property for short-term gains does not, under this definition, prohibit it from classifying properties that are held for long-term capital appreciation as investment properties.

How we see it

While there is no explicit guidance in Section 16 on how to quantify 'short-term', it seems reasonable to define this period based on an entity's operating cycle. That is, for an entity which chooses to use the adapted format in presenting its statement of financial position, as long as an asset is a 'current asset' in terms of the definition in Appendix I to FRS 102 (see Chapter 6 at 4.1.1), an entity could conclude that the asset is held for a short term.

In practice, the classification between investment property and property intended for sale in the ordinary course of business can be a difficult judgement. There is only a fine line between:

- A property held for capital appreciation, and therefore classified as investment property.
- And
- A property intended for sale in the ordinary course of business, which would be classified as inventory.

For example, the owner will undertake activities to increase the property's value prior to sale or where there is uncertainty in obtaining permits required from relevant authorities prior to commencing construction activities. In the latter case, the property, e.g., land, may continue to appreciate in value during the period when there are no development activities - see 3.2.5 below.

Another example is where an entity acquires a tenanted property with a view to redevelop the property and to resell it in the future, but active development will only commence after the existing lease reaches the end of its term, i.e., the entity receives rent payments during the intervening period. As set out at 3.1.8 above, the receipt of rental income from a property would not necessarily be the deciding factor. Certainly, other than for land (see 3.1.4 above), there is no deemed 'default' classification when the future use of a property has not yet been determined (see also discussion in section 3.1 above).

How we see it

While there are different treatments for short-term and long-term holdings of property, sometimes significant judgement is involved in determining whether a property qualifies as investment property or is inventory, not least because the intentions of management are a critical factor. Exercise of judgement is also important because whilst paragraph 9 of Section 16 requires property held as inventory to be reclassified as investment property when the property meets the definition of investment property and there is evidence of a change in use such as the inception of an operating lease to another party, in contrast, a reclassification from investment property to inventories would require a different evidence of a change in use such as the commencement of a development with a view to sale (see 3.4.1 below).

Accordingly, an entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance in Section 16. If significant, disclosure of this judgement would be required by Section 8. [FRS 102.8.6].

3.1.10 Property where rentals are determined by reference to the operations in the property

It may also be inappropriate to consider a property as investment property if the owner is significantly exposed to the operation of the business in the property through a linkage between the rentals charged and the performance of the business.

For a property that is leased out to a retailer under a lease contract in which rentals are being determined by reference to turnover or profit, the appropriate classification of the property can be difficult.

How we see it

Section 16 is silent on this matter. In our view, it would be reasonable to consider the related principles in IAS 40 as allowed by Section 10. In the case described above, if the turnover- or profit-related element is a very significant proportion of total rental, then consideration must be given to whether the landlord is so involved with the underlying business as to make classification of the property as investment property inappropriate. This will be a matter of judgement based on any other specific facts and circumstances (for example, the length of the lease, the level of exposure to the performance of the underlying business or the degree of involvement in the management of the underlying business).

Accordingly, an entity develops criteria so that it can exercise that judgement consistently in accordance with the definition of investment property and with the related guidance in Section 16. If significant, disclosure of this judgement would be required by Section 8. [FRS 102.8.6].

3.1.11 Property held for own use ('owner-occupied')

As noted in 3.1 above, owner-occupied property, that is property (either owned or held by a lessee as right-of-use asset) held for use in the production or supply of goods or services or for administrative purposes, is specifically excluded from being treated as investment property and is subject to the provisions of Section 17 or, where applicable, Section 20. Under adopted IFRS, owner-occupied property includes (among other things):

- Property that is going to be owner-occupied in the future (whether or not it has first to be developed).
 - Property occupied by employees (whether or not they pay rent at market rates).
- And
- Owner-occupied property awaiting disposal. [IAS 40.9].

Note that the treatment in the consolidated financial statements of a property held by a group entity (either owned or held by a lessee as right-of-use asset) for rent to another group entity under an operating lease, can be different from the treatment in standalone financial statements of such individual group entity. This is further discussed in 3.1.2 above.

3.1.12 Group of assets leased out under a single operating lease

It is sometimes the case in practice that a group of assets comprising land, buildings and 'other assets' is leased out by a lessor under a single lease contract in order to earn rental income. In such a case, the 'other assets' would generally comprise assets that relate to the manner in which the land and buildings are used under the lease. The issue that arises is under what circumstances the 'other assets' must be regarded by the lessor as part of an investment property rather than as a separate item of PP&E (or another asset). This is shown in the following Illustration:

Illustration 3-1: Definition of an investment property: a group of assets leased out under a single operating lease

A lessor enters into the following two single contract leases in order to earn rental income. All the individual assets subject to the leases meet the test of being classified as an operating lease. The lessor applies the fair value measurement model for subsequent measurement of investment property.

Lease 1: Vineyard and winery

A vineyard including a winery is leased out under an operating lease. The vineyard comprises the following assets:

- Land
- Vineyard infrastructure (e.g., trellises)
- Winery building structures

- Winery plant and machinery (crushing equipment, distilling equipment)
- Vines (grapes are excluded, as they belong to the lessee)

Lease 2: Port

A port is leased out under an operating lease. The port comprises the following assets:

- Land
- Warehouses
- Transport infrastructure to and from the port (roads, rail tracks, bridges)
- Wharves
- Light towers (that enable the 24-hour operation of the port)
- Specialised container cranes (to be able to move containers around)

To what extent can the 'other assets' included in the leases (but which are not considered to constitute a piece of land or a building) be included in the investment property definition under Section 16?

The consequence of including plant and equipment in the definition of investment property is that if the investment property is accounted for at fair value, changes in the fair value of that plant and equipment will, like changes in the fair value of the land and buildings, be recognised in profit or loss.

From a literal reading of the definition of an investment property (see 3.1 above), it could be argued that an investment property can consist only of a building (or part of a building), a piece of land, or both and cannot include 'other assets'. However, such an interpretation is inconsistent when determining the carrying amount of investment property under the fair value model, which implies that a broader interpretation is more appropriate.

Under adopted IFRS, further guidance is given as follows: [IAS 40.50(a), IAS 40.50(b)]

Extract from IAS 40

- 50** In determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:
- (a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as property, plant and equipment.
 - (b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset.
 - (c) ...

Although paragraph 50 of IAS 40 addresses the fair valuation of investment property, it nevertheless implies that other assets that are integral to the land and buildings or are otherwise required to be included in the lease in order to generate rental income under the lease concerned must also be regarded as being part of the investment property. Further, the separation of this group of assets in two parts - one part being classified as investment property and the other part being classified as an item of property, plant and equipment - might be misleading, as the entire group of assets generates a single stream of revenue.

Consequently, an item other than a piece of land or a building must be regarded by a lessor as being part of an investment property if this item is an integral part of it, that is, it is necessary for the land and buildings to be used by a lessee in the manner intended and is leased to the lessee on the same basis (e.g., as a package with the same lease term) as the land and buildings. In determining whether all the assets can be classified as investment property, the following conditions must be considered:

- The land and buildings must be the 'dominant assets' that form the investment property.
 - The 'other assets' are leased to the lessee together with the land and building as a whole.
- And
- The entire group of assets is generating the income stream from the lease contract.

How we see it

The determination as to whether or not an item constitutes an integral part of an investment property requires judgement and will depend on the particular facts and circumstances. However, it is our view that in order for all the assets to be classified as investment property, all the conditions referred to above must be present.

This means that, in the case of Lease 1, if the entire group of assets is leased with the purpose of enabling the lessee to produce grapes and, subsequently, wine, the investment property comprises the land, the vineyard infrastructure, the winery building structures and the winery plant and machinery. The vineyard infrastructure (e.g., trellises as they are essential to support the vines) is integral to the investment property, as it is necessary in order for the property to function properly (it is necessary for growing the grapes). The winery plant and machinery (crushing equipment, distilling equipment) are also integral to the investment property, as plant and machinery are necessary to process the grapes in order to make wine. Vines, which meet the definition of biological assets, are subject to the requirements of Section 34 *Specialised Activities* and whilst vines are important assets to produce grapes, they are not integral for the main property and other assets to function properly. Further, under adopted IFRS, they are excluded because 'biological assets related to agricultural activity' are outside the scope of IAS 40. [IAS 40.4(a)].

In the case of Lease 2, if the entire group of assets is leased with the purpose of enabling the lessee to use the assets to operate them as a port, the investment property comprises all of the assets, i.e., the land, the warehouses, the transport infrastructure, the wharves, the light towers, and the specialised container cranes. This is because all the assets are necessary for the port to function as intended.

3.2 Measurement at initial recognition

Section 16 requires an investment property to be measured at its cost at initial recognition. The cost of purchased investment property comprises its purchase price and any directly attributable costs such as legal fees, brokerage fees, property transfer taxes and other transaction costs. The purchase price might be paid in cash or deferred beyond normal credit terms (see 3.2.1 below). For a self-constructed investment property, Section 16 requires the cost to be determined in accordance with paragraphs 10 to 14 of Section 17. [FRS 102.16.5].

How we see it

Although specific reference to Section 17 is made only when determining the cost of a self-constructed investment property (see above and 3.2.3 below), we consider that the principles in Section 17 must still be applied to the recognition of costs in Section 16, i.e., for both self-constructed property and completed property. This means that only those elements of cost that are allowed by Section 17 could be capitalised and that capitalisation ceases when the asset has reached the condition necessary for it to be capable of operating in the manner intended by management.

These recognition principles in Section 17, together with the discussions of other practical issues, are set out in detail in Chapter 20 at 3.3.3 and 3.4.

An investment property held by a lessee as a right-of-use asset is recognised in accordance with Section 20 (see 3.2.4 below). [FRS 102.16.6].

3.2.1 Deferred payments

In considering the purchase price, if payment for the property is deferred beyond normal credit terms, the present value of all future payments is calculated in order to arrive at the cost. [FRS 102.16.5]. Accordingly, any difference between the present value and the total payments to be made is recognised as interest expense over the credit period.

3.2.2 Initial measurement of assets acquired in exchange transactions

Unlike for a 'self-constructed' property (see 3.2.3 below), Section 16 is silent on how to measure the cost of a 'completed' investment property acquired in part or in whole in exchange for a non-monetary asset.

However, guidance is contained in Section 17 in respect of how to measure the cost of an item of PP&E in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. This states that the cost of acquired asset is measured at fair value unless: [FRS 102.17.14]

- The exchange transaction lacks commercial substance.
- Or
- The fair value of neither the asset received nor the asset given up is reliably measurable. In that case, the asset's cost is measured at the carrying amount of the asset given up.

As discussed in 3.2 above, we consider that the principles in Section 17 must still be applied to the recognition of costs of acquired investment property in Section 16. Accordingly, an entity acquiring an investment property in exchange for a non-monetary asset or assets, or a combination of monetary and

non-monetary assets must follow the guidance in Section 17 as described above. Note that under the UK law, only profits realised at the balance sheet date may be included in the profit and loss account. [1 Sch 13(a)]. Therefore, any resulting gain or loss in the above exchange transactions is likely to be an unrealised profit or loss and would be reported in other comprehensive income to the extent that the consideration received does not meet the definition of a 'qualifying consideration' (such as investment property).

This guidance is further discussed in Chapter 20 at 3.4.4.

3.2.3 Self-constructed property

To determine the cost of a self-constructed investment property, Section 16 refers to the guidance in paragraphs 10 to 14 of Section 17 (see Chapter 20 at 3.4). [FRS 102.16.5]. This means that only those costs that are allowed by Section 17 can be capitalised and that capitalisation ceases when the asset has reached the condition necessary for it to be capable of operating in the manner intended by management.

Therefore, start-up costs (unless necessary to bring the property into working condition) and operating losses incurred before the investment property achieves the planned occupancy or rental income level are not to be capitalised because at the date of physical completion, the asset would be capable of operating in the manner intended by management. This is consistent with the principles in IAS 40. Also, consistent with IAS 40 and common practice, the cost of investment property is not increased by abnormal amounts of wasted material, labour, or other resources incurred in constructing or developing an investment property. [IAS 40.23].

In addition to the purchase price and costs directly attributable to bringing the property to the condition necessary for it to be capable of operating in the manner intended by management, the cost of a self-constructed investment property also comprises the initial estimate of costs, recognised and measured in accordance with Section 21 *Provisions and Contingencies*, of dismantling and removing the property and restoring the site on which it is located (see Chapter 24). If a self-constructed property meets the definition of a qualifying asset, its cost could also include any eligible borrowing costs capitalised in accordance with Section 25 *Borrowing Costs*, to the extent that the entity chooses to do so as an accounting policy choice (see Chapter 27). [FRS 102.17.10].

Paragraphs 11 to 14 of Section 17, referred to above, also provide guidance in determining which costs are not capitalisable, treatment of income and expenses of incidental operations during construction of a property, accounting for deferred payments and accounting for exchanges of assets when acquiring a property.

The above elements of cost are further discussed in Chapter 20 at 3.4.1 to 3.4.4.

3.2.3.A Cost of a building to be demolished in connection with the construction of a new building

It is not uncommon for property companies to acquire land with an existing building where the planned redevelopment requires the demolition of that building and its replacement with a new building that is to be held as investment property. In this case, the entity classifies the land and building on initial recognition as one item of investment property under Section 16 and measures the investment property based on its cost (see 3.2 above). [FRS 102.16.5]. Subsequently, the land and building are measured as one item at fair value at each reporting date (see 3.3 below). [FRS 102.16.7].

Entities holding investment properties may also decide to replace existing buildings with new ones and continue to hold these as investment properties. If an entity decides to replace an existing building with a new one but will continue to hold it as investment property, then the highest and best use of the land might not match the current use of the land. The value of the land may increase by constructing a different property (for example with more floors or with a different purpose). When determining the fair value of the investment property, the entity takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use (see 3.3.8 below). [FRS 102.2A.9]. Therefore, the existing building and land will be measured as one single asset based on its fair value. As the new building is constructed, the property (land and building) will continue to be measured as one single asset based on fair value from a market participant's perspective.

Entities replacing an existing building (accounted for as PP&E or inventory) with a building for their own use or a building to be sold in the ordinary course of their business will deal with the land and buildings under Section 17 (see Chapter 20 at 3.4.1.G) or Section 13 (see Chapter 16 at 3.2.14), respectively.

3.2.4 Initial measurement of property held under a lease

As discussed in 3.1.5 above, under Section 20, lessees apply a single model for most leases, i.e., unlike lessors, lessees do not need to classify leases as finance leases or as operating leases. Section 20 requires lessees to recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets (see Chapter 23).

An investment property held by a lessee as a right-of-use asset must be measured initially at its cost in accordance with Section 20 (see Chapter 23 at 6.2.1). [FRS 102.16.6]. The treatment of initial direct costs by a lessee applying Section 20 is discussed in section 3.2.9.B below.

3.2.5 Expenditure prior to planning permissions/zoning consents

In the UK, as well as in many jurisdictions, permissions from relevant authorities are required prior to development of new or existing property, and the ability to start physical construction of the development depends on these permissions.

Application for such permissions supports the entity's intention as to the use of the property and may be considered as a factor in classifying the asset. However, unless an entity is considering a number of possible uses of the asset at its initial recognition, the uncertainty in obtaining the relevant permission would usually not affect the classification of the property which, as set out in 3.1 above, is mainly based on the entity's intention when the property is first acquired. Subsequent to initial recognition, assets might be reclassified into and from investment property (see 3.4.2 below).

The likelihood of obtaining such permissions, however, is relevant in recognition and measurement of any additional costs to the property. Developers typically incur significant costs prior to such permissions being granted and such permissions are rarely guaranteed.

How we see it

In assessing whether pre-permission expenditure can be capitalised - assuming it otherwise meets the criteria - a judgement must be made, at the date the expenditure is incurred, of whether there is sufficient probability that the relevant permissions will be granted.

Conversely, if during the application and approval process of such permits it is no longer expected that necessary permits will be granted, capitalisation of pre-permission expenditure must cease and any related amounts that were previously capitalised and that will not be recovered in the future would be written off through determining the subsequent fair value of the property. Under the fair value model (see 3.3 below), it would not affect the measurement of the investment property in the statement of financial position; it would only affect presentation of write-off of expenses and fair value gains and losses in the income statement.

If, however, the property is measured at cost amount less impairment, e.g., due to the fact that the fair value of investment property can no longer be measured reliably (see 3.3.3 below), the carrying amount of any related property subject to development or redevelopment (or, if appropriate, the cash generating unit where such an asset belongs) must be tested for impairment, where applicable, in accordance with Section 27 *Impairment of Assets* (see Chapter 29).

3.2.6 Income from tenanted property during development

An entity may have acquired an investment property, which has been generating rental income, but subsequently intends to redevelop it with the same purpose of renting it out in the future. An issue that can arise is whether rental and similar income generated by existing tenants in a property development may be capitalised and offset against the cost of developing that property.

Section 17 requires that the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense (see Chapter 20 at 3.4.2). [FRS 102.17.12]. We consider that rental and similar income from existing tenants are incidental operations to the development. The existence of the tenant is not a necessary condition for the property to be developed to a state capable of operating in the manner intended by management; management could have developed the property in the absence of any existing tenants.

How we see it

In our view, there must not be a measurement difference between the cost of a property development dealt with under Section 16 and the cost of a property development dealt with under Section 17.

Therefore, rental and similar income generated by existing tenants in a property dealt with under Section 16 and now intended for redevelopment must not be capitalised against the costs of the development. Rather, rental and similar income are recognised in profit or loss in accordance with the requirements of Section 20 (see Chapter 23), together with any related expenses. For these purposes it is irrelevant whether the investment property is held at fair value, or in certain cases, at cost (see 3.3 below).

3.2.7 Payments by the vendors to the purchaser

In some instances, a transaction for the purchase of an investment property may include an additional element where the vendor repays fixed or variable amounts to the purchaser - e.g., when the vendor agrees to compensate the purchaser for specific transaction costs incurred or perhaps described as representing a rental equivalent for a period of time such as rental guarantees.

The question then arises whether, in the financial statements of the purchaser, these payments are recorded as income (albeit perhaps recognised over a period of time) or as a deduction from the acquisition cost of the investment property on initial recognition.

How we see it

In our view, such amounts described above are an integral part of the acquisition transaction and must invariably be treated as a deduction from the acquisition cost of the investment property because the payment is an element of a transaction between a vendor and purchaser of the property (rather than, for example, a landlord and tenant in respect of rental guarantees).

In the event that the repayments by the vendor are spread over time, the fair value of the right to receive those payments is deducted from the cost of the investment property and an equivalent financial asset is recognised. The financial asset would be accounted for in accordance with Section 11 *Basic Financial Instruments* and/or Section 12 *Other Financial Instruments Issues* which could lead to it being classified as financial asset at amortised cost or at fair value through profit or loss (see Chapter 13 at 6).

3.2.8 Acquisition of investment property or business combination

It is not uncommon for property companies to acquire a single investment property, with lease agreements with multiple tenants over varying periods and associated processes, such as cleaning, maintenance and administrative services such as rent collection. Further, the discussion in 3.1.3 above relates to 'ancillary services' and while these are often insignificant to the overall arrangement as to disqualify a property from being an investment property, these could nonetheless be considered 'processes' (see Chapter 22 at 3.2.2) that could result in the acquired set of activities constituting a business.

Therefore, judgement is required to determine whether the acquisition of investment property is an acquisition of an asset or a group of assets, or a business combination within the scope of Section 19.

[FRS 102.16.2A].

Consistent with IAS 40, it is worth clarifying that the discussion about 'ancillary services' in 3.1.3 above relates to whether or not a property is owner-occupied property or investment property and not to determining whether or not a property is a business as defined in Section 19. Determining whether a specific transaction meets the definition of a business combination as defined in Section 19 and includes an investment property as defined in Section 16 requires the separate application of both sections.

[FRS 102.16.2A]. Accordingly, reference must be made to Section 19 (see Chapter 22 at 3.2) to determine whether it is a business combination and this judgement will rest upon the facts and circumstances of each acquisition. If significant, disclosure of this judgement would be required by Section 8. [FRS 102.8.6].

Section 19 establishes different accounting requirements for a business combination as opposed to the acquisition of an asset or a group of assets that does not constitute a business (see 3.2.8.A below).

Therefore, determining whether an acquired investment property is a business or not, could result in significantly different accounting outcomes, both at the date of acquisition (i.e., at initial recognition) and subsequently. If dealt with as an acquisition of a business, then the initial accounting for investment property is considerably more complex. For example, amongst other requirements:

- Initial direct costs are expensed (Section 16 requires these to be capitalised - see 3.2 above).
- Deferred tax assets and liabilities are recognised if the transaction is a business combination, but not recognised if it is an asset acquisition.
- Goodwill (positive or negative) arises only on business combinations.

Judging whether an acquisition is a business combination or not is therefore of considerable importance.

How we see it

It will be a matter of judgement for preparers to conclude that, when applying the guidance in Section 19, if acquired processes are considered to be insignificant (whether by reference to guidance in IAS 40 as discussed in 3.1.3 above or otherwise) an investment property acquisition is within the scope of Section 16 rather than Section 19. This judgement will rest upon the facts and circumstances of each acquisition. If significant, disclosure of this judgement would be required by Section 8.

The definition of a business is applied regardless of whether the entity purchases a property directly or, in the case of consolidated financial statements, via the shares in another entity.

See Chapter 22 at 3.2 for the detailed guidance in determining whether an acquisition of an integrated set of activities and assets meets the definition of a business combination.

3.2.8.A Acquisition of a group of assets that does not constitute a business ('the group')

The purchase price of an investment property may result from an allocation of the price paid for a group of assets. However, Section 19 applies only to business combinations - therefore if the group of assets is not a business, Section 19 does not apply, nor does it specify how to account for a group of assets. The initial recognition and measurement of the assets acquired will depend on the nature of the particular assets and the requirements of FRS 102 for such assets. Many assets, such as PP&E, investment property, intangible assets or inventories, are required to be measured initially at cost. Therefore, it will be necessary to make some apportionment of the overall cost of the group of assets to the individual assets.

How we see it

One possible approach to making such an allocation would be to apply the guidance in paragraph 2(b) of IFRS 3 *Business Combinations* for the acquisition of a group of assets that is not a business (see Chapter 22 at 3.1). In such cases the acquirer must identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Section 18 *Intangible assets other than Goodwill*) and liabilities assumed and allocate the cost of the group to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.

There may be other approaches, however, whatever approach is used to allocate the overall cost to the individual assets or liabilities, no goodwill arises since goodwill (positive or negative) is recognised only in a business combination.

When applying the principles of IFRS 3, it is also worth noting that the IFRS IC noted the requirement of paragraph 2(b) of IFRS 3 as described above and also noted that other IFRS accounting standards include initial measurement requirements for particular assets and liabilities (e.g., IFRS 9 *Financial Instruments* for financial instruments).

The IFRS IC observed that if an entity initially considers that there might be a difference between the sum of individual fair values of the identifiable assets and liabilities and the transaction price, the entity first reviews the procedures it has used to determine those individual fair values to assess whether such a difference truly exists before allocating the transaction price. The IFRS IC then considered two possible ways of accounting for the acquisition of the group of assets.

Under the first approach an entity:

- Identifies the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition.
 - Determines the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition.
- And then
- Applies the initial measurement requirements in applicable standards to each identifiable asset acquired and liability assumed. The entity accounts for any difference between the amount at which the asset or liability is initially measured and its individual transaction price applying the relevant requirements.

Applying the second approach, for any identifiable asset or liability initially measured at an amount other than cost, an entity initially measures that asset or liability at the amount specified by the applicable standard. The entity deducts from the transaction price of the group the amounts allocated to the assets and liabilities initially measured at an amount other than cost and then allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of acquisition.

The IFRS IC concluded that a reasonable reading of the requirements in paragraph 2(b) of IFRS 3 on the acquisition of the group results in one of the two approaches outlined above (i.e., a policy choice) and that an entity would apply its reading of the requirements consistently to all acquisitions of a group of assets that does not constitute a business.⁹⁷

If material, disclosure of accounting policy information on acquisition of a group of assets that is not a business and significant judgement made in applying such accounting policy would be required by Section 8. [FRS 102.8.5, FRS 102.8.6].

3.2.9 Lease incentives and initial direct costs of leasing a property

In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. The lessor or the lessee (or both) may also incur costs that are directly attributable to negotiating and arranging a lease. However, Section 16 provides no specific guidance on accounting for lease incentives and initial costs of obtaining a lease.

3.2.9.A Lease incentives

Lease incentives are defined as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee. [FRS 102 Appendix I].

In practice, examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

Under Section 20, lease incentives are deducted from 'lease payments' made by a lessee to a lessor relating to the right to use an underlying asset during the lease term. [FRS 102 Appendix I]. Accordingly, for lessees, lease incentives that are received by the lessee at or before the lease commencement date reduce the initial measurement of a lessee's right-of-use asset. [FRS 102.20.47(b)]. Lease incentives that are receivable by the lessee at lease commencement date reduce a lessee's lease liability (and therefore the right-of-use asset as well). [FRS 102.20.51(a)].

For lessors, lease incentives that are paid or payable to the lessee are also deducted from lease payments. Lease payments under operating leases are recognised by lessors as income on either a straight-line basis or another systematic basis. [FRS 102.20.106]. Accordingly, for operating leases, lessors defer any lease incentives paid or payable to the lessee and recognise the resulting accrual as a reduction to lease income over the lease term in order to recognise the lease payments as income at an amount that is net of lease incentives. This means that such accrued rental income will be recovered as part of the cash payments to be received from the lessee over the remaining lease term.

The accounting for lease incentives applied in practice by lessors of investment property is illustrated below.

Illustration 3-2: Lessor accounting for lease incentives under Section 16

On 1 January 20X5, an investor acquires a property with an acquisition cost of £80 million, which is assumed to be its fair value at the date of acquisition. On the same day, the investor leases the property under an operating lease to a lessee with a five-year term. The market rent for such a property is assessed to be £4 million per annum, representing a yield of 5%. The lessor and lessee agree to the following lease payments and conditions:

- Year 1 (20X5): rent free
- Year 2: £5 million
- Year 3: £5 million
- Year 4: £5 million
- Year 5: £5 million

⁹⁷ [IFRIC Update](#), November 2017, available on the IFRS Foundation's website.

The rent for years 2 to 5 is paid at the beginning of each year. As the lease incentive (the rent-free period) is an integral component of the lease agreement it is assumed that, in exchange for the rent-free period, the lessee provides a flow of lease rental payments to the lessor in years 2 to 5 that are higher than what they would be if no incentive was provided.

Assume that the rent-free period is taken into account by the appraiser in arriving at the fair value of the property on the date of acquisition. In the example, the fair value of the investment property as at 31 December 20X5 (end of year 1) and 31 December 20X6 (end of year 2) is assumed to be £82 million.

There are two acceptable approaches for a lessor of investment property to account for lease incentive (e.g., a rent-free period):

Approach A

The investment property is recorded at fair value (e.g., based on the expected cash flows). On the basis that the property is to be recorded at its fair value, the lease payments according to the operating lease contract are taken into account by the valuer in arriving at the fair value of the property. As the lease incentive is related to the consideration for the use of the asset, it affects the rental income as presented in the income statement. The lessor would record the following journal entries ('JE') in 20X5 and 20X6:

Extracts from the ledgers for the years ended 31 December 20X5 and 20X6

(All figures in £ millions)

	20X5				20X6			
	As at 1 Jan 20X5	JE (1)	JE (2)	JE (3)	As at 31 Dec 20X5	JE (4)	JE (5)	As at 31 Dec 20X6
Balance sheet								
Investment property	-	80	2	-	82	-	-	82
Cash	80	(80)	-	-	-	5	-	5
Net Assets	80	-	2	-	82	5	-	87
Share capital	80	-	-	-	80	-	-	80
Retained earnings	-	-	-	-	-	-	-	2
Net income	-	-	2	-	2	5	-	5
Total Equity	80	-	2	-	82	5	-	87

Income statement

Gains or (losses) from fair value adjustments	-	-	2	(4)	(2)	-	1	1
Rental income	-	-	-	4	4	5	(1)	4
Net income	-	-	2	-	2	5	-	5

Reconciliation of the carrying amount of the investment property

Net book value	78	79
Plus: tenant lease incentives	4	3
Market value	82	82

Journals:

- (1) Paragraph 5 of Section 16 requires investment property to be measured initially at its cost (see 3.2 above), which is £80 million in the fact pattern.
- (2) At the balance sheet date, the investment property must be measured at fair value in accordance with Section 2A, which is £82 million. The change in fair value is recognised in profit and loss. See 3.3 below for further discussions on subsequent measurement of an investment property under the fair value model.

- (3) In line with paragraph 3 of Section 2A, the fair value measurement reflects 'assumptions that market participants would use when pricing the asset'. A market participant, using an income approach to value its investment property, would consider the expected cash flows that the lessee will pay. It will not consider income recognised in prior periods associated with the lease incentive. As such, the expected future cash flows are taken into account in determining the fair value of the investment property.
- Appendix I to FRS 102 notes that lease payments are "Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives...". Paragraph 106 of Section 20 states that "A lessor shall recognise lease payments from operating leases as income on a straight-line basis, unless either: (a) another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished; or (b) the lease payments are structured to increase in line with expected general inflation (based on published indices or statistics) to compensate for the lessor's expected inflationary cost increases. If the lease payments vary according to factors other than general inflation, then this condition is not met."
- Therefore, in order to recognise the lease payments from operating leases (including any deductions related to lease incentives) as income on a straight-line basis, the total rental income over the period of the lease (£20 million) is apportioned evenly over the five-year period: rental income of £4 million is recognised each year.
- (4) The cash received of £5 million for the second year of the lease term is recorded.
- (5) To continue to recognise the rental income in accordance with Section 20, an entry is made reducing the rental income to the appropriate amount (i.e., £4 million in the fact pattern). The offsetting entry is to the gain or loss from change in fair value of the investment property.

Approach B

A separate asset is recorded to straight line the cost of the consideration in the form of the lease incentive (rent-free period) over the term of the lease. To avoid double-counting, the lessor adjusts the carrying amount of the investment property downwards to take into account the fact that the actual return to the lessor will be lower because the lessor has agreed to offer a rent-free period and has recorded this lease incentive separately as an asset:

Extracts from the ledgers for the years ended 31 December 20X5 and 20X6

(All figures in £ millions)

	20X5					20X6				
	As at 1 Jan 20X5	JE (1)	JE (2)	JE (3)	JE (4)	As at 31 Dec 20X5	JE (5)	JE (6)	JE (7)	As at 31 Dec 20X6
Balance sheet										
Investment property	-	80	2	-	(4)	78	-	-	1	79
Other assets	-	-	-	-	4	4	-	(1)	-	3
Cash	80	(80)	-	-	-	-	5	-	-	5
Net Assets	80	-	2	-	-	82	5	(1)	1	87
Share capital	80	-	-	-	-	80	-	-	-	80
Retained earnings	-	-	-	-	-	-	-	-	-	2
Net income	-	-	2	-	-	2	5	(1)	1	5
Total Equity	80	-	2	-	-	82	5	(1)	1	87

Income statement

Gains or (losses) from fair value adjustments	-	-	2	(4)	-	(2)	-	-	1	1
Rental income	-	-	-	4	-	4	5	(1)	-	4
Net income	-	-	2	-	-	2	5	(1)	1	5

Journals:

(1), (2) and (3) are the same as in Approach A above.

- (4) Discussion in 3.3.2.B below specifies that in determining the carrying amount of investment property at fair value, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example, the fair value of investment property excludes prepaid or accrued operating lease income, because the entity recognises it as a separate liability or asset. Therefore, a reclassification is made to separate the other asset (i.e., lease incentive) that arises from straight-lining the lease payments from the investment property.
- (5) The cash received of £5 million for the second year of the lease term is recorded.
- (6) To continue to recognise the rental income in accordance with Section 20, the decrease of the carrying amount of the separate asset that arises from straight-lining the lease incentive is recognised as reduction of rental income over the lease term.
- (7) At the end of 20X6 the fair value of the investment property in the fact pattern is £82 million. The combined carrying amount of the investment property and separately recognised lease incentive asset is £81 million. Therefore, in order to continue to measure the investment property at fair value in accordance with paragraph 7 of Section 16 and the discussion in 3.3.2.B below, an increase in the fair value of the investment property of £1 million is recognised as a gain from fair value adjustments.

How we see it

Approach A and Approach B discussed above, in our view, are both acceptable approaches when accounting for lease incentives provided to lessees and thus, either can be applied as a matter of accounting policy choice. Such policy choice is applied consistently and if considered material to users of the financial statements, disclosure would be required by Section 8.

Consequently, some lessors present any accrued rental income (i.e., outstanding unamortised deferred lease incentives) as a separate asset, but other lessors present these together with (or as part of) the related investment property - see Illustration 3-2 above. However, lease incentives do not form part of the cost of the investment property (see also 3.3.6.A below for the discussion of adjusting the fair value of an investment property to avoid 'double counting' in circumstances where a lease incentive exists and is recognised separately). It is therefore relevant to distinguish between lease incentives and other capital expenditure.

There is no additional guidance in Section 20 to assist in the identification of incentives, but a similar requirement existed in previous United Kingdom GAAP (in Urgent Issues Task Force ('UITF') abstract 28 *Operating lease incentives*) and provides helpful additional detail:

"A payment (or other transfer of value) from a lessor to (or for the benefit of) a lessee should be regarded as a lease incentive when that fairly reflects its substance. A payment to reimburse a lessee for fitting-out costs should be regarded as a lease incentive where the fittings are suitable only for the lessee and accordingly do not add to the value of the property to the lessor. On the other hand, insofar as a reimbursement of expenditure enhances a property generally and causes commensurate benefit to flow to the lessor, it should be treated as reimbursement of expenditure on the property. For example, where the lifts in a building are to be renewed and a lease has only five years to run, a payment made by the lessor may not be an inducement to enter into a lease but payment for an improvement to the lessor's property."⁹⁸

For further discussions on lease incentives, see Chapter 23 at 5.5.2, 6.2.1 and 6.2.2.

98 UITF abstract 28 - Operating lease incentives, UK Accounting Standards Board, February 2001, para. 3.

3.2.9.B Initial direct costs of obtaining a lease

Lessors and lessees apply the same definition of initial direct costs.

Appendix I to FRS 102 defines initial direct costs as “Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained ...”. [FRS 102 Appendix I]. Examples of such costs are commissions and contingent fees that would not have been incurred if the lease had not been obtained. Accordingly, in addition to excluding allocated costs (e.g., salaries), initial direct costs exclude costs incurred regardless of whether the lease is successfully finalised (e.g., fees for certain legal advice, estate agent fees not contingent upon success). Certain payments made by a lessee to an existing tenant to incentivise that tenant to terminate its lease could also be regarded by the lessee as initial direct costs incurred to obtain a new lease.

Under Section 20, lessors are required to add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income. [FRS 102.20.108]. For lessees, Section 20 requires initial direct costs to be included in the initial measurement of the right-of-use asset. [FRS 102.20.47].

While Section 16 does not contain specific guidance on the accounting treatment of initial direct costs of arranging leases over a property (e.g., legal and agency fees), due to the requirements of Section 20 mentioned above, such costs must be recognised as an expense over the term of the resultant lease.

This means, if the property is carried at cost amount less impairment, e.g., due to the fact that the fair value of investment property can no longer be measured reliably (see 3.3.4 below), such costs are presented as part of the cost of the investment property, even if they do not strictly form part of it and are then amortised separately over the lease term.

An entity using the fair value model must also initially include these costs as part of the carrying amount of the investment property. However, at the next reporting date such initial costs could be recognised in profit and loss in the reported fair value gain or loss, as they would otherwise exceed the fair value of the related investment property. This is consistent with the treatment of transaction costs incurred on acquisition of a property discussed in 3.3.5 below.

Alternatively, under the fair value model, we also believe that the initial direct costs included in the carrying amount of the investment property could be recognised subsequently as an expense over the lease term on the same basis as the lease income. Accordingly, the amortisation of the initial direct costs is presented separately from the gain or loss from fair value adjustments on investment property. In addition, the gain or loss on fair value adjustments is credited by the same amount as the amortisation charge in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is equal to its fair value at each reporting date.

The accounting for initial direct costs of operating leases applied in practice by lessors of investment property is illustrated below.

Illustration 3-3: Lessor accounting for initial direct costs of operating leases under Section 16

On 1 January 20X5, an investor acquires a property at a cost of £100 million. On the same day, the investor leases the property under an operating lease to a lessee with a five-year term for a yearly rent of £5 million. The lessor incurs legal fees of £4 million in arranging the lease contract. According to an appraisal by an independent valuer, the fair values of the property as at 31 December 20X5 and 31 December 20X6 is £100 million.

There are two acceptable approaches for a lessor of investment property to account for initial direct costs of operating leases:

Approach A

On acquisition, the initial direct costs would be capitalised into the investment property, but subsequently, they are expensed through the change in the fair value of the investment property.

The lessor would record the following journal entries (‘JE’) in 20X5 and 20X6 (time value of money is ignored):

Extracts from the ledgers for the years ended 31 December 20X5 and 20X6

(All figures in £ millions)

	20X5					20X6		
	As at 1 Jan 20X5	JE (1)	JE (2)	JE (3)	JE (4)	As at 31 Dec 20X5	JE (5)	As at 31 Dec 20X6
Balance sheet								
Investment property	-	100	4	-	(4)	100	-	100
Cash	100	(100)	(4)	5	-	1	5	6
Net Assets	100	-	-	5	(4)	101	5	106
Share capital	100	-	-	-	-	100	-	100
Retained earnings	-	-	-	-	-	-	-	1
Net income	-	-	-	5	(4)	1	5	5
Total Equity	100	-	-	5	(4)	101	5	106
Income statement								
Gains or (losses) from fair value adjustments	-	-	-	-	(4)	(4)	-	-
Rental income	-	-	-	5	-	5	5	5
Net income	-	-	-	5	(4)	1	5	5

Journals:

- Paragraph 5 of Section 16 states that an investment property is measured initially at its cost and transaction costs are included in the initial measurement (see 3.2 above).
- Section 16 does not contain specific guidance on the accounting treatment of initial direct costs that are incurred in arranging a lease contract for an investment property that is measured at fair value. Therefore, it seems appropriate to apply the guidance for the accounting of initial direct costs incurred by a lessor under an operating lease that is included in Section 20. Paragraph 108 of Section 20 requires a lessor to add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income. Initial direct costs (e.g., legal fees) would initially be added to the carrying amount of the investment property when incurred, similar to transaction costs discussed in paragraph 5 of Section 16 (see 3.2 above). Therefore, the initial direct costs of £4 million must be added to the carrying amount of the investment property.
- The rental income for the first year of the lease term (£5 million) is recognised.
- Subsequently, the investment property, which includes the initial direct costs, is measured at fair value. Appendix I to FRS 102 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Paragraph 7 of Section 16 refers to Section 2A and paragraph 8 of Section 2A requires that the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability must not be adjusted for transaction costs. Therefore, the subsequent measurement of the investment property would exclude transaction costs.
In order to adjust the investment property to its fair value (£100 million), an adjustment of £4 million is recognised in profit and loss as required by paragraph 7 of Section 16.
- The cash received of £5 million for the second year of the lease term is recorded.

Approach B

On acquisition, the initial direct costs, generally, are added to the carrying amount of the leased asset and subsequently recognised as an expense over the lease term on the same basis as the lease income. The amortisation of the initial direct costs is presented separately from the gain or loss from fair value adjustments. In addition, the gain or loss on fair value adjustments is credited by the same amount as the

amortisation charge in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is equal to its fair value at each reporting date.

The lessor would record the following journal entries ('JE') in 20X5 and 20X6 (time value of money is ignored):

Extracts from the ledgers for the years ended 31 December 20X5 and 20X6

(All figures in £ millions)

Balance sheet	20X5						20X6			
	As at 1 Jan 20X5	JE (1)	JE (2)	JE (3)	JE (4)	JE (5)	As at 31 Dec 20X5	JE (6)	JE (7)	As at 31 Dec 20X6
Investment property	-	100	4	-	(4)	-	100	-	-	100
Cash	100	(100)	(4)	5	-	-	1	5	-	6
Net Assets	100	-	-	5	(4)	-	101	5	-	106
Share capital	100	-	-	-	-	-	100	-	-	100
Retained earnings	-	-	-	-	-	-	-	-	-	1
Net income	-	-	-	5	(4)	-	1	5	-	5
Total Equity	100	-	-	5	(4)	-	101	5	-	106

Income statement

Gains or (losses) from fair value adjustments	-	-	-	-	(4)	0.8	(3.2)	-	0.8	0.8
Amortisation of initial direct costs	-	-	-	-	-	(0.8)	(0.8)	-	(0.8)	(0.8)
Rental income	-	-	-	5	-	-	5	5	-	5
Net income	-	-	-	5	(4)	-	1	5	-	5

Journals:

(1), (2), (3) and (4) are the same as in Approach A above.

(5) According to paragraph 108 of Section 20 and paragraph 7 of Section 16, in order to recognise initial direct costs as an expense over a five-year term on a straight-line basis, the total amount of initial direct costs (£4 million) is apportioned evenly over the five-year period and thus, an amortisation expense of £0.8 million is recognised each year. It is appropriate to present this separately from the gain or loss from fair value adjustments.

The gain or loss on fair value adjustments is credited by the same amount as the amortisation expense in each period to ensure that the carrying amount of the investment property (including the unamortised initial direct costs) is stated at fair value at reporting date.

(6) The cash received of £5 million for the second year of the lease term is recorded.

(7) To continue to recognise amortisation of initial direct costs and the investment property at its fair value at each reporting date, as required by paragraph 108 of Section 20 and paragraph 7 of Section 16, respectively, reclassifications of the appropriate amounts based on the amortisation expense are made at each reporting date (i.e., £0.8 million in the fact pattern).

How we see it

Approach A and Approach B discussed above, in our view, are acceptable approaches when accounting for initial direct costs of operating leases and thus, either can be applied as a matter of accounting policy choice. Such policy choice is applied consistently and if considered material to users of the financial statements, disclosure would be required by Section 8.

For further discussions on initial direct costs of obtaining a lease, see Chapter 23 at 5.7.1 and 5.7.2.

3.2.10 Variable and contingent consideration

The terms of purchase of investment property may sometimes include a variable or contingent amount that cannot be determined at the date of acquisition. For example, the vendor may have the right to additional consideration from the purchaser in the event that a certain level of income is generated from the property; or its value reaches a certain level; or if certain legislative hurdles, such as the receipt of zoning or planning permission, are achieved.

The two key issues with regards to the accounting for variable or contingent consideration in an asset purchase are 1) whether and when to recognise a liability for that variable or contingent consideration, and 2) whether subsequent changes to the estimate of that variable or contingent consideration are accounted for as part of the cost of the acquired asset.

Section 16 has no explicit guidance on the treatment of variable or contingent payments to be incurred in connection with the purchase of investment property. As discussed in section 3.2 above, the principles in Section 17 relating to determining the attributable costs in an asset purchase apply to the recognition of costs in Section 16. Accordingly, for the detailed discussions of key accounting considerations related to the treatment of variable or contingent payments in an asset purchase, including the general approaches applied in practice, see Chapter 20 at 3.4.1.I.

How we see it

Consistent with the discussions in Chapter 20 at 3.4.1.I, entities will need to develop and apply an accounting policy in respect of whether and when the obligation to make contingent payments is recognised as a liability. In doing so, entities will need to apply the hierarchy in Section 10 (see Chapter 9 at 3.1). The policy selected must result in information that is relevant and reliable in the particular circumstances and must be consistently applied to similar transactions. Different payments may have different types of variability. Therefore, it might be appropriate for an entity to have different policies for dissimilar transactions.

Where the accounting for variability or contingency is not prescribed in another section in FRS 102 (see Chapter 20 at 3.4.1.I), an entity must adopt and apply a consistent accounting policy in relation to whether subsequent payments or subsequent changes to the measurement of a recognised liability to make variable or contingent payments are included as part of the cost of the acquired asset (e.g., investment property) or expensed as incurred, in accordance with the hierarchy in Section 10. An entity must exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in its particular circumstances.

If information about the selected accounting policy is expected to be material to users of the financial statements, that accounting policy information must be disclosed.

Of course, for investment property held at fair value, capitalising or expensing the remeasurements of any liability recognised for the variable or contingent consideration primarily affects classification within the income statement.

It is important to note that developing a policy (as described above) is not available for the contingent costs of acquiring investment property as part of a business combination. The treatment of contingent costs in these circumstances is described in Chapter 22 at 3.6.2.

3.2.11 Other aspects of cost recognition - repairs and maintenance

As discussed in 3.2 above, we consider that the principles in Section 17 must still be applied to the recognition of costs in Section 16. This means that only those elements of cost that were allowed by Section 17 could be capitalised and that capitalisation ceases when the asset has reached the condition necessary for it to be capable of operating in the manner intended by management.

Section 17 contains guidance on accounting for repairs and maintenance (see Chapter 20 at 3.3.3). Accordingly, day-to-day servicing, by which is meant the repairs and maintenance of the property which largely comprises labour costs, consumables and minor parts, are recognised in profit or loss as incurred. [FRS 102.17.15]. However, the treatment is different if large parts of the properties have been replaced, e.g., interior walls that are replacements of the original walls. In this case, the cost of replacing the original part will be recognised at the time that cost is incurred if the recognition criteria are met, while the carrying amount of the original part is derecognised (see 3.5.3 below and Chapter 20 at 3.3.3.A). [FRS 102.17.6].

The inference is that by restoring the asset to its originally assessed standard of performance, the new part will meet the recognition criteria and future economic benefits will flow to the entity once the old part is replaced. The inference is also that replacement is needed for the total asset to be operative. This being the case, the new walls will therefore meet the recognition criteria, and the cost will therefore be capitalised.

Other than interior walls, large parts that might have to be replaced include elements such as lifts, escalators and air conditioning equipment.

3.3 Measurement after initial recognition

Once recognised, an investment property must be measured at fair value at each reporting date (except in the cases described in 3.1.2 and 3.1.7 above, and in 3.3.3 below) with changes in fair value recognised in profit or loss. When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it measures the right-of-use asset, and not the underlying property, at fair value.

[FRS 102.16.7]. See 3.3.1 and 3.3.2 below for discussions on determining the fair value of an investment property.

The FRC's appendix on the legal requirements of FRS 102 clarifies that fair value movements on investment properties can be included in the profit and loss account under paragraph 40 of Schedule 1 of the Regulations despite the fact that unrealised gains on investment properties are not usually realised profits as defined by the Companies Act. [FRS 102.A3.27].

Although the default reserve within equity for fair value movements on investment property is retained earnings, the FRC observed that entities measuring investment properties at fair value may transfer such amounts to a separate non-distributable reserve, instead of a transfer to retained earnings, but are not required to do so. Presenting fair value movements that are not distributable profits in a separate reserve may assist with the identification of profits available for that purpose. [FRS 102.A3.28]. Any such transfer from retained earnings to a non-distributable reserve is made in the statement of changes in equity.

Unless carried under the cost model in Section 17 or Section 20 in certain cases as discussed at 3.1.2 and 3.1.7 above, no depreciation is required on investment properties as the Regulations do not require depreciation of investment properties measured under the fair value accounting rules.

Section 16 permits an entity to subdivide investment property into classes such that some classes may be measured at cost, and others at fair value (for example, investment property rented to another group entity - see 3.1.2 above). The FRC's appendix on the legal requirements of FRS 102 takes the view that such requirement that allows certain class of investment property to be held at fair value and other class of such items at cost is 'consistent with the most reasonable and common sense interpretation' of paragraph 39 of Schedule 1 of the Regulations which permits investment property to be included at fair value provided that the fair value can reliably be determined. [FRS 102.A3.37D].

3.3.1 The fair value model

Under Section 16, an investment property is measured at its fair value at the end of the reporting period and a gain or loss arising from changes in the fair value in the reporting period is recognised in profit or loss for that period. Section 16 also emphasises that when a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it measures the right-of-use asset, and not the underlying property, at fair value. [FRS 102.16.7].

Appendix I to FRS 102 defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

[FRS 102 Appendix I]. Section 16 refers to the guidance on determining fair value in Section 2A. [FRS 102.16.7]. Section 2A provides a fair value measurement framework that applies whenever fair value measurement is permitted or required. Section 2A does not specify when an entity is required to use fair value, but rather, provides guidance on how to measure fair value under FRS 102 when fair value is required or permitted by a section in FRS 102. See Chapter 10 for the detailed discussion of such guidance.

The definition of fair value described above and the guidance on fair value measurement in Section 2A are aligned with IFRS 13. [FRS 102.BC.B2A.2].

How we see it

While entities cannot presume this always to be the case, in practice, the fair value estimate arrived at under Section 2A may be similar to that estimated for 'market value' as defined by the Royal Institution of Chartered Surveyors ('RICS') and the International Valuation Standards Council ('IVSC'). Their definition of 'market value' being "the estimated amount for which an asset and/or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion".⁹⁹

The price in the market (either in the principal or most advantageous market) used to measure fair value must not be adjusted for transaction costs. This is because transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction. [FRS 102.2A.8]. They will differ depending on how an entity enters into a transaction for the asset or liability.

Transaction costs incurred by a purchaser on acquisition are dealt with in 3.3.5 below and in Chapter 10 at 4.7.1.

3.3.2 Estimating fair value

Many entities use an external valuer to estimate fair value based on the RICS and/or IVSC Valuation Standards. In practice, the use of an independent valuer with a recognised and relevant professional qualification and with recent experience in the location and category of the investment property being valued is generally preferred by many entities over valuations prepared in-house, albeit there is no requirement for an entity to use an independent valuer in determining the fair value of investment property. However, if there has been no such independent valuation, this must be disclosed (see 4.3 below). [FRS 102.16.10(b)].

How we see it

Management needs to be aware of the conceptual differences between Section 2A and International Valuation Standards to ensure any values used for financial reporting that are obtained from appraisals, whether external or internal, are consistent with the objective of fair value measurement in accordance with Section 2A.

Although an appraisal is normally undertaken by professionally qualified and experienced independent valuers, an appraiser does not need to be independent of the reporting entity. If the internal appraisals are of such a quality that the fair values of investment property are reliably measured in accordance with Section 2A (see 3.3.3 below), then no additional appraisals by an independent valuer are required.

How we see it

We acknowledge that a fair value measured by the entity itself may be less reliable than a fair value measured by an independent valuer. However, we believe that the users of financial statements are made aware of this potential weakness and its possible impact on a true and fair presentation by the disclosure requirements in paragraph 10(b) of Section 16 which requires disclosures to be made about the extent of involvement of independent valuers in measuring fair values (see 4.1 below).

When estimating the fair value of the property in accordance with Section 2A, the objective is to estimate the price that would be received to sell an investment property in an orderly transaction between market participants at the measurement date under current market conditions. [FRS 102.2A.2, FRS 102.2A.4]. This objective applies regardless of the techniques and inputs used to measure fair value (see 3.3.2.A below).

Under adopted IFRS, IAS 40 has certain requirements in addition to those in IFRS 13. In particular, IAS 40 requires that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing investment property under current market conditions. [IAS 40.40]. For example, in a transaction to sell an investment property, it is likely that market participants would consider the existing lease agreements in place.

⁹⁹ IVS 102 Bases of Value, International Valuation Standards, IVSC, effective 31 January 2025, Appendix: IVS-Defined Basis of Value, para. A10.01, p.24.

This is consistent with the general requirement in Section 2A and in IFRS 13 that an entity must measure the fair value using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. [FRS 102.2A.2, IFRS 13.22].

Section 20 specifies the basis for initial recognition of the cost of an investment property held by a lessee as a right-of-use asset (see 3.2.4 above). In line with the discussion in 3.3.1 above, an investment property held by a lessee as a right-of-use asset is remeasured to fair value and that the right-of-use asset, and not the underlying property, will be measured at fair value. [FRS 102.16.7]. Generally, the determination of the fair value of right-of-use assets is relatively straightforward if the sublease does not contain any options or variable lease payments. Determining the fair value would involve projecting the cash flows that the entity expects to receive from subleasing the asset and these cash flows would also normally be relatively straightforward because it is likely that a sublease would already be in place.

If leases have variable and optional payments, or if there is no active market for the right-of-use asset, the principles in Section 2A must be sufficient to help lessees to measure the fair value of those right-of-use assets. It is also reasonable to consider the guidance in paragraph 50(d) of IAS 40 which explains when to include in the measurement of the right-of-use asset options and variable lease payments that are not included in the measurement of the lease liability. Paragraph 50(d) of IAS 40 states that the fair value of investment property held by a lessee as a right-of-use asset reflects expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model (see 3.3.7 below).

[IAS 40.50].

When lease payments are at market rates, the fair value of an investment property held by a lessee as a right-of-use asset at acquisition, net of all expected lease payments (including those relating to recognised lease liabilities), must be zero. Thus, remeasuring a right-of-use asset from its initial cost in accordance with Section 20 to fair value (taking into account the discussion in 3.3.2.B below) must not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition (e.g., for investment property leased to other group entity - see 3.1.2 above).

3.3.2.A Methods of estimation

Section 2A requires an entity to use the following order of methodology in estimating the fair value of an asset: [FRS 102.2A.15]

Extract from Section 2A

- 2A.15** The entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of inputs determined by reference to a market price in an active market. An entity shall use the following methodology to estimate fair value:
- (a) The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date.
 - (b) When an unadjusted quoted price is not available, the price of a recent orderly transaction between market participants for an identical or comparable asset or liability provides evidence of fair value. However, this price may not be a reliable estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of the transaction, and the measurement date.
 - (c) If neither (a) nor (b) above are available or reliable, the fair value shall be estimated using another valuation technique. The objective of using another valuation technique is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date.

An 'active market' is defined as a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. [FRS 102 Appendix I].

How we see it

In our view, it would be rare for real estate to be in methodology (a) above (i.e., an unadjusted quoted price) in estimating its fair value, as typically, there are no active markets for identical real estate assets (due to the uniqueness of each real estate asset).

In market conditions where similar real estate is actively purchased and sold, and the transactions are observable, the fair value measurement might be in methodology (b) above. This methodology will be unusual for real estate, but that determination will depend on the facts and circumstances.

Accordingly, the use of another valuation technique (i.e., methodology (c) above) is likely to be much more common for estimating fair value of real estate.

An entity must use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value. [FRS 102.2A.15]. Section 2A does not specify or rank the techniques an entity must use to measure fair value. However, it requires them to be consistent with one or more of the three broad approaches: the market approach; the cost approach; and the income approach. [FRS 102.2A.16]. When selecting the most appropriate inputs to a valuation technique from multiple available inputs, those that maximise the use of inputs determined by reference to a market price in an active market, must be selected. [FRS 102.2A.15]. That is, Section 2A requires an entity to prioritise observable inputs over unobservable inputs.

Valuation techniques used to measure fair value must be applied consistently. However, Section 2A states that a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. This may be the case, for example, if new markets develop or new information becomes available. Revisions resulting from such a change in the valuation technique used or in its application are accounted for as a change in accounting estimate in accordance with Section 10 (see Chapter 9 at 3.4). In this case, an entity is not required to provide the disclosures required by paragraph 18 of Section 10. [FRS 102.2A.17].

See Chapter 10 at 4.11 for further discussion on selecting appropriate valuation techniques and inputs.

3.3.2.B 'Double-counting' of assets and liabilities

Unlike in IAS 40, Section 16 does not explicitly address the potential for double-counting assets and liabilities that are recorded separately in the statement of financial position, but also included within a valuation of an investment property. Common situations where this might otherwise happen are as follows:

- Equipment, fixtures and fittings such as lifts or air-conditioning are often an integral part of a building and is generally included in the fair value of the investment property, rather than recognised separately as PP&E.
- Additional assets may be necessary in order the property can be used for its specific purposes. So, if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognise that furniture as a separate asset.
- When an entity separately recognises prepaid or accrued operating lease income and lease incentives in the statement of financial position, the investment property valuation may also include such items. If so, an adjustment is required to avoid double-counting the asset or liability (see 3.3.6 below).
- The fair value of investment property held by a lessee as a right-of-use asset reflects expected cash flows, including variable lease payments that are expected to become payable. If a property valuation of investment property held by a lessee as a right-of-use asset is obtained net of the valuer's estimate of the present value of the future lease obligations, (which is usually the case), an amount must be added back by adjusting for the lease liability recognised in the statement of financial position, to arrive at the carrying amount of the investment property, because the lease liability is already recognised in the statement of financial position (see 3.3.7 below).

How we see it

An entity must take care, when determining the carrying amount of investment property under the fair value model, not to double count assets or liabilities that are recognised separately. An entity would need to consider the specific inputs included in the investment property valuation to assess whether it includes assets and liabilities which are also recognised separately on the statement of financial position. If so, in our view, an adjustment will always be required to avoid double-counting assets or liabilities.

Conversely, an entity may have other assets that have not been included within the valuation, in which case these will be recognised separately and accounted for in accordance with relevant sections of FRS 102, e.g., Section 17 for PP&E.

3.3.3 Inability to determine fair value of investment property

As discussed in 3.3.2.A above, in determining the fair value of an investment property, an entity must use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, prioritising observable inputs over unobservable inputs. However, valuation techniques, or the use of multiple techniques, can often produce a range of reasonable valuations. Therefore, selection of the most appropriate fair value within the range requires judgement, considering qualitative and quantitative factors specific to the measurement. *[FRS 102.2A.20]*.

When an entity estimates the fair value of an investment property using appropriate valuation techniques, there could be an indication that its fair value will not be reliably measurable. For example, there might be clear evidence that the variability in the range of reasonable fair value measurements will be so great, and the probabilities of the various outcomes so difficult to assess, that the usefulness of a single measure of fair value will be negated. In this case, Section 2A precludes the entity from measuring the asset at fair value. *[FRS 102.2A.22]*.

Following the guidance on determining fair value in the Section 2A, if a reliable measure of fair value is no longer available for an investment property measured at fair value, its carrying amount at the last date the investment property was reliably measurable becomes its new 'cost'. The entity must measure the investment property at this 'cost' amount less impairment (if any), until a reliable measure of fair value becomes available (see Chapter 10 at 4.11.5). *[FRS 102.2A.23, FRS 102.BC.B16.4]*.

Note that while such property is held at cost less impairment, an investment property whose fair value can no longer be measured reliably must still be classified as investment property, instead of transferring and accounting for it as PP&E or if applicable, as a right-of-use asset (see 3.4 below).

The FRC particularly noted that in the UK, entities should generally be able to obtain a fair value for an investment property, which would provide useful, decision-relevant information to users of the financial statements. *[FRS 102.BC.B16.1]*. Further, the FRC noted that prior to the introduction of FRS 102, investment properties were required to be measured at open market value. *[FRS 102.BC.B16.4]*. Therefore, it appears reasonable to expect that in practice, the inability to determine fair value of investment property would occur only in exceptional cases.

The accounting consequences when the fair value cannot be measured reliably for investment property under construction and mixed use property are discussed at 3.3.4 below and 3.1.7 above, respectively. See Chapter 10 at 4.11.5 for further discussion on determining a reliable measure of fair value.

3.3.4 The fair value of investment property under construction

In practice, many entities engage professionally qualified and experienced independent valuers in estimating the fair value of investment property under construction.

How we see it

Determining the fair value of investment property under construction will often be more judgemental than for completed property because:

- There are generally few or limited observable transactions for investment property under construction. Where such assets are transacted, this is typically when they are in the very early stages of development or when they are nearly complete and substantially let.
- Additional assumptions must be made about the risks and costs of any incomplete construction.

It is worth noting that, in light of the requirements of Section 2A, an entity will have to determine whether fair value can be reliably measured or not under the requirements in Section 2A. This is discussed in Chapter 10 at 2.4 and Chapter 10 at 4.11.5.

As discussed in 3.1.1 above, the reference to Section 17 when determining the cost of a self-completed property implies that the FRC believes that an investment property under construction is normally recognised and measured initially at cost under Section 17 on the grounds that the fair value cannot be reliably measurable until completion. However, as also discussed in 3.1.1 above, if the fair value can be reliably measured during construction, then FRS 102 would require that investment property under construction is held at fair value. *[FRS 102.16.7]*.

Therefore, where an entity determines that the fair value of an investment property under construction is not reliably measurable but it expects the fair value to be reliably measurable when construction is complete, it is reasonable to expect that such investment property under construction is measured at cost until such time as the fair value becomes reliably measurable or construction is completed (whichever comes earlier). In any event, some entities do consider that not all of their investment property under construction can be reliably measured and have developed criteria to make that assessment.

Once construction of such property is complete, it can be presumed that fair value can be measured reliably. If this is not the case, and this will be only in exceptional situations, then the guidance discussed in 3.3.3 above must be followed.

3.3.5 Transaction costs incurred by the purchaser of an investment property

An issue that arises in practice is whether transaction costs that have been incurred by the reporting entity on purchase of an investment property must be taken into account in determining the subsequent fair value of the property when applying the fair value model. This is shown in the following Illustration:

Illustration 3-4: The fair value model and transaction costs incurred at acquisition

On 1 January 20X6 Entity A acquired an investment property for a purchase price of £10,000. In addition, Entity A incurred legal costs of £200 in connection with the purchase and paid property transfer tax of £400. Accordingly, the investment property was initially recorded at £10,600. Entity A applies the fair value model for subsequent measurement of investment property:

	Development of prices in property market	Appraised market value of property	Cost of property initially recognised	Difference
		£	£	£
Scenario 1	Unchanged	10,000	10,600	(600)
Scenario 2	Slightly increased	10,250	10,600	(350)
Scenario 3	Significantly increased	11,000	10,600	400
Scenario 4	Decreased	9,500	10,600	(1,100)

The issue that arises in practice is whether or not the acquisition-related transaction costs that were incurred by Entity A on 1 January 20X6 can be considered in determining the fair value of the investment property at the next reporting date.

The acquisition-related transaction costs incurred by Entity A would not be considered separately in determining the fair value of an investment property in accordance with Section 2A. In the example above, on the next reporting date the carrying amount to be recorded in the statement of financial position is its fair value, measured in accordance with Section 2A. Changes from the initial carrying amount to the appraised market value at the subsequent reporting date (reflected in the 'Difference' column in the table) are recognised in profit or loss. [FRS 102.16.7].

Although Section 16 states that transaction costs incurred by a purchaser on the acquisition of an investment property are included in the cost of the investment property at initial recognition, [FRS 102.16.5], if an entity applies the fair value model, the same investment property that was recorded at cost on initial recognition is subsequently measured at fair value in accordance with Section 2A. The fact that the cost of the investment property recorded on initial recognition included legal and other transaction costs is irrelevant to the subsequent fair value measurement of the asset.

Section 2A clarifies that "the price in the market shall not be adjusted for transaction costs because they are not a characteristic of an asset or a liability; they are specific to a transaction". [FRS 102.2A.8].

Likewise, when measuring the fair value of an investment property, it is not appropriate to add the acquisition-related transaction costs incurred by the purchaser to fair value, as these have no relevance to the fair value of the property. Therefore, some or all of the transaction costs incurred when acquiring the investment property that were capitalised in accordance with Section 16 will effectively be expensed as part of the subsequent fair value gain or loss.

See Chapter 10 at 4.7.1 for further discussion.

3.3.6 Prepaid and accrued operating lease income

3.3.6.A Accrued rental income and lease incentives

The discussion in 3.3.2.B above about avoiding double-counting assets or liabilities recognised separately is most commonly encountered when the carrying amount of an investment property is reduced below its fair value to the extent that a separate asset arises under Section 20. For example, when an entity offers an initial rent-free period to a lessee, it will accrue an asset during the rent-free period and then amortise it over the remaining lease term, thereby spreading the reduction in rental income over the term of the lease. If such asset is separately recognised from the investment property, the amount of that separate asset is excluded from the fair value of the investment property in order to arrive at the carrying amount of the investment property for the purposes of the financial statements, and thus, avoid double counting (see 3.2.9.A above).

3.3.6.B Prepaid rental income

The same principles as discussed in 3.2.9.A and 3.3.6.A above are applied when rental income arising from an operating lease is received in advance i.e., as a policy choice, the resulting liability could be recognised either separately from, or included in, the carrying amount of the investment property. The former treatment is demonstrated in the Illustration below:

Illustration 3-5: Investment property and rent received in advance

A company owns land with an estimated value of £10 million as at 1 January 20X5 that is accounted for as investment property. The company applies the fair value model in Section 16 and has a reporting period ending on 31 December each year.

The land was not let until, on 30 December 20X5, a lease of 50 years was granted for consideration of £9.5 million received in advance. The lease is considered to be an operating lease. No rental income was recognised in 20X5 as it was considered immaterial. An external valuer estimated that, after the grant of the 50-year lease, the fair value of the company's interest in the land as at 31 December 20X5 was £1 million. As at 31 December 20X6 the external valuer estimated the fair value of the interest in the property was £1.2 million.

The resultant accounting entries are summarised below.

Extracts from the ledgers for the year ended 31 December 20X5

(All figures in £ millions)

	As at 1 January 20X5	Journal (1)	Journal (2)	Journal (3)	As at 31 December 20X5
Investment property	10.0	-	(9.0)	9.5	10.5
Cash	-	9.5	-	-	9.5
Deferred income	-	(9.5)	-	-	(9.5)
Net Assets	<u>10.0</u>	<u>-</u>	<u>(9.0)</u>	<u>9.5</u>	<u>10.5</u>
Share capital	10.0	-	-	-	10.0
Retained profit	-	-	(9.0)	9.5	0.5
Total Equity	<u>10.0</u>	<u>-</u>	<u>(9.0)</u>	<u>9.5</u>	<u>10.5</u>

Journals:

- (1) Issue of lease (£9.5 million received on issue of lease).
- (2) Write down investment property to £1 million external valuation.
- (3) Write up book value of property by the amount of unamortised deferred revenue in the statement of financial position.

Extracts from the ledgers for the year ended 31 December 20X6*(All figures in £ millions)*

	As at 1 January 20X6	Journal (1)	Journal (2)	Journal (3)	As at 31 December 20X6
Investment property	10.5	-	(9.3)	9.31	10.51
Cash	9.5	-	-	-	9.5
Deferred income	(9.5)	0.19	-	-	(9.31)
Net Assets	<u>10.5</u>	<u>0.19</u>	<u>(9.3)</u>	<u>9.31</u>	<u>10.7</u>
Share capital	10.0	-	-	-	10.0
Retained profit	0.5	0.19	(9.3)	9.31	0.7
Total Equity	<u>10.5</u>	<u>0.19</u>	<u>(9.3)</u>	<u>9.31</u>	<u>10.7</u>

Journals:

- (1) Amortise rent (one year of the £9.5 million received for 50 years).
- (2) Write down investment property to £1.2 million external valuation.
- (3) Write up the book value of property by the amount of unamortised deferred revenue in the statement of financial position (£9.31 million).

3.3.7 Valuation adjustment to the fair value of properties held under a lease

As discussed in 3.3.2 and 3.3.2.B above, the fair value of investment property held by a lessee as a right-of-use asset will reflect expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the carrying amount of the investment property using the fair value model.

Therefore, if the entity obtains a property valuation net of the valuer's estimate of the present value of future lease obligations (which is usual practice), to the extent that the lease obligations have already been accounted for in the statement of financial position as a lease obligation, an amount is to be added back to arrive at the carrying amount of the investment property for the purposes of the financial statements.

The valuation adjustment referred to above is achieved by adjusting for the lease liability recognised in the financial statements.

This is shown using the information in the following Illustration:

Illustration 3-6: Valuation of a property held under a lease

Entity A pays £991,000 for a 50-year leasehold interest in a property which is classified as an investment property using the fair value model. In addition, a ground rent of £10,000 is payable annually during the lease term, the present value of which is calculated at £99,000 using a discount rate of 10% which reflects the rate implicit in the lease at that time. The company has initially recognised the investment property at the following amount:

	£'000
Amount paid	991
Present value of the ground rent obligation on acquisition	<u>99</u>
Cost recorded for financial reporting purposes	1,090

Assume at the next reporting date the leasehold interest in the property has a fair value of £1,006,000 measured (based on market participant assumptions) as follows:

	£'000
Present value of estimated future lease income	1,089
Less: Present value of the ground rent obligation at the reporting date *	<u>(83)</u>
Fair value	1,006

* The market required yield has changed to 12%. Therefore, the present value of the ground rent obligations of £10,000 per annum for the remaining 49 years is now £83,000.

At the same time the ground rent lease liability has reduced to £98,000 as payments are made.

This would give the following results:

	£'000
Fair value	1,006
Add recognised lease liability	98
Carrying amount for financial reporting purposes	1,104

The statement of financial position of Entity A would therefore contain the following items:

	Investment property	Lease liability
	£'000	£'000
On acquisition	1,090	99
End of year 1	1,104	98

3.3.8 Future capital expenditure and development value ('highest and best use')

It is common for the value of land to reflect its potential future use and the value of land may increase in the event that the owner obtains any required permissions for a change in the use of that land.

It may be, for example, that a permission to change from an industrial to residential use will increase the value of the property as a whole, notwithstanding that the existing industrial buildings are still in place. This increase in value is typically attributable to the land, rather than the buildings.

It is therefore important to note that Section 2A requires consideration of all relevant factors in determining whether the highest and best use of a property can be something other than its current use at the measurement date. Section 2A presumes that an entity's current use of an asset is generally its highest and best use unless market or other factors suggest that a different use of that asset by market participants would maximise its value. [FRS 102.2A.11].

Section 2A states: [FRS 102.2A.9, FRS 102.2A.10]

Extract from Section 2A

- 2A.9** A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.
- 2A.10** The highest and best use takes into account the use of the asset that is physically possible, legally permissible and financially feasible.

Whilst Section 2A does not have further guidance, IFRS 13 further explains that a use that is physically possible takes into account the physical characteristics of the asset (e.g., the location or size of a property) that market participants would take into account when pricing the asset. A use that is legally permissible takes into account any legal restrictions on the use of the asset (e.g., the zoning regulations applicable to a property) that market participants would take into account when pricing the asset. A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use) to produce an investment return that market participants would require from an investment in that asset put to that use. [IFRS 13.28]

How we see it

Considerable judgement may have to be applied in determining when an anticipated change is legally permissible. For example, if approval is required for rezoning land or for an alternative use of existing property interests, it may be necessary to assess whether such approval is a substantive legal requirement or not. See Chapter 10 at 4.8.1 for further discussion on determining highest and best use.

If management determines that the highest and best use of an asset differs from its current use, certain valuation matters must be considered. Appraisals that reflect the effect of a reasonably anticipated change in what is legally permissible must be carefully evaluated. If the appraised value assumes that a change in use can be obtained, the valuation must also reflect the cost associated with obtaining approval for the change in use and transforming the asset, as well as capture the risk that the approval might not be granted (that is, uncertainty regarding the probability and timing of the approval).

Expectations about future improvements or modifications to be made to the property to reflect its highest and best use may be considered in the appraisal, such as the renovation of the property or the conversion of an office into condominiums, but only if and when other market participants would also consider making these investments and reflect only the cash flows that market participants would take into account when assessing fair value.

See Chapter 10 at 4.8 for further discussion on application of Section 2A requirements to non-financial assets which includes determining highest and best use.

3.3.9 Negative present value

In some cases, an entity expects that the present value of its payments relating to an investment property (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts. An entity applies Section 21 *Provisions and Contingencies* to determine whether to recognise a liability and, if so, how to measure that liability.

3.4 Transfers of assets to or from investment property

The instances where Section 16 explicitly requires transfers of investment property to PP&E or to right-of-use assets are the following:

- When an entity chooses to account for investment property (or part of such property) that is rented to another group entity by transferring its owned property to PP&E and applying the cost model in accordance with Section 17, or if the property is held by the entity as the lessee, to right-of-use assets and applying the cost model in accordance with Section 20 (see 3.1.2 above).
And
- When the entire mixed use property is accounted for as PP&E in accordance with Section 17 in the case of property held by the owner or, as a right-of-use asset in accordance with Section 20 in the case of property held by the entity as the lessee, because the fair value of the investment property component cannot be measured reliably (see 3.1.7 above).

Section 16 also establishes a guiding principle regarding transfers to, or from, investment property as follows: [FRS 102.16.9]

Extract from Section 16

16.9 Unless otherwise required by this FRS, an entity shall transfer a property to, or from, investment property only when the property meets, or ceases to meet, the definition of investment property and there is evidence of that change.

It reflects the principle that a transfer of a property to, or from, investment property is required only when there is a change in use which would involve:

- (a) An assessment of whether a property meets, or has ceased to meet, the definition of investment property.
And
- (b) Supporting evidence that a change in use has occurred.

This means that, unless specifically required by FRS 102 (such as items described above), there must be evidence that a change in use has occurred to support a transfer of property. Accordingly, a change in management's intentions, in isolation, would not be enough to support a transfer of property. This is because management's intentions, alone, do not provide evidence of a change in use. Observable actions toward effecting a change in use must have been taken by the entity during the reporting period to provide evidence that such a change has occurred.

The assessment of whether a change in use has occurred is based on an assessment of all the facts and circumstances and judgement is needed to determine whether a property qualifies as investment property. If significant, disclosure of this judgement would be required by Section 8. [FRS 102.8.6].

If it is determined that a change in use has occurred, Section 16 requires an entity to transfer the property to, or from, investment property.

We illustrate the application of this principle with an example below:

Illustration 3-7: Transfers from inventory

In 20X5, an entity purchased land with the intention of constructing an apartment building on the land and selling the apartments to private customers. Accordingly, the land was classified as inventory. During 20X5, the prices for residential properties decreased and the entity decided to change its original business plans at the beginning of 20X6. Instead of constructing an apartment building and selling the apartments, the entity decided to construct an office building that it would lease out to tenants. The entity holds and manages other investment property as well.

During the first half of 20X6, the entity obtained permission from the relevant authorities to commence the construction and hired an architect to design the office building. The physical construction of the office building began in August 20X6. No operating leases had been agreed with other parties for the lease of office space. However, negotiations had been held with potential tenants.

The inception of an operating lease is generally evidence of a change in use for a transfer from inventories to investment property. However, even in the absence of the inception of an operating lease, there may be other circumstances that provide evidence of a change in use. In determining whether there is sufficient evidence for a change in use from inventory to investment property, all of the following criteria must be considered:

- The entity has prepared a business plan that reflects the future rental income generated by the property and this is supported with evidence that there is demand for rental space.
- The entity can demonstrate that it has the resources, including the necessary financing or capital, to hold and manage an investment property (which requires different skills than developing a property). If the entity also owns other investment property, this could be more easily demonstrated. However, if this property would be the entity's only investment property, it may be harder to demonstrate this.
- The change in use is legally permissible. That is, the entity has obtained permission from relevant authorities for the change in use. In cases where the approval of the change in use is merely a routine or a non-substantive legal requirement (i.e., not at the discretion of the authorities), the entity's request for permission may be sufficient evidence.

And

- If the property must be further developed for the change in use, development has commenced.

How we see it

Judgement is required when the change in use is evidenced by circumstances other than the inception of an operating lease. We would generally conclude that there is sufficient evidence for a change in use from inventory to investment property if all of the criteria referred to above are met.

For the scenario described in the fact pattern above, the entity met the above criteria at the point in time when it obtained permission from the relevant authorities to change the use of the property and commenced development of the property by hiring an architect. At that time, the land would be transferred from inventory to investment property as it is now held to earn rentals rather than sale proceeds.

3.4.1 Transfers from investment property to inventory

Transfers to inventory are more difficult to deal with by way of the application of a general principle since it is a common practice in the real estate industry to hold investment properties as assets 'available' for sale. This is especially the case when an entity believes it is economical to sell the assets before they reach their peak of capital growth, or when recycling of equity (selling owned property to buy new property) presents more opportunities for capital appreciation, or in situations where an entity urgently needing cash for operations wants to release money tied up in real estate properties. FRS 102 does not provide further guidance on this therefore, it would be reasonable to consider the related guidance in adopted IFRS.

Under IAS 40, unless there is development with a view to sale, it will not be possible to reclassify investment property as inventory even if the entity holding that property changes its intentions and is no longer holding that property for rental or capital appreciation. [IAS 40.57(b)]. Accordingly, when an entity decides to dispose of an investment property without development, it continues to classify the property as an investment property until it is derecognised (see 3.5 below) and does not reclassify it as inventory. Similarly, if an entity begins to redevelop an existing investment property for continued future use as investment property, the property remains an investment property and is not reclassified as owner-occupied property during the redevelopment. [IAS 40.58].

3.4.2 Accounting treatment of transfers

When an entity completes the construction or development of a self-constructed investment property that will be carried at fair value (i.e., no actual reclassification to investment property), any difference between the fair value of the property at that date and its previous carrying amount must be recognised in profit or loss. [FRS 102.16.7].

When an entity uses the cost model in Section 17 or Section 20 for certain investment property (see 3.1.2, 3.1.7 above) or the entity measures the investment property at cost amount less impairment (see 3.3.3 above), then transfers between such investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes.

Section 16 provides guidance in accounting for transfers to, or from, investment property under the fair value model. These are discussed below.

3.4.2.A Transfer from investment property to owner-occupied property

When a property ceases to meet the definition of an investment property, for example it becomes owner-occupied or the commencement of development with a view to owner-occupation, the deemed cost for subsequent accounting as PP&E (in accordance with Section 17 - see Chapter 20) or as a right-of-use asset (in accordance with Section 20 - see Chapter 23) must be its fair value at the date of change in use.

[FRS 102.16.9A].

The carrying amount of the investment property at the date of transfer becomes its 'cost'. There is no ability to restate the asset back to cost less depreciation and impairment, and reverse out previous fair value gains.

Where the 'cost' of such property described above is not the historical cost amount, under UK law the property is being carried at a revalued amount under the alternative accounting rules. Consequently, any upwards revaluation compared to the historical cost amounts must be transferred to the statutory revaluation reserve (as a reserves transfer) and the statutory disclosures for revalued assets would apply. [1 Sch 34, 1 Sch 35]. Company law and Section 17 disclosure requirements for revalued properties will apply to the property on an ongoing basis even if the entity applies the cost model going forward, including the need to disclose comparable amounts determined according to the historical cost accounting rules (see Chapter 20 at 3.10.1). [FRS 102.17.32A].

Subsequently, there may be transfers of reserves to the extent the entity is realising the revaluation reserve. The alternative accounting rules allow that an amount may be transferred from the revaluation reserve to the profit and loss account, if the amount was previously charged to the profit and loss account or represents a realised profit. [1 Sch 35(3)]. Therefore, where depreciation or an impairment has been charged based on the deemed cost which exceeds the historical cost, the excess depreciation or impairment (over that which would have been charged based on historical cost) may be transferred from the revaluation reserve to retained earnings (as a reserves transfer). Similarly, on sale of the asset, the amount in the revaluation reserve, where realised on sale, could be transferred to retained earnings (as a reserves transfer in equity). See also relevant discussions in Chapter 20 at 3.7.3.A.

Investment property transferred to PP&E where the fair value of that property can still be measured reliably, for example a transfer to PP&E because the property is no longer held to earn rentals and/or capital appreciation, can be measured subsequently under either the cost or revaluation models of Section 17 (provided that where the revaluation model is selected, this must be applied to all items of PP&E in the same class) - see Chapter 20 at 3.7. [FRS 102.17.15]. Similarly, if the fair value of an investment property can still be measured reliably but the property is transferred to right-of-use asset because of a change in use, the property can be measured subsequently under either the cost model of Section 20 or the revaluation model of Section 17 (provided that where the revaluation model is selected, this must be applied to all items of right-of-use assets that relate to the same class of property) - see Chapter 23 at 6.3.1.B. [FRS 102.20.55, FRS 102.20.61].

3.4.2.B Transfer from investment property to inventories

When a property ceases to meet the definition of an investment property and it becomes inventory (e.g., commencement of development with a view to sale - 3.4.1 above), the deemed cost for subsequent accounting as an inventory (in accordance with Section 13 - see Chapter 16) must be its fair value at the date of change in use. [FRS 102.16.9A].

The carrying amount of the investment property at the date of transfer becomes its 'cost'. There is no ability to restate the asset back to cost less depreciation and impairment, and reverse out previous fair value gains. However, using such cost as 'deemed cost' of any investment property transferred to inventory - which is usually then carried using the cost model at the lower of cost and net realisable value - may represent a departure from Company Law where this 'cost' is not the same as the historical cost amount. Inventories are no longer permitted to be stated at their current cost under the alternative accounting rules nor does this 'deemed cost' apply the fair value accounting rules. Therefore, in some situations, use of 'deemed cost' would require necessary disclosures relating to the true and fair override of Company Law.

[1 Sch 10(2)].

Please also see other practical considerations discussed at 3.1.9 and 3.4.1 above.

3.4.2.C Transfer from owner-occupied property to investment property

If an owner-occupied property becomes an investment property, an entity must apply Section 17 (for owned property) or Section 20 (for property held by a lessee as a right-of-use asset) up to the date of change in use. The entity must treat any difference at that date between the carrying amount of the property in accordance with Section 17 or Section 20 (as applicable) and its fair value in the same way as a revaluation in accordance with Section 17 or Section 20 (as applicable). [FRS 102.16.9B]. The treatment depends on whether it is a decrease or increase in value and whether the asset had previously been revalued or impaired in value (see Chapter 20 at 3.7.4 and 3.7.5).

Accordingly, up to the date when an owner-occupied property becomes an investment property carried at fair value, an entity depreciates the property (or the right-of-use asset) and recognises any impairment losses that have occurred. At that date, any difference between the carrying amount of the property in accordance with Section 17 or Section 20 (as applicable) and its fair value is treated in the same way as a revaluation in accordance with Section 17 or Section 20 (as applicable). In other words:

- (a) Any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.
- (b) Any resulting increase in the carrying amount is treated as follows:
 - (i) To the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss does not exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised.
 - (ii) Any remaining part of the increase is recognised in other comprehensive income and increases the revaluation surplus within equity.

If the owner-occupied property had not previously been revalued, the transfer to investment property does not imply that the entity has now chosen a policy of revaluation for other property accounted for under Section 17 or Section 20 (as applicable) in the same class.

How we see it

While not explicitly addressed in Section 16, or Section 17 or Section 20, if an owner-occupied property had not previously been revalued, the revaluation arising on transfer to investment property that is recognised in other comprehensive income may, but is not required to, be accumulated in retained earnings because the asset is measured under fair value accounting rules going forward.

When an owner-occupied property that has previously been revalued (e.g., a revaluation reserve was created or retained on measuring the property at deemed cost on transition to FRS 102) or that had been previously measured under the revaluation model in Section 17 is transferred to investment property, in our view, any amounts in the revaluation reserve may likewise, but are not required to, be transferred to retained earnings via the statement of changes in equity (as this is no longer a revaluation under the alternative accounting rules).

However, as discussed at 3.3 above, an entity is not precluded from transferring the revaluation reserve to a separate non-distributable reserve, instead of to retained earnings, because this may assist with the identification of distributable profits. [FRS 102.A3.28]. Any such transfer from retained earnings to a non-distributable reserve is a reserves transfer that is shown in the statement of changes in equity.

Subsequently, when the property is derecognised (see 3.5 below), any amount accumulated in the revaluation reserve (or in a separate non-distributable reserve) relating to that item, where realised on derecognition, could be transferred to retained earnings. Again, any transfer is made directly from such reserves to retained earnings, and not through profit or loss. [1 Sch 35(3)].

3.4.2.D Transfer from inventories to investment property

As described in Illustration 3-7 above, the inception of an operating lease to another party is generally evidence of a change in use for a transfer from inventories to investment property (see also other considerations discussed in 3.1.8 above).

For a transfer from inventories to investment property that will be carried at fair value, any difference between the fair value of the property at that date and its previous carrying amount must be recognised in profit or loss. [FRS 102.16.9C].

How we see it

The above treatment is consistent with the treatment of sales of inventories. However, this does not mean that revenue is recognised upon transfer of a property from inventory to investment property because control of the property is not transferred to a customer (i.e., the same property remains with the entity) and it is not a transaction that has commercial substance.

3.5 Derecognition

Accounting for disposals of investment property is not addressed specifically within Section 16. However, Section 17 has requirements and guidance in respect of derecognition of PP&E, including replacement of parts, which can be applied to investment properties. See Chapter 20 at 3.8 for further guidance.

Accordingly, an investment property must be derecognised (eliminated from the statement of financial position) on disposal or when the investment property is permanently withdrawn from use (i.e., retirement) and no future economic benefits are expected from its disposal. [FRS 102.17.27].

A disposal of an investment property may be achieved by: [FRS 102.17.28].

- Its sale
 - When it becomes the subject of a finance lease (the owner becoming the lessor)
- Or
- When it becomes the subject of a sale and leaseback deal (the original owner becoming the lessee)

These derecognition rules also apply to a part of the investment property that has been replaced (see 3.5.3 below).

Section 20 applies if a property is disposed of by the owner becoming a lessor in a finance lease (see Chapter 23 at 7.3), or if a property is the subject of a sale and leaseback transaction (see Chapter 23 at 9).

Consistent with Section 17, if disposal of investment property is achieved by sale, the determination of the timing of recognition of any gain or loss must be in accordance with Section 23 *Revenue from Contracts with Customers*. Consequently, the date of disposal for investment property that is sold is the date the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied at a point in time in Section 23 (see Chapter 25 at 8.2).

[FRS 102.17.29]. In many cases, control will transfer when the buyer obtains legal title and physical possession of the asset. However, this may occur prior to legal settlement if it can be demonstrated that control has passed to the buyer before that date.

For the detailed discussion and requirements of Section 23 on satisfaction of performance obligations, see Chapter 25 at 8.

Under UK company law, any profit treated as unrealised, becomes realised as the related asset is sold for qualifying consideration. Therefore, when the property is derecognised, any amount accumulated in the revaluation reserve (or in a separate non-distributable reserve) relating to that item, where realised on derecognition, could be transferred to retained earnings. Any transfer is made directly from such reserves to retained earnings, and not through profit or loss. [1 Sch 35(3)].

3.5.1 Calculation of gain or loss on disposal

Following guidance in Section 17, gains and losses on retirement or disposal of investment property are calculated based on the difference between the net disposal proceeds (after deducting direct costs of disposal) and the carrying amount of the asset. [FRS 102.17.30]. Section 17 does not give guidance on how to determine the carrying amount of the asset (nor IAS 40). Possible alternatives would include the use of (i) the carrying amount in the financial statements of the last full period of account, or (ii) the carrying amount in the latest interim financial statements, or (iii) the updated carrying amount at the date of disposal.

How we see it

In our view, determining the carrying amount of the asset using any of the possible alternatives described above is a policy choice for an entity to make and is primarily a matter of income statement presentation to the extent that an entity presents gains and losses on disposal separately from gains and losses on revaluation.

Gains and losses on retirement or disposal of investment property are recognised in profit or loss, unless it is a sale and leaseback and Section 20 requires a different treatment, in the period of retirement or disposal. The entity must not classify such gains as revenue. [FRS 102.17.28]. See Chapter 23 at 9 for a discussion of sale and leaseback under Section 20.

Neither Section 16 nor Section 17 specifies how the disposal proceeds is determined. However, Section 23 provides guidance on determination of transaction price. Under Section 23, an entity is required to consider the terms of the contract and its customary business practices in determining the transaction price. Transaction price would be the amount of consideration to which an entity expects to be entitled in exchange for transferring the property to a buyer, excluding amounts collected on behalf of third parties (e.g., sales taxes). The consideration in a contract may include fixed amounts, variable amounts, or both.

In many cases, the transaction price may be readily determined if the entity receives payment when it transfers the property and the price is fixed. In other situations, it could be more challenging as it may be affected by the nature, timing and amounts of consideration.

Determining the transaction price is discussed in detail in Chapter 25 at 6.

Subsequent changes to the estimated amount of the consideration included in the gain or loss could be accounted for in accordance with the requirements for changes in the transaction price in Section 23. This is further discussed in Chapter 25 at 7.5.

If an entity retains any liabilities after disposing of an investment property these are measured and accounted for in accordance with Section 21 or other relevant sections of FRS 102, as appropriate. Accounting for such liabilities depends on specific facts and circumstances as such a liability may represent a provision (e.g., assurance-type warranty provisions) or a contingent liability under Section 21, or a financial liability under Section 11 or Section 12, or a separate performance obligation (e.g., service-type warranties) or variable consideration (e.g., fines and penalties) under Section 23. See also related discussions in Question 6-4 in Chapter 25 at 6.2.1.

3.5.2 Sale prior to completion of construction

A property that is subject to sale prior to completion of construction, if not previously classified as investment property, is likely to be property intended for sale in the ordinary course of business (see 3.1.9 above) and is therefore not likely to be investment property. Accordingly, the requirements in Section 23 must be followed.

If, however, the property subject to sale prior to completion of construction is previously classified as investment property, guidance discussed in 3.2 and 3.5.1 above would be followed. Any consequent construction services to be provided by the seller would likely be subjected to the requirements of Section 23.

For further discussion of Section 23, see Chapter 25.

3.5.3 Replacement of parts of investment property

For certain investment property that is carried under the cost model in Section 17 or Section 20 (see 3.1.2 and 3.1.7 above), an entity applies the guidance relevant to replacement of parts of PP&E in Section 20 (see Chapter 20 at 3.8). That is, the entity derecognises the carrying amount of the original part. A replaced part might not be a part that was depreciated separately, in which case, if it is not practicable to determine the carrying amount of the replaced part, it may be acceptable for the entity to use the cost of the replacement as an indication of an appropriate carrying amount (see Chapter 20 at 3.3.3). This does not mean that the entity has to apply depreciated replacement cost, rather that it can use the cost of the replacement as an indication of the original cost of the replaced part in order to reconstruct a suitable carrying amount for the replaced part.

Section 16 does not address replacement of parts of investment property using fair value model (nor replacement of parts of investment property measured at cost amount less impairment - see 3.3.3 above). Therefore, it is reasonable to consider the guidance in Section 17 as described above.

When an entity that applies the fair value model wishes to capitalise a replacement part (provided it meets the recognition criteria in 3.1 above), the question arises of how to deal with the cost of the new part and the carrying amount of the original. The basic principle is that the entity derecognises the carrying amount of the replaced part - as discussed above. However, the problem frequently encountered is that even if the cost of the old part is known, its carrying amount - at fair value - is usually by no means clear. It is possible also that the fair value may already reflect the loss in value of the part to be replaced, because the valuation reflected the fact that an acquirer would reduce the price accordingly.

As all fair value changes are taken to profit or loss, it is reasonable to conclude that it is not necessary to identify separately the elements that relate to replacements from other fair value movements. Therefore, if it is not practical to identify the amount by which fair value must be reduced for the part replaced, the cost of the replacement is added to the carrying amount of the asset and the fair value of the investment property as a whole is reassessed. Also, it can be noted that this is the treatment that would be applied to additions that did not involve replacing any existing part of the property.

3.5.4 Compensation from third parties

For certain investment property that is carried under the cost model in Section 17 or Section 20 (see 3.1.2 and 3.1.7 above), an entity applies the guidance in Section 17 to the treatment of compensation from third parties if property has been impaired, lost or given up (see Chapter 20 at 3.6.6.A). It stresses that impairments or losses of investment property, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events that have to be accounted for separately. However, Section 16 does not address these for investment property using fair value model. Therefore, it is reasonable to consider the guidance in Section 17 as described above.

Accordingly, impairment of investment property will be recorded automatically if the fair value model is used; but if the property is accounted for using the cost model in Section 17 or Section 20, it is to be calculated in accordance with Section 27 (see Chapter 29). If the entity no longer owns the asset, for example, because it has been destroyed or subject to a compulsory purchase order, it will be derecognised (see 3.5 above). Compensation from third parties (for example, from an insurance company) for property that was impaired, lost or given up is recognised in profit or loss when the compensation is virtually certain. [FRS 102.17.25]. The cost of assets restored, purchased or constructed as replacements is accounted for wholly on its own merits according to the recognition and measurement rules covered in sections 3.2 and 3.3 above.

4 Presentation and disclosures

The key presentation requirements are set out in 4.1 and 4.2 below. However, refer to Chapter 6 for the detailed discussion of the requirements for financial statement presentation relevant to investment property.

The main disclosure requirements of Section 16 and other sections of FRS 102 relating to investment property are set out at 4.3 and 4.4 below, respectively. Other disclosures required by the Companies Act in respect of investment property are set out at 4.5 below.

4.1 Presentation in the statement of financial position

Section 4 *Statement of Financial Position* provides presentation guidance for the statement of financial position (see Chapter 6).

When using the 'statutory formats' (see Chapter 6 at 4.2 and 5.3.3.A), investment property would be included within tangible fixed assets. While it is not required to present investment property on the face of the balance sheet, The Regulations permit items to be shown in greater detail. Further, FRS 102 requires additional line items, headings and subtotals when relevant to an understanding of the entity's financial position. [FRS 102.4.3]. Therefore, some entities may consider it appropriate to present investment property as a separate line item on the face of the balance sheet.

For an entity using the 'adapted formats' (see Chapter 6 at 4.1 and 4.1.4), and when material, investment property carried at fair value through profit or loss is required to be presented as a separate line item on the statement of financial position as an item within non-current assets. [FRS 102.4.2A]. However, if 'adapted formats' of presentation of the financial statements are used, an entity generally continues to classify an investment property subsequently intended to be disposed of as non-current unless it is expected to be realised within 12 months after the reporting period, in which case it must be classified as current (see discussion in Chapter 6 at 4.1.1.C).

As discussed in 3.3 above, the FRC observed that entities measuring investment properties at fair value may transfer fair value movements to a separate non-distributable reserve, instead of a transfer to retained earnings, but are not required to do so. Presenting fair value movements that are not distributable profits in a separate reserve may assist with the identification of profits available for that purpose. [FRS 102.A3.28]. Any such transfer from retained earnings to a non-distributable reserve is made in the statement of changes in equity.

4.2 Presentation in the income statement

Section 4 *Statement of Comprehensive Income and Income Statement* provides presentation guidance for the income statement (see Chapter 6).

Neither 'statutory formats' nor 'adapted formats' specify how changes in the fair value and gains or losses of investment property must be presented in the income statement. However, both allow an entity to present additional line items, headings and subtotals when it is relevant to an understanding of the entity's financial performance (see Chapter 6 at 5.7.2). [FRS 102.5.5C, FRS 102.5.9]. Further, when material, fair value changes and gains or losses on disposal of investment property may be presented as separate line items on the face of the income statement or in the notes. [FRS 102.5.9A]. However, for disposal of investment property, resulting gains must not be classified as revenue (see 3.5.1 above).

Some companies may elect to disclose the results of operating activities, or a similar line item, even though this term is not defined. In such cases, the entity must ensure that the amount disclosed is representative of activities that would normally be regarded as 'operating'. It would be inappropriate to exclude items clearly related to operations, such as profits or losses on the sale of investment property, because they occur irregularly or infrequently or are unusual in amount (see Chapter 6 at 5.7.3). [FRS 102.5.9B]. The same analysis is applied when presenting changes in the fair value of investment properties in the income statement. An entity that presents a measure of operating profit in its income statement must determine whether changes in the fair value of its investment property form part of operating activities of the entity and therefore, include such changes in fair value in that measure.

In line with this, it is worth noting that one European regulator has concluded that fair value changes arising from investment property must be taken into account when determining operating results. This decision was reported in the European Securities and Markets Authority's ('ESMA') *Report - 11th Extract from the EECS's Database of Enforcement (ESMA/2011/265)*. The regulator's rationale for this decision was that fair value changes in investment property are a normal part of the activities of a real estate company and feature in the description of the business model of that real estate business.¹⁰⁰

4.3 Disclosures required by Section 16

The following disclosures are required by Section 16: *[FRS 102.16.10]*

- The methods and significant assumptions applied in determining the fair value of investment property.
- The extent to which the fair value (as measured or disclosed in the financial statements) is based on a valuation by an independent valuer who holds a recognised and relevant professional qualification and has recent experience in the location and class of the investment property being valued. If there has been no such valuation, that fact must be disclosed (e.g., a statement that the fair value of investment property is based on internal appraisals rather than on a valuation by an independent valuer as described above).
- The existence and amounts of any restrictions on the realisability of investment property or the remittance of income and proceeds of disposal.
- Contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

And

- A reconciliation between the carrying amounts of investment property at the beginning and end of the period; showing separately:
 - Additions, disclosing separately additions resulting from acquisitions through business combinations.
 - Net gains and losses arising from fair value adjustments.
 - Transfers to and from PP&E - see 3.4 above.
 - Transfers to and from inventories - see 3.4 above.

And

- Other changes (e.g., disposals).

The reconciliation need not be presented for prior periods.

Section 16 further states that all relevant disclosures required for leases which a reporting entity has entered into must be disclosed in accordance with Section 20. *[FRS 102.16.11]*. That is, an entity discloses those items in Section 20 which requires the owner of an investment property to provide lessors' disclosures about leases into which it has entered. Section 20 also requires a lessee that holds an investment property as a right-of-use asset to provide lessees' disclosures and lessors' disclosures for any operating leases into which it has entered. Accordingly, see Chapter 23 at 6.8 and 7.8 for the required disclosures of lessees and lessors, respectively.

The above disclosures are required for all investment property (except for those transferred to, and accounted for, as either PP&E or right-of-use assets as required or allowed by Section 16 - see 3.1.2 and 3.1.7 above). This may mean that the above disclosures are also applicable to investment properties whose fair value can no longer be measured reliably. Such properties are still classified as investment property but are measured at cost amount less impairment, if any, until a reliable measure of fair value becomes available (see 3.3.3 above). *[FRS 102.2A.23]*. However, it is reasonable to expect that only those disclosures that are considered relevant to such properties would be provided. For example, the first two bullet points above might not be relevant.

Entities might also need to consider providing further information about such properties whose fair value can no longer be measured reliably and may consider the disclosures required by IAS 40 such as: *[IAS 40.78]*

- The reconciliation described above could disclose the amounts for such investment property held at cost separately from amounts relating to other investment property held at fair value.
- A description of such investment property.
- An explanation of why fair value cannot be measured reliably.

¹⁰⁰ [Report: 11th Extract from the EECS's Database of Enforcement \(ESMA/2011/265\)](#), ESMA, August 2011, paras. 76-81. Available on the ESMA's website.

- If possible, the range of estimates within which fair value is highly likely to lie.
And
- On disposal of investment property not carried at fair value:
 - The fact that the entity has disposed of investment property not carried at fair value.
 - The carrying amount of that investment property at the time of sale.
And
 - The amount of gain or loss recognised.

The reconciliation described above may also need to show impairment losses and reversals of impairment losses, together with corresponding accumulated opening and ending balances.

Section 27 requires disclosure of impairment losses and reversals of impairment losses including the line item(s) in the statement of comprehensive income (or the income statement, if presented) in which those impairment losses are included or reversed. It also requires an entity to disclose a description of the events and circumstances that led to the recognition or reversal of the impairment loss (see Chapter 29 at 7).

The disclosure requirements for investment properties measured using the cost model in Section 17 or Section 20 (e.g., certain investment property rented to another group entity and/or mixed use property but the fair value of the investment property component cannot be measured reliably - see 3.1.2 and 3.1.7 above, respectively) are set out in Section 17 or Section 20, as applicable (see Chapter 20 at 3.10).

[FRS 102.16.4A].

4.3.1 Fair value estimates

For entities that apply the fair value model in Section 16, attention will focus on the judgemental and subjective aspects of property valuations, because they will be reported in profit or loss.

Note that when a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised separately (see 3.3.2.B above), the entity must consider disclosing a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease liabilities that have been added back, and any other significant adjustments.

4.3.1.A Methods and assumptions

Methods of estimating fair value is discussed in 3.3.2.A above. Section 16 requires disclosure of the methods and significant assumptions applied in determining the fair value of investment property (see 4.1 above). This is also consistent with the requirement in Section 8 to disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. [FRS 102.8.7]. However, no further guidance is provided.

Section 16 refers to Section 2A for guidance on fair value determination which, as discussed in 3.3.1 above, is aligned with IFRS 13. Note that IFRS 13 expands the disclosures related to fair value to enable users of financial statements to understand the valuation techniques and inputs used to develop fair value measurements. Accordingly, an entity may consider the disclosure requirements of IFRS 13, as applied by FRS 102 preparers, for example:

- The methodology used in estimating the fair value, i.e., methodology (a), (b) or (c) as described in paragraph 15 of Section 2A (see 3.3.2.A above). [IFRS 13.93(b)].
- Amount of transfers between methodology (a) and (b) as described in paragraph 15 of Section 2A (see 3.3.2.A above), the reasons and related accounting policies. [IFRS 13.93(c)].
- For fair value measurement using methodology (b) and (c) in paragraph 15 of Section 2A (see 3.3.2.A above), the valuation technique and the inputs used, and changes in the valuation technique, if applicable, and the reasons for those changes. [IFRS 13.93(d)].
- If the highest and best use of a non-financial asset differs from its current use, disclose that fact and the reason for it. [IFRS 13.93(i)].

- For fair value measurement using methodology (c) in paragraph 15 of Section 2A (see 3.3.2.A above):
 - Quantitative information regarding the significant unobservable inputs. *[IFRS 13.93(d)].*
 - A reconciliation from the opening balances to the closing balances (including gains and losses, purchases, sales, issues, settlements and where all such amounts are recognised). *[IFRS 13.93(e)].*
 - The total gains or losses included in profit or loss that are attributable to the change in unrealised gains or losses relating to those assets held at the reporting date, and a description of where such amounts are recognised. *[IFRS 13.93(f)].*
 - A description of the valuation process used by the entity. *[IFRS 13.93(g)].*
- And
 - A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs might result in a significantly different amount and, if applicable, a description of interrelationships between those inputs and other unobservable inputs and of how they might magnify or mitigate the effect of changes in the unobservable inputs. *[IFRS 13.93(h)].*

An entity also assesses whether additional information must be disclosed in order to help financial statement users better understand and evaluate the quantitative information provided by the entity. *[IFRS 13.92]*. This assessment requires judgement and will depend on the specific facts and circumstances of the entity and the needs of the users of its financial statements. For example, if climate risk factors have a material impact on the fair value measurements, an entity might disclose whether and how climate-related factors have been incorporated within the methodologies and inputs.

4.3.1.B Level of disaggregation

As discussed in 3.3.1 and 4.3.1.A above, Section 16 refers to Section 2A for guidance on fair value determination which is aligned with IFRS 13. However, Section 2A does not include disclosure requirements nor further guidance as to the level of information to be provided relating to fair value determination for investment property. Accordingly, an entity may consider the applicable guidance in IFRS 13. Under IFRS 13, as applied by FRS 102 preparers, related fair value disclosures are required for each class of assets (and liabilities). These classes are determined based on:

- The nature, characteristics and risks of the asset or liability.
- And
- The methodology used in estimating the fair value, i.e., methodology (a), (b) or (c) as described in paragraph 15 of Section 2A (see 3.3.2.A above). *[IFRS 13.94]*.

The determination of the appropriate class of assets will require significant judgement. At one end of the spectrum, the properties in an operating segment (as defined by IFRS 8 *Operating Segments*) may be a class of assets for the purpose of the disclosures required by IFRS 13. This may be the case if the properties have the same risk profile (for example, the segment comprises residential properties in countries with property markets of similar characteristics) even if there are a large number of properties in the segment.

At the other end of the spectrum, IFRS 13 disclosures may be required for individual properties or small groups of properties if the individual properties or groups of properties have different risk profiles (for example, a real estate entity with two properties - an office building in a developed country and a shopping centre in a developing country).

The number of classes may need to be greater for fair value measurements which follow the methodology '(c)' in 3.3.3.A above because those measurements have a greater degree of uncertainty and subjectivity.

A class of assets and liabilities will often require greater disaggregation than the line items presented in the statement of financial position. However, sufficient information must be provided to permit reconciliation to the line items presented in the statement of financial position.

When determining the appropriate classes, entities must also consider all of the following: *[IFRS 13.92]*

- The level of detail necessary to satisfy the disclosure requirements.
- How much emphasis to place on each of the various requirements.
- How much aggregation or disaggregation to undertake.
- And
- Whether users of financial statements need additional information to evaluate the quantitative information disclosed.

Determining appropriate classes of assets and liabilities for which disclosures about fair value measurements must be provided requires considerable judgement. *[IFRS 13.94]*.

4.4 Disclosures required by other sections of FRS 102 in respect of investment property

In addition to the required disclosures in 4.1 above, other sections of FRS 102 might require disclosures of specific information relating to investment property, for example:

- Section 8 requires disclosure of, if considered material, accounting policy for investment property and the significant judgements made in the process of applying such accounting policy. [FRS 102.8.5, FRS 102.8.6].
- If, at the reporting date, an entity has a binding sale agreement for a major disposal of assets (such as an investment property) or a disposal group (which may include investment property), Section 4 *Statement of Financial Position* requires the following disclosures: [FRS 102.4.14]
 - A description of the asset(s) or the disposal group.
 - A description of the facts and circumstances of the sale.
 And
 - The carrying amount of the assets or, for a disposal group, the carrying amounts of the assets and liabilities within the disposal group.

Appendix I to FRS 102 defines a disposal group as "A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of paragraphs 27.24 to 27.27 of this FRS." [FRS 102 Appendix I]. See Chapter 6 for further details.

- In addition to specific examples given in paragraph 11 of Section 32 *Events after the End of the Reporting Period*, if a decline in fair value of investment property between the end of the reporting period and the date when the financial statements are authorised for issue is material, an entity may need to give additional disclosure related to nature of the non-adjusting events and an estimate of its financial effect or a statement that such an estimate cannot be made. [FRS 102.32.7, FRS 102.32.10]. See Chapter 34 for further details.
- If a self-constructed property meets the definition of a qualifying asset and to the extent that the entity chooses to capitalise eligible borrowing costs to the cost of the qualifying asset as an accounting policy, the amount of borrowing costs capitalised in the period and the capitalisation rate would be required to be disclosed in accordance with Section 25 (see Chapter 27). [FRS 102.17.10].

4.5 Additional disclosures required by The Regulations

The following disclosures are required by the Regulations for investment properties measured at fair value through profit or loss in addition to those required by Section 16:

- The fair value and the changes in value included in the profit and loss account. [1 Sch 55, 2 Sch 66, 3 Sch 73].
 - The balance sheet items affected and the basis of valuation adopted in determining the amounts of the assets. [1 Sch 58, 2 Sch 69, 3 Sch 76].
 - The comparable amounts determined under the historical accounting rules (aggregate cost and cumulative depreciation) or the differences between the fair value and historical cost, had the asset always been recorded at historical cost. [1 Sch 58, 2 Sch 69, 3 Sch 76].
- And
- An analysis of land and buildings between freehold tenure and leasehold tenure splitting the land held on leasehold tenure between land held on long lease (50 years or more) and short lease. [1 Sch 53, 2 Sch 64, 3 Sch 71, 10 Sch 7].

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for investment properties (IP) are set out below.

FRS 102		IFRS
Measurement and recognition		
Measurement basis at initial recognition	If payment for the asset is deferred beyond normal credit terms, the cost is the present value of all future payments (see 3.2.1 above). Although expected to be materially similar, it is not the cash price equivalent at the recognition date like in IAS 40.	If payment for the asset is deferred beyond normal credit terms, interest is recognised over the period of credit i.e., the measurement of cost of IP is the cash price equivalent at the recognition date.
	No explicit requirements on exchanges of assets. It is expected to follow guidance in Section 17 (see 3.2.2 above) which is similar to IFRS except that any resulting gain or loss is likely to be an unrealised profit or loss and would be reported in other comprehensive income.	Subject to conditions (e.g., transaction has economic substance and fair value is reliably measurable), IAS 40 requires all acquisitions of IP in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value. Any resulting gain or loss is reported in the income statement.
Measurement basis after initial recognition	IP is measured at fair value, except for IP (or part of such property) rented to another group entity which can be accounted for in an entity's individual accounts either at fair value in accordance with Section 16 or by transferring the property to PP&E or to right-of-use assets and accounted for using the cost model in accordance with Section 17 or Section 20, respectively (see 3.3 and 3.1.2 above).	An entity has a choice between fair value or cost model in measuring IP, with certain exceptions for insurers and similar entities. While there is a choice between fair value or cost model in measuring IP, there is no option to classify a property rented to another group entity as PP&E or right-to-use asset in an entity's individual financial statements (see 2.1 above).
Inability to reliably measure fair value	If a reliable measure of fair value is no longer available for an asset measured at fair value, its carrying amount at the last date the asset was reliably measurable becomes its new cost. The entity measures the asset at this cost amount less impairment, if any, until a reliable measure of fair value becomes available (see 3.3.3 above). See also similar issue below which is specific to 'Mixed use properties'.	Only in exceptional cases and only on initial recognition (either by acquisition or change in use) that an entity will be able to conclude that it will not be able to reliably measure the IP's fair value on a continuing basis. If this exceptional situation occurs, that property is then measured using the cost model in IAS 16 (for owned IP) or in IFRS 16 (for IP held as a right-of-use asset) until disposal date and the property is assumed to have a nil residual value.

Mixed use properties	Separated if the IP and other property components can be sold separately or leased out under a finance lease separately but if fair value for the IP component cannot be measured reliably, the entire property is accounted for as PP&E or as right-of-use asset, whichever is applicable (see 3.1.7 above).	Separated if the IP and PP&E components can be sold or leased (under a finance lease) separately. It is only in exceptional cases and only on initial recognition (either by acquisition or change in use) that the entity will be able to conclude that it will not be able to reliably measure the IP's fair value on a continuing basis. In the event that no separation is possible, the entire property is accounted for as PP&E or as right-of-use asset, whichever is applicable, only if significant proportion is used for non-IP purposes (see 2.2 above).
Ancillary services	No guidance (see 3.1.3 above)	Where ancillary services are significant, a property must be accounted for as owner-occupied (i.e., PP&E) rather than as investment property.
Transfers of IP	Section 16 is silent on transfers of a revaluation surplus to retained earnings. However, the Regulations permit such transfers of amounts if the amount represents realised profit (see 3.4.2 above).	IAS 40 provides more detailed guidance on accounting of transfers of IP, including transfers of revaluation surplus to retained earnings i.e., when the related asset is derecognised.
Property held for provision of social benefits	Not classified as IP but accounted for as PP&E (see 3.1.6 above)	No specific guidance.
Disclosures - Fair value model		
Fair value measurement disclosures	The methods and significant assumptions applied in determining the fair value of investment property are disclosed. Section 16 refers to Section 2A for guidance on fair value measurements but no further disclosures are required.	IAS 40 refers to IFRS 13 for fair value measurements. IFRS 13 expands the disclosures related to fair value to enable users of financial statements to understand the valuation techniques and inputs used to develop fair value.
Classification of IP	No specific disclosure requirement although Section 8 would require disclosure of significant judgements made when applying accounting policies	Criteria used to distinguish IP from other assets, where classification is difficult is required to be disclosed by IAS 40
Reconciliation between carrying amounts at beginning and end of the period	The reconciliation need not be presented for prior periods (see 4.3 above)	Reconciliation of the relevant comparative period(s) must be disclosed

Reconciliation between valuation and carrying amounts	No explicit requirement to disclose reconciliation between valuation and carrying amounts. However, it is expected to provide such reconciliation (similar to IFRS), if adjustments are significant (see 4.3.1 above).	When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, for example to avoid double-counting of assets or liabilities that are recognised separately (see 3.3.2.B above), the entity must disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately the aggregate amount of any recognised lease liabilities that have been added back, and any other significant adjustments.
Inability to reliably measure fair value	For mixed use properties (see above), no other disclosures required other than the amounts of transfers to PP&E which are included in the reconciliation of carrying amounts of IP at beginning and end of the period. Entities, however, may consider providing similar disclosures required by IFRS for IP measured using cost, less any impairment, during the period that fair value cannot be measured reliably (see 4.3 above).	In addition to disclosing the reconciliation of carrying amounts at beginning and end of the period for such investment property separately from amounts relating to other investment property, extra disclosures are required by IAS 40 such as a description of the IP and reasons for why fair value cannot be reliably measured, possible range of estimates within which fair value is highly likely to lie, and specific details on subsequent disposal of such IP (i.e., the fact that the entity has disposed of IP not carried at fair value; the carrying amount of that IP at the time of sale and the amount of gain or loss recognised).
Expenses recognised in profit or loss	There are no specific expense items recognised in profit or loss that are required to be disclosed in the notes to the financial statements.	Amounts recognised in relation to direct operating expenses are required to be disclosed separately for let and vacant IP. For insurance companies and other entities which chooses different models to measure certain investment properties (see 2.1 above), the cumulative change in fair value recognised in P&L on a sale of IP from a pool of assets under the cost model into a pool of assets under the fair value model are required to be disclosed.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

asset	A present economic resource controlled by the entity as a result of past events.
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.
deemed cost	An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value. For the purposes of applying the lessor accounting requirements in Section 20, fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
group	A parent and all its subsidiaries.
investment property	Property (land or a building, or part of a building, or both) held by the owner, or by the lessee as a right-of-use asset, to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.
owner-occupied property	A property held by the owner, or by the lessee as a right-of-use asset, for use in the production or supply of goods or services or for administrative purposes.
right-of-use asset	An asset that represents a lessee's right to use an underlying asset for the lease term.

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Chapter 20

Property, plant and equipment

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Overview

This chapter deals with the requirements of Section 17 Property, Plant and Equipment ('Section 17'), which prescribes the accounting treatment for property, plant and equipment (PP&E). The principal issues in accounting for PP&E are determining the appropriate initial recognition and cost of assets, subsequent measurement of carrying amounts, and depreciation charges and impairment losses to be recognised in relation to them. Section 17 also prescribes the disclosures that an entity must provide about PP&E.

What you need to know

- Section 17 applies to all property, plant and equipment, unless explicitly excluded from its scope.
 - Other standards may require items similar to PP&E to be recognised on a different basis from that required by Section 17 (e.g., Section 20 Leases which prescribes the accounting treatment for leased assets).
 - Section 17 allows one of two alternatives to be chosen as the accounting policy for measurement of PP&E after initial recognition:
 - The cost model
 - Or
 - The revaluation model
- The choice must be applied to an entire class of PP&E.

1 Introduction

This chapter covers the accounting for property, plant and equipment and for investment property that is rented to another group entity when the reporting entity chooses to use the cost model as permitted by paragraph 4A of Section 16 *Investment Property* (see Chapter 19).

Overall, Section 17 is largely similar to IAS 16 *Property, Plant and Equipment*. Both Section 17 and IAS 16 have similar definitions of property, plant and equipment and require that such assets are initially recorded at cost and subsequently carried using either a cost model or a revaluation model. Revaluation gains and losses are recognised in the statement of other comprehensive income except for losses below cost (which are recognised in profit and loss) and for gains to the extent that they reverse previously recognised losses in profit and loss.

2 Comparison between Section 17 and IFRS

As discussed at 1 above, Section 17 is largely similar to IFRS. However, there are also certain key differences which are discussed at 2.1 to 2.7 below. The table at 4 below contains a summary of the major GAAP differences.

2.1 Accounting for non-current assets held for sale

For entities reporting under IFRS, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires that an item of PP&E must be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than continuing use, though continuing use is not in itself precluded for assets classified as held for sale. [IFRS 5.6]. Once this classification has been made, depreciation ceases, even if the asset is still being used, but the assets must be carried at the lower of their previous carrying amount and fair value less costs to sell. [IFRS 5.15].

In contrast, FRS 102 does not have a 'held-for-sale' category for non-current assets. Therefore, there is no reclassification of assets or suspension of depreciation - see 3.5.6.B below. However, in our view, if 'adapted formats' of presentation of the financial statements are used, an entity must generally continue to classify PP&E intended to be disposed of as non-current unless it is expected to be realised within 12 months after the reporting period, in which case it must be classified as current (see Chapter 6 at 4.1.3). A plan to dispose of an asset before the previously expected date is an indicator of impairment that triggers the calculation of the asset's recoverable amount for the purpose of determining whether the asset is impaired (see Chapter 29 at 4.3). [FRS 102.17.26].

2.2 Revenue-based depreciation method

The use of 'revenue expected to be generated' as the basis to depreciate PP&E is not explicitly prohibited under FRS 102 (see 3.6.5 below). In contrast, IAS 16 states that a depreciation method that is based on revenue which is generated by an activity that includes the use of an asset is not appropriate. [IAS 16.62A].

However, it must be noted that under both IAS 16 and Section 17, the depreciation method selected must reflect the pattern in which the asset's future economic benefits are expected to be consumed. The revenue generated by an activity that requires the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. Revenue reflects the output of the asset, but it also reflects other factors that do not affect depreciation, such as changes in sales volumes and selling prices, the effects of selling activities and other inputs and processes. The price component of revenue may be affected by inflation or foreign currency exchange rates. This means that revenue does not, as a matter of principle, reflect how an asset is used or consumed. Therefore, despite the fact that revenue-based depreciation is not explicitly prohibited under FRS 102, it would not be appropriate to select a revenue-based depreciation method where that did not reflect the consumption of the economic benefits of the asset.

2.3 Intra-group investment property

Under FRS 102 an entity can choose to bring investment properties rented to another group entity within the scope of Section 17 if it applies the cost model to their subsequent measurement (see 3.1 below).

This option is not available under IAS 40 *Investment Property* although IAS 40 permits cost less impairment as a measurement option. Under IAS 40 property rented to other group entities is classified as an investment property if it meets the definition of investment property.

2.4 Bearer plants

IAS 16 and IAS 41 *Agriculture* define a bearer plant as a living plant which is used in the production or supply of agricultural produce, is expected to bear produce for more than one period and has a remote chance of being sold as agricultural produce, except for incidental scrap sales. [IAS 16.6, IAS 41.5].

Section 34 *Specialised Activities* does not make a distinction between biological assets and bearer plants. Therefore, bearer plants are treated as biological assets and accounted for in accordance with Section 34.

In contrast, IAS 41 does distinguish between biological assets and bearer plants. Bearer plants are scoped out of IAS 41 and instead fall in the scope of IAS 16. [IAS 16.3(b), IAS 41.1].

2.5 Disposal of PP&E

Under FRS 102, gains and losses on disposal are calculated as the difference between any net disposal proceeds and the carrying value of the item of PP&E. [FRS 102.17.30]. Section 17 does not provide further guidance on how the disposal proceeds must be determined. However, IAS 16 requires that the amount of consideration on disposal to be included in the gain or loss on derecognition of PP&E must be determined in accordance with the requirements for determining the transaction price in IFRS 15 *Revenue from Contracts with Customers*. In addition, subsequent changes to the estimated amount of consideration included in the gain or loss must be accounted for in accordance with the requirements for changes in transaction price in IFRS 15. [IAS 16.72]. As a result of this the gain or loss on disposal calculated under FRS 102 may be different to that calculated under IAS 16. See 3.7 below for further details of the requirements in relation to derecognition of PP&E under FRS 102.

2.6 Income earned before an asset is available for use

Both IAS 16 and FRS 102 specify that the cost of an item of PP&E includes the costs of testing whether the asset is functioning properly. [IAS 16.17(e), FRS 102.17.10].

Sometimes, income may be earned from selling items produced when testing the functionality of an item of PP&E prior to it being available for use. Historically, entities applying IAS 16 and FRS 102 adopted a similar approach to accounting for such income. Specifically, it was an explicit requirement of IAS 16 and common practice under FRS 102, for entities to recognise cost after deducting the net proceeds from selling any items produced while bringing the asset to its location and condition (such as samples produced when testing equipment).

However, in May 2020, the IASB issued an amendment to IAS 16, which prescribes new accounting and disclosure requirements in respect of the accounting for proceeds from selling items produced while bringing an item of PP&E to the location and condition necessary for it to be capable of operating in the manner intended by management. Under the amendment, for IFRS reporters, proceeds from selling such items, and the cost of those items, must be recognised in profit or loss. The requirement to recognise the proceeds and related costs in profit and loss applies irrespective of whether those operations are necessary to bring the item to its intended location and operating condition.

FRS 102 has not been amended to reflect this amendment to IFRS, and the Standard does not contain further guidance relating to costs of testing whether the asset is functioning properly. However, FRS 102 states that income and related expenses of incidental operations during construction or development of an item of PP&E are recognised in profit or loss "if those operations are not necessary to bring the item to its intended location and operating condition". [FRS 102.17.12]. As such, it is common practice for income which an entity judges to be attributable to the testing of an assets functionality to be deducted from the cost of the item of PP&E under FRS 102. The amendments to IAS 16 may lead to differences arising in the measurement of cost between IFRS and FRS 102 for entities who earn income prior to items of PP&E being ready for their intended use.

2.7 Disclosures

The disclosure requirements of Section 17 (see 3.9 below) are less extensive than those of IAS 16. In addition, unlike IAS 16, Section 17 does not require comparative information to be presented in the reconciliation of the carrying amount from the beginning to the end of the reporting period. [FRS 102.17.31].

3 Requirements of Section 17 for property, plant and equipment

3.1 Scope of Section 17

Section 17 applies to the accounting for:

(a) PP&E

And

(b) Investment property that is rented to another group entity when the reporting entity chooses to use the cost model as permitted by paragraph 4A of Section 16 (see Chapter 19) *[FRS 102.17.1]*

Section 17 does not apply to:

- PP&E classified as investment property (see Chapter 19), except where the investment property is rented to another group company and the reporting entity chooses to apply the cost model.
- Biological assets related to agricultural activity (see Chapter 36).
- Heritage assets (see Chapter 36).

And

- Mineral rights and mineral reserves such as oil, gas, and similar 'non-regenerative' resources (see Chapter 36). *[FRS 102.17.3]*.

Although Section 17 scopes out biological assets and mineral resources, any PP&E used in developing or maintaining such resources would be within scope. Section 17 is silent as to whether a biological asset meeting the definition of a 'bearer plant' (e.g., fruit tree) is within its scope. However, Section 34 does not make a distinction between biological assets and bearer plants. Therefore, bearer plants are treated as biological assets and accounted for in accordance with Section 34 (see Chapter 36 at 2.3.2).

Other sections of FRS 102 may require an item of PP&E to be recognised on a basis different from that required by Section 17. For example, Section 20 *Leases* has its own rules regarding recognition and measurement. Under Section 20, for the majority of leases, a lessee recognises an asset on its balance sheet representing the right to use the underlying asset (i.e., the right-of-use asset). See Chapter 23 for a description of how an item of PP&E held under a lease is recognised and initially measured. Once a right-of-use asset has been recognised under Section 20, its treatment thereafter is in accordance with Section 17, unless it applies the fair value model for investment property held under a lease.

3.2 Recognition

An item of PP&E must be recognised (i.e., its cost included as an asset in the statement of financial position), only if it is probable that future economic benefits associated with the item will flow to the entity and if its cost can be measured reliably. *[FRS 102.17.4]*.

3.2.1 Aspects of recognition

3.2.1.A Spare parts and minor items

Spare parts, stand-by equipment and servicing equipment are recognised in accordance with Section 17 when they meet the definition of PP&E. Otherwise, such items are classified as inventory. *[FRS 102.17.5]*.

Materiality judgements are considered when deciding how an item of PP&E should be accounted for. Major spare parts may, for example, be considered as qualifying as PP&E, while smaller spares may be carried as inventory and as a practical matter many companies have a minimum value for capitalising assets.

Some types of business may have a very large number of minor items of PP&E such as spare parts, tools, pallets and returnable containers, which nevertheless are used in more than one accounting period. There are practical problems in recording these on an asset-by-asset basis in an asset register; they are difficult to control and frequently lost. The main consequence is that it becomes very difficult to depreciate them. Generally, entities write off such immaterial assets as expenses in the period of addition. Section 17 does not prescribe what actually constitutes a single item of PP&E. Therefore, in our view, entities must apply judgement in defining PP&E in their individual circumstances. It may be appropriate to aggregate some parts (such as tools, moulds and dies) and to apply the requirements of Section 17 to the aggregate amount (presumably without having to identify the individual assets).

3.2.1.B Environmental and safety equipment

There may be expenditures forced upon an entity by legislation that requires it to buy 'assets' that do not directly increase the expected future benefits expected to flow from the asset. Examples would be safety or environmental protection equipment. While Section 17 has no specific guidance, it would be reasonable to consider the related guidance in IFRS when accounting for such costs.

IAS 16 explains that the acquisition of such assets, although not directly increasing the future economic benefits of any particular existing item of PP&E, may be necessary for an entity to obtain the future economic benefits from its other assets. Therefore, such items of qualify for recognition because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements. The entity may be unable to manufacture and sell the chemicals, or a plant might have to be closed down if these safety or environmental expenditures were not made. [IAS 16.11].

In addition, an entity may voluntarily invest in environmental equipment even though it is not required by law to do so. If the entity can demonstrate that the expenditure is likely to increase the economic life of a related asset or enables the entity to derive additional economic benefit working in conjunction with other assets, the expenditure meets the definition of an asset. Expenditure that relates to repairs and maintenance or that forms part of period costs or operational costs cannot be capitalised as an asset.

Consistent with IAS 16, whenever safety and environmental assets are capitalised, the resulting carrying amount of the asset, and any related asset, are required to be reviewed for impairment in accordance with Section 27 *Impairment of Assets* (see 3.5.6 below).

3.2.1.C Economic benefits and costs associated with property developments

Section 17 requires that PP&E is recognised only when it is probable that future economic benefits associated with the item will flow to the entity.

For example, in relation to property development, many jurisdictions require permissions prior to development whilst developers, including entities developing property for their own use, typically incur significant costs prior to such permissions being granted.

In assessing whether such pre-permission expenditures can be capitalised, assuming they otherwise meet the criteria, a judgement must be made at the date the expenditure is incurred of whether it is sufficiently probable that the relevant permission will be granted. Such expenditure does not become part of the cost of the land; to the extent that it can be recognised it will be as part of the cost of a separate building.

How we see it

If the granting of necessary permits is no longer expected during the application and approval process, capitalisation of pre-permission expenditures must cease and any related amounts that were previously capitalised should be written off in accordance with Section 27 and accordingly, the carrying amount of any related item of PP&E subject to development or redevelopment (or, if appropriate, the cash generating unit where such an asset belongs) must be tested for impairment, where applicable.

3.2.1.D Classification as PP&E or intangible assets

Certain intangible assets may be embedded or contained within an item of PP&E, and this can raise questions in determining whether such assets should be accounted for under Section 17 or Section 18 *Intangible Assets other than Goodwill*. In practice, items such as computer software purchased by entities are frequently capitalised as part of a tangible asset, for example as part of an accounting or communications infrastructure. Equally, internally written software may be capitalised as part of a tangible production facility, and so on. Judgement must be exercised in deciding whether such items are to be accounted for under Section 17 or Section 18, and this distinction becomes increasingly important if the two sections prescribe differing treatments in any particular case.

Section 17 does not refer to this type of asset. In contrast, Section 18 contains explicit guidance, stating that where an asset incorporates both intangible and tangible elements, an entity needs to exercise judgement in determining whether the asset should be treated as PP&E or as an intangible asset, for example:

- Computer software that is embedded in computer-controlled equipment that cannot operate without that specific software is an integral part of the related hardware and is treated as PP&E.

- Software which is not an integral part of the related hardware is treated as an intangible asset. For example, application software that is being used on a computer is generally easily replaced and is not an integral part of the related hardware, whereas the operating system normally is integral to the computer and is included in PP&E.

And

- A database that is stored on a compact disc is considered to be an intangible asset because the value of the physical medium is wholly insignificant compared to that of the data collection. [FRS 102.18.3B].

It is worthwhile noting that as the 'parts approach' in Section 17 (see 3.2.2 below) requires an entity to account for significant parts of an asset separately, this raises 'boundary' problems between Section 17 and Section 18 when software and similar expenditure are involved.

How we see it

We believe that where Section 17 requires an entity to identify significant parts of an asset and account for them separately, the entity needs to evaluate whether any software-type intangible part is integral to the larger asset or whether it is really a separate asset in its own right. The intangible part is more likely to be an asset in its own right if it was developed separately or if it can be used independently of the item of PP&E.

3.2.1.E Classification of items as inventory or PP&E when minimum levels are maintained

Entities may acquire items of inventory on a continuing basis, either for sale in the ordinary course of business or to be consumed in a production process or when rendering services.

This means there will always be a core stock of that item (i.e., a minimum level of inventory is maintained). This does not in itself turn inventory into an item of PP&E, since each individual item will be consumed in a single operating cycle. However, there may be cases where it is difficult to judge whether an item is part of inventory or is an item of PP&E. This may have implications on measurement because, for example, PP&E has a revaluation option (see 3.4 and 3.6 below) that is not available for inventory.

How we see it

In our view, an item of inventory is accounted for as an item of PP&E if it:

- Is not held for sale or consumed in a production process or during the process of rendering services.
- Is necessary to operate or benefit from an asset during more than one operating cycle.

And

- Cannot be recouped through sale (or is significantly impaired after it has been used to operate the asset or benefit from that asset).

This applies even if the part of inventory that is an item of PP&E cannot be physically separated from the rest of inventories.

When assessing whether 'core stock' must be classified as PP&E or inventories, an entity considers the definition of inventories. In doing so it must be noted that there is no reason why one should not distinguish assets with a different use, and account for them differently. Further, if the items are necessary to bring another item of PP&E to the condition necessary for it to be capable of operating in the manner intended by management, this meets the definition of cost of an item of PP&E in paragraph 17.10(b).

Consider the following scenarios:

Illustration 3-1: Classification of items as inventory or PP&E when minimum levels are maintained

Scenario 1

An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part of that gas will only be used to keep the cave under pressure in order to be able to extract gas from the cave.

It is not possible to distinguish the gas that will be used to keep the cave under pressure and the rest of the gas (that is, it is not possible to identify the specific molecules in each of the two categories). Gas will be turned around on a continuing basis. Still, it is possible to measure the quantity of the gas that will not be recoupable from the cave for selling purposes.

In this scenario, the total volume of gas must be virtually split into (i) gas held for sale and (ii) gas held to keep the cave under pressure. The former must be accounted for under Section 13 *Inventories*. The latter is necessary to operate the cave over more than one operating cycle and must be accounted for as PP&E and depreciated over the period the cave is expected to be used.

Scenario 2

An entity operates an oil refining plant. In order for the refining process to take place, the plant must contain a certain minimum quantity of oil. This can only be taken out once the plant is abandoned and would then be polluted to such an extent that the oil's value is significantly reduced as it can only be sold as sludge.

In this scenario the part of the oil that is necessary to operate (in technical terms) the plant and cannot be recouped (or can be recouped but would then be significantly impaired), even when the plant is abandoned, must be considered as an item of PP&E and amortised over the life of the plant.

Scenario 3

An entity sells gas and has at any one time a certain quantity of gas in its gas distribution network.

In this scenario, the gas in the pipeline is not necessary to operate the pipeline. It is held for sale or to be consumed in the production process or process of rendering services. Therefore, this gas is accounted for as inventory.

In scenarios (1) and (2) above, recognising these items as inventories would lead to an immediate loss because these items cannot be sold or consumed in a production process or during the process of rendering services. This does not properly reflect the fact that the items are necessary to operate another asset over more than one operating cycle.

3.2.1.F Production stripping costs of surface mines

Under FRS 102, there is no specific guidance on production stripping costs of surface mines. However, the approach in Section 17 in relation to accounting for parts (see 3.2.2 below) seems to be consistent with the specific guidance provided in IFRS.

IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* states that costs associated with a 'stripping activity asset' (i.e., the costs associated with gaining access to a specific section of the ore body) are accounted for as an additional component of an existing asset. [IFRIC 20.10]. Other routine stripping costs are accounted for as current costs of production (i.e., inventory).

The Interpretations Committee's intention was to maintain the principle of IAS 16 by requiring identification of the 'component' of the ore body for which access had been improved, as part of the criteria for recognising stripping costs as an asset. An entity will have to allocate the stripping costs between the amount capitalised (as it reflects the future access benefit) and the amount that relates to the current-period production of inventory. This allocation must be based on a relevant production measure.

This component approach follows the principle of separating out parts of an asset that have costs that are significant in relation to the entire asset and when the useful lives of those parts are different. [IAS 16.44].

This interpretation is discussed in more detail in the most recent version of the EY publication International GAAP®.

3.2.1.G Expenditure on the development of infrastructure relating to new technologies

An entity may incur expenditure on the development of infrastructure relating to new technologies. One instance in which this may be particularly relevant is those entities incurring expenditure arising from the need to address impacts of climate change (e.g., hydrogen processing or carbon capture and storage (CCS) facilities). Such development costs are recognised as an item of PP&E if it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably. [FRS 102.17.4]. The entity will need to consider at which point there is sufficient and reliable information to meet the PP&E recognition criteria. This is key as there will likely be more uncertainty about the total project costs of assets relating to new technologies compared to existing technologies. Therefore, there is greater potential for significant time and cost overruns.

3.2.1.H Aggregation of items of PP&E

Entities may have items of PP&E that are considered insignificant at the overall entity level because the entity is of such a size that the individual assets are considered insignificant to the entity as a whole. As described in section 3.2.1.A above, Section 17 does not prescribe the 'unit of measure' for recognition, i.e., what constitutes an item of PP&E and the extent to which items can be aggregated. It would be reasonable to refer to the guidance in IAS 16 in this regard, which notes that it may be appropriate to aggregate individually insignificant items such as moulds, tools and dies, and to apply the standard to the aggregate value. [IAS 16.9]. However, it is noted that IAS 16 is silent on whether this approach may be used to aggregate properties or similar assets that are individually immaterial.

There are instances in which the aggregation of items on the grounds that they are immaterial to the entity purely by virtue of their size may result in accounting that is inconsistent with the broader requirements of Section 17. For example, the aggregation of individually immaterial assets into a single asset could lead to a factory being considered a single asset, instead of distinguishing between the land, buildings, plant and machinery, which would clearly be against both the letter and spirit of Section 17. The following illustration shows another situation:

Illustration 3-2: Aggregation of individual properties

An entity owns a large number of individual properties from which it earns both rental income and other trading income, such that the properties do not meet the definition of investment properties under Section 16. The entity applies the revaluation model for subsequent measurement of its properties.

Each property is individually immaterial to the entity. Nevertheless, each property is recorded separately in the entity's books and records, is monitored separately by management and generates individual cash flows. Therefore, each individual property is regarded as a separate item of PP&E under Section 17.

If such an entity did aggregate all its properties, any downward revaluations on individual properties to the income statement would be inappropriately offset by revaluation gains arising on other properties within the aggregated group.

How we see it

FRS 102 is silent on the issue of aggregation of items of PP&E. It would be reasonable for entities to consider the requirements of paragraph 9 of IAS 16 in developing their accounting policy for PP&E, but in doing so, it is our view that paragraph 9 applies to small items (such as tools) that are capitalised together into a single amount and are not subsequently viewed by management or monitored as single assets. In our view, the paragraph cannot be used to justify the aggregation of individual assets if the entity itself views and monitors the assets individually, the assets generate separately identifiable cash flows or the assets are subject to separate contractual arrangements.

3.2.2 Accounting for parts ('components') of assets

Section 17 requires entities to identify major parts of items of PP&E on initial recognition. This is necessary for two reasons:

- In order to apply the depreciation requirements where the major components of an asset have different patterns of consumption of economic benefits (see 3.2.2.A).
And
- In order to apply the derecognition requirements when part of an item of PP&E is replaced (see 3.2.3).
[FRS 102.17.6, FRS 102.17.16]

Section 17 uses the terms 'part' and 'component' although neither term is defined. The process of identifying and separately recognising the major components of an item PP&E is often referred to as 'componentisation'.

3.2.2.A Identifying 'major components' for depreciation purposes

The initial cost of an item of PP&E to be allocated to its 'major components' and each component must be depreciated separately where there are different patterns of consumption of economic benefits.

[FRS 102.17.6, FRS 102.17.16]. Therefore, an entity will have to identify the major components of the asset on initial recognition in order to depreciate the asset appropriately. There is no requirement to identify all components, only major components.

The unit of measurement to which Section 17 applies (i.e., what comprises an item of PP&E) is not itself defined. Therefore, the identification of major components will require the exercise of judgement after considering the specific facts and circumstances. However, components that have a cost that is significant in relation to the total cost of the asset will usually be a 'major component'.

Components may be physical components, but where relevant, non-physical parts may also be identified to reflect the need for the asset to undergo major inspections or overhauls. Major inspections are discussed further in section 3.2.3.B below. The separation of an asset into major physical components is illustrated in Illustration 3-3.

Illustration 3-3: Identification of major components for depreciation purposes

An entity buys a property with an estimated useful life of 25 years for £4 million. The property's roof is expected to require replacement every 10 years at an estimated cost of £250,000. The building is also internally configured using partition walls to create the required workspaces (such as open plan areas and meeting rooms), and this internal configuration is expected to be replaced every 7 years at an estimated cost of £350,000.

The entity is required under IAS 16 to allocate the amount initially recognised to its significant parts, and therefore it determines that it should:

- Regard the roof as a significant part with a cost of £250,000 and a useful life of 10 years.
 - Regard the internal partitioning as a significant part with a cost of £350,000 and a useful life of 7 years.
- And
- The remaining cost of £3.4 million should be allocated to the building component with a useful life of 25 years.

As set out at 3.2.2 above, in addition to the requirement to componentise for depreciation purposes, Section 17 requires entities to derecognise an existing part or component when it is replaced, regardless of whether it has been depreciated separately. The accounting for subsequent expenditure on replacement of parts is discussed further at 3.2.3 and 3.2.3.A below.

3.2.2.B Land and buildings

Section 17 requires that the land and the building elements of property are treated as separate assets and accounted for separately, even when they are acquired together. [FRS 102.17.8].

3.2.3 Initial and subsequent expenditure

Section 17 makes no distinction in principle between the initial costs of acquiring an asset and any subsequent expenditure upon it. In both cases any and all expenditure must meet the recognition rules, and be expensed in profit or loss if it does not.

A distinction is drawn between servicing and more major expenditures. Day-to-day servicing (e.g., repairs and maintenance of PP&E, which largely comprises labour costs and minor parts) must be recognised in profit or loss as incurred. [FRS 102.17.15]. However, if the cost involves replacing a part of the asset, this replacement part must be recognised, i.e., capitalised as part of the PP&E, if the recognition criteria are met. The carrying amount of the part that has been replaced must be derecognised. [FRS 102.17.6].

Identification of parts is discussed at 3.2.2 above and the accounting for replacement parts is discussed further at 3.2.3.A below.

3.2.3.A Subsequent expenditure on replacement of parts

When discussing subsequent expenditure, Section 17 states that parts of some items of PP&E may require replacement at regular intervals. [FRS 102.17.6]. Examples of parts which may require replacement at regular intervals during the life of the asset include the roofs of buildings, relining a furnace after a specified number of hours of use, or replacing the interiors of an aircraft several times during the life of the airframe. There could also be parts which may involve less frequently recurring replacements, such as replacing the interior walls of a building.

Section 17 does not state that replacement expenditures necessarily qualify for recognition. For example, aircraft interiors are clearly best treated as separate components as they have a useful life different from that of the asset of which they are part. With the other examples, such as interior walls, it is less clear why they meet the recognition criteria. However, replacing internal walls or similar expenditures may extend the useful life of a building while upgrading machinery may increase its capacity, improve the quality of its output or reduce operating costs. Hence, this type of expenditure may give rise to future economic benefits.

Entities are required to derecognise the carrying amount of an existing part when it is replaced, regardless of whether it has been depreciated separately. If it is impracticable for an entity to identify the carrying amount of the replaced part, it may be estimated using the current cost of the replacement part as a proxy for the original cost of the replaced part and adjusting it for depreciation and impairment. [FRS 102.17.6]. This is consistent with the treatment for 'major inspections' discussed at 3.2.3.B below.

Given there is no requirement to identify all components, in practice an entity may not actually identify the parts or components of an asset until it incurs the replacement expenditure, as in the following Illustration.

Illustration 3-4: Recognition and derecognition of parts

An entity buys a piece of machinery with an estimated useful life of ten years for £10 million. The asset contains two identical pumps, which are assumed to have the same useful life as the machine of which they are a part. After seven years one of the pumps fails and is replaced at a cost of £200,000. The entity had not identified the pumps as separate parts and does not know the original cost. It uses the cost of the replacement part to estimate the carrying value of the original pump. With the help of the supplier, it estimates that the cost would have been approximately £170,000 and that this would have a remaining carrying value after seven year's depreciation of £51,000. Accordingly, it derecognises £51,000 and capitalises the cost of the replacement.

3.2.3.B Cost of major inspections

A condition of continuing to operate an item of PP&E (e.g., a bus) may include a requirement to perform regular major inspections for faults regardless of whether parts of the item are replaced. When a major inspection is performed, Section 17 requires the cost of the inspection to be recognised in the carrying amount of the item of PP&E as a replacement (and considered a separate part) if the recognition criteria are satisfied (see 3.2 above). [FRS 102.17.7].

This approach maintains a degree of consistency with Section 21 *Provisions and Contingencies* which prohibits an entity from making provisions if there are no obligations. Therefore, an entity is prohibited by Section 21 from making, for example, a provision to overhaul an owned aircraft engine by annually providing for a quarter of the cost for four years and then utilising the provision when the engine is overhauled in the fourth year. Instead, the cost of a major inspections is added to the asset's cost if the recognition criteria are satisfied and then depreciated over the period until the next major inspection.

Any remaining carrying amount of the cost of the previous major inspection (as distinct from physical parts) is derecognised. In the same way as described at 3.2.3.A above for replacement parts more generally, this is done regardless of whether the cost of the previous major inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed. [FRS 102.17.7]. Accordingly, if the element relating to the inspection had previously been identified, it would have been depreciated between that time and the current overhaul and its carrying amount would be known. However, if it had not previously been identified, Section 17 allows the entity to reconstruct the carrying amount of the previous inspection (i.e., to estimate the net depreciated carrying value of the previous inspection that will be derecognised using the estimated cost of a future similar inspection as an indication of the cost of the existing inspection component that must be derecognised).

These principles may need to be considered by entities which are required to undertake major overhauls or redesigns of items of PP&E as a result of the impacts of climate change on their business. To the extent that such activities result in the replacement of asset parts, entities will need to apply the 'major inspection and overhaul' principles of Section 17 in determining the appropriate treatment.

3.2.4 Properties with mixed use

There may be instances where a property has mixed use, for example, it could be partly owner-occupied and partly held for rental. Section 16 provides guidance relating to the allocation of mixed-use property between investment property and PP&E (see Chapter 19 at 3.1.7).

3.3 Measurement at initial recognition

Section 17 draws a distinction between measurement at initial recognition (i.e., the initial treatment of an item of PP&E on acquisition) and measurement after initial recognition (i.e., the subsequent treatment of the item). Measurement after initial recognition is discussed at 3.4, 3.5 and 3.6 below.

Section 17 states that "an entity shall measure an item of property, plant and equipment at initial recognition at its cost". [FRS 102.17.9]. What may be included in the cost of an item is discussed below.

3.3.1 Elements of cost and cost measurement

FRS 102 sets out what constitutes the cost of an item of PP&E on initial recognition: [FRS 102.17.10]

Extract from Section 17

- 17.10** The cost of an item of property, plant and equipment comprises all of the following:
- (a) Its purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
 - (b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These can include the costs of site preparation, initial delivery and handling, installation and assembly, and testing of functionality.
 - (c) The initial estimate of the costs, recognised and measured in accordance with Section 21 *Provisions and Contingencies*, of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.
 - (d) Any borrowing costs capitalised in accordance with paragraph 25.2.

Item (c) above requires that site restoration and other environmental restoration and similar costs be estimated and capitalised at initial recognition, in order that such costs can be recovered over the life of the item of PP&E, even if the expenditure will only be incurred at the end of the item's life. The obligations are calculated in accordance with Section 21.

A common instance of (c) is dilapidation obligations in lease agreements, under which a lessee is obliged to return premises to the landlord in an agreed condition. Arguably, a provision is required whenever the 'damage' is incurred. Therefore, if an entity rents a building and constructs a dividing wall to convert the single building into two premises, and has an obligation to make good at the end of the lease term, the tenant must immediately provide for the costs of so doing. The 'other side' of the provision entry is an asset that will be amortised over the lease term. This reflects the fact that the cost to the tenant of the leasehold improvement includes both the cost of constructing the dividing wall, but also the resulting costs which the entity will have to incur in the future to restore the property.

Obligations that arise as a result of using the asset to produce inventories during a particular period are not capitalised as part of the item of PP&E. These are production costs and are included in the cost of inventories. Such costs are dealt with in accordance with Section 13 (discussed in Chapter 16 at 3.2). Obligations that arise due to general use (for example, costs associated with wear and tear arising from the use of a leasehold building for administrative purposes) are expensed as incurred.

3.3.1.A 'Directly attributable' costs

This is the key issue in the measurement of cost. Section 17 gives examples of types of expenditure that are, and are not, considered to be directly attributable. The following are examples of those types of expenditure that are considered to be directly attributable and hence must be included in cost at initial recognition: [FRS 102.17.10(b)]

- Costs of site preparation.
- Initial delivery and handling costs.
- Installation and assembly costs.

And

- Cost of testing of functionality.

Costs are only eligible for capitalisation until the point at which the asset has been brought to the location and condition for it to be capable of being operated in a manner intended by management. However, FRS 102 does not provide guidance on assessing the point at which this has occurred, and therefore, judgement may be required in determining the period during which testing costs must be capitalised. While FRS 102 has no further guidance relating to the measurement of costs of testing whether the asset is functioning properly, it is reasonable and common practice to recognise costs after deducting the net proceeds from selling any items produced while bringing the asset to its location and condition (such as samples produced when testing equipment). Income received during the period of construction of PP&E is considered further at 3.3.2 below.

How we see it

In our view, the depreciation charge associated with right-of-use assets during the construction period of an asset may also be a directly attributable cost to be included as part of the cost of the PP&E if those lease costs are 'directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management'. This may be the case, for example, where a building is constructed on land that is leased. Determining whether the depreciation expense associated with a right-of-use asset is directly attributable requires judgement, taking into account all relevant facts and circumstances.

Certain types of expenditure are not directly attributable costs associated with an item of PP&E and therefore, cannot be recognised as part of the cost of an asset. This must be considered in assessing whether a lease cost is included in the cost of an item of PP&E. Some specific examples of ineligible costs are discussed further at 3.3.1.C below. The prohibition from including general overheads and costs related to opening a new facility in the cost of an item of PP&E may be particularly relevant when assessing whether lease costs should be capitalised.

Other types of costs expected to be considered to be directly attributable costs are the following:

- Costs of employee benefits (as defined in Section 28 *Employee Benefits*) arising directly from the construction or acquisition of the item of PP&E. This means that the labour costs of an entity's own employees (e.g., site workers, in-house architects and surveyors) arising directly from the construction, or acquisition, of the specific item of PP&E may be recognised.

And

- Professional fees.

3.3.1.B Borrowing costs

Entities are not required to capitalise borrowing costs. However, in line with item (d) at 3.3.1 above and Section 25 *Borrowing Costs*, such costs may be capitalised in respect of certain qualifying assets to the extent that the entity has made an accounting policy choice to capitalise borrowing costs in respect of such assets. A qualifying asset is "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale". [FRS 102 Appendix I]. The treatment of borrowing costs is discussed separately in Chapter 27.

3.3.1.C Costs that are not PP&E costs

The following costs are not costs of PP&E and must be recognised as an expense when they are incurred: [FRS 102.17.11]

- Costs related to opening a new facility.
 - Costs of introducing a new product or service (including costs of advertising and promotional activities).
 - Costs of conducting business in a new territory or with a new class of customer (including costs of staff training).
- And
- Administration and other general overhead costs.

Administration and other general overhead costs are not costs of an item of PP&E. This means that employee costs not related to a specific asset, such as site selection activities and general management time, do not qualify for capitalisation. Entities are also not allowed to recognise so-called 'start up costs' as part of the item of PP&E. These include costs related to opening a new facility, introducing a new product or service (including costs of advertising and promotional activities), conducting business in a new territory or with a new class of customer (including costs of staff training) and similar items. [FRS 102.17.11]. These costs must be accounted for in the same way as similar costs incurred as part of the entity's on-going activities (in general, expensed as incurred).

3.3.1.D Cessation of capitalisation

Only those costs directly attributable to bringing the asset to the location and condition for it to be capable of being operated in a manner intended by management can be capitalised. [FRS 102.17.10(b)]. Once that has occurred capitalisation must cease. This will usually be the date of practical completion of the physical asset.

An entity is not precluded from continuing to capitalise costs during an initial commissioning period that is necessary for installation or assembly or testing equipment. In contrast, no new costs should be capitalised if the asset is fully operational but is not yet achieving its targeted output, usage or profitability because demand is still building up, for example in a new hotel that initially has high room vacancies. In these cases, the asset is clearly in the location and condition necessary for it to be capable of operating in the manner intended by management.

Entities need to identify the point at which major assets are considered to be in the location and condition necessary for it to be capable of operating in the manner intended by management and apply that policy consistently.

3.3.1.E Self-built assets

Section 17 is silent on construction costs of an item of self-built PP&E. If an asset is self-built by the entity, the same general principles apply as for an acquired asset i.e., only those costs directly attributable to bringing the asset to the location and condition for it to be capable of being operated in a manner intended by management can be capitalised. This includes assembly costs. [FRS 102.17.10(b)]. Consistent with IAS 16 and common practice, abnormal amounts of wasted resources, whether labour, materials or other resources, must not be included in the cost of self-built assets. [IAS 16.22]. Section 25, discussed in Chapter 27, contains criteria relating to the recognition of any interest as a component of a self-built item of PP&E (in instances in which an entity has selected an accounting policy of capitalising eligible borrowing costs).

If the same type of asset is made for resale by the business, it must be recognised at cost of production, but including attributable overheads in accordance with Section 13 (see Chapter 16 at 3.2). [FRS 102.13.8, FRS 102.13.9].

3.3.1.F Deferred payment

The cost of an item of PP&E is its cash price equivalent at the recognition date. This means that if payment is made in some other manner, the cost to be capitalised is the normal cash price. If the payment terms are extended beyond 'normal' credit terms, the cost to be recognised must be the present value of all future payments. [FRS 102.17.13]. Accordingly, any difference between the present value and the total payments must be treated as an interest expense over the period of credit, unless such interest is capitalised in accordance with Section 25 (see 3.3.1.B above). Right-of-use assets are discussed in Chapter 23.

3.3.1.G Land and buildings to be redeveloped

It is common for property developers to acquire land with an existing building where the planned redevelopment necessitates the demolition of that building and its replacement with a new building that is to be held to earn rentals or will be owner-occupied. As discussed in 3.2.2.B above, Section 17 requires that the land and the building elements of property are treated as separate assets and accounted for separately, even when they are acquired together. [FRS 102.17.8].

How we see it

In our view, if the existing building is unusable or likely to be demolished by any party acquiring it, it is appropriate for the entire, or a large part of, the purchase price be allocated to land. Similarly, subsequent demolition costs should be treated as being attributable to the cost of the land.

Owner-occupiers may also replace existing buildings which are in use within their business with new facilities for their own use or to rent to others.

How we see it

Here the consequences are different and the carrying amount of the existing building cannot be rolled into the costs of the new development. The existing building must be depreciated over its remaining useful life to reduce the carrying amount of the asset to its residual value (presumably nil) at the point at which it is demolished.

Consideration must be given as to whether the asset is impaired in accordance with Section 27. Many properties do not directly generate independent cash inflows (i.e., they are part of a cash-generating unit) and reducing the useful life will not necessarily lead to an impairment of the cash-generating unit, although by the time the asset has been designated for demolition it may no longer be part of a cash-generating unit (see Chapter 29).

Developers or owner-occupiers replacing an existing building with a building to be sold in the ordinary course of their business will deal with the land and buildings under Section 13 (see Chapter 16 at 3.1.1.B).

3.3.1.H Transfers of assets from customers

An entity may be entitled to consideration in the form of goods, services or other non-cash consideration (e.g., PP&E), in exchange for transferring goods or services to a customer. Examples include:

- A supplier who receives a contribution to the development costs of specific tooling equipment from another manufacturer to whom the supplier will sell parts, using that specific tooling equipment under a supply agreement.
- Suppliers of utilities who receive items of PP&E from customers that are used to connect them to a network through which they will receive ongoing services (e.g., electricity, gas, water or telephone services). A typical arrangement is one in which a builder or individual householder must pay for power cables, pipes, or other connections.
- In outsourcing arrangements, the existing assets are often contributed to the service provider, or the customer must pay for assets, or both.

Section 17 has no specific guidance on transfers of assets from customers other than for circumstances when the transfer involves an exchange of assets - see 3.3.4 below. However, relevant principles exist in other sections of FRS 102.

When an entity (i.e., the seller or vendor) receives, or expects to receive, non-cash consideration from a customer in relation to a revenue contract that is within the scope of Section 23 *Revenue from Contracts with Customers*, the fair value of the non-cash consideration is included in the transaction price.

[FRS 102.23.61]. The Section 23 requirements regarding non-cash consideration are discussed in Chapter 25.

FRS 102 does not then address the initial measurement of any asset arising from the non-cash consideration, however the Basis for Conclusions on IFRS 15 (the IFRS accounting standard on which Section 23 is based) states that "once recognised, any asset arising from the non-cash consideration would be measured and accounted for in accordance with other relevant requirements ..." (e.g., IAS 16).

[IFRS 15.BC253]. As such, for an IFRS reporter, the fair value measured in accordance with IFRS 15 would be the deemed cost of the item of PP&E on initial recognition. Applying similar principles, under FRS 102, the fair value measured in accordance with Section 23 would be the deemed cost of the item of PP&E on initial recognition under Section 17.

Outside of transactions in the scope of Section 23, transfers that are government grants are within the scope of Section 24 *Government Grants* (discussed in Chapter 26). Assets used in a service concession or resources from non-exchange transactions are within the scope of Section 34 (see Chapter 36). Accordingly, an entity applying FRS 102 may use the principles set out in these sections of FRS 102 and at 3.3.4 below i.e., recognition of the asset transferred at fair value. [FRS 102.17.14, FRS 102.24.5].

3.3.1.I Variable consideration

The purchase price of an item of PP&E might include variable or contingent amounts. The final purchase price of an item of PP&E is not known when the terms include a variable or contingent amount that is linked to future events that cannot be determined at the date of acquisition. The total consideration could vary based on the performance of an asset - for example, the revenue or EBITDA generated, for a specified future period, by the asset or a business in which the asset is used. Some arrangements can contain more than one source of variability.

Generally, where the payment of variable or contingent consideration is outside the control of both the buyer and the seller, we expect that the obligation to make the payment(s) would meet the definition of a financial liability, to be accounted for by applying Section 12 *Other Financial Instruments Issues*, and should be recognised when the item of PP&E is purchased. [FRS 102.22.3A]. This means that any measurement changes to that liability would be recorded in the statement of profit or loss. However, in some instances contracts are more complex and it can be argued that the subsequent changes to the initial estimate of the purchase price must be capitalised as part of the cost of the asset, similar to changes in a decommissioning liability (see 3.3.3 below). Further, many consider that these are executory payments that are not recognised until incurred.

How we see it

In the absence of specific guidance, an entity develops an accounting policy for variable consideration relating to the purchase of PP&E in accordance with the hierarchy in Section 10 *Accounting Policies, Estimates and Errors*. An entity must exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in its particular circumstances.

In practice, there are different approaches for treating the estimated future variable payments. Some entities do not capitalise these amounts upon initial recognition of the asset and then either expense or capitalise any payments as they are incurred. Other entities include an estimate of future amounts payable on initial recognition with a corresponding liability being recorded. Under this approach subsequent changes in the liability are either capitalised or expensed.

3.3.1.J Acquisition of a group of assets

The purchase price of an individual item of PP&E may be an allocation of the price paid for a group of assets. Where an item of PP&E is acquired as part of a collection of assets, entities are required to apply judgement to determine whether the transaction is the acquisition of a group of assets or a business combination within the scope of Section 19 *Business Combinations and Goodwill*. [FRS 102.17.3A]. FRS 102 does not provide specific guidance when an entity acquires a group of assets that do not comprise a business. However, it is clear that the entity must identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for intangible assets in Section 18) and liabilities assumed. The cost of the group of assets would be allocated to the individual identifiable assets and liabilities on a reasonable and consistent basis. For example, the principles in Section 19 could be applied to allocate the entire cost to individual items (see Chapter 22), except for the fact that, in this case, such allocation does not give rise to goodwill.

3.3.1.K Dismantling and restoration costs

Section 17 requires the initial estimate of the costs, recognised and measured in accordance with Section 21, of dismantling and removing an item of PP&E and restoring the site on which it is located to be included as part of the item's cost. This applies whether the obligation is incurred when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

3.3.1.L Cost of property, plant and equipment acquired in a business combination

When PP&E is acquired as part of a business combination, those items are initially measured at their acquisition-date fair values. This acquisition date fair value forms the cost of the asset for the purposes of subsequent measurement. The accounting for business combinations under Section 19 is discussed in Chapter 22.

3.3.2 Incidental and non-incidental income

The cost of an item of PP&E includes any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

[FRS 102.17.10(b)]. However, during the construction of an asset, an entity may enter into incidental operations that are not, in themselves, necessary to meet this objective.

Using a building site as a car park prior to starting construction is an example of an incidental operation. Income and expenses related to incidental operations are recognised in profit or loss because incidental operations during construction or development of PP&E are not necessary to bring an item to the location and operating condition intended by management. [FRS 102.17.12]. These income and expenses would be included in their respective classifications of income and expense in profit and loss and not included in determining the cost of the asset.

However, in some cases, income is generated wholly and necessarily as a result of the process of bringing the asset into the location and condition for its intended use, for example from the sale of samples produced when testing the equipment concerned to determine whether the asset is functioning properly. It has historically been considered reasonable and common practice for FRS 102 reporters to reduce the cost of such testing by the net proceeds from selling any items produced while bringing the asset to that location and condition. This approach was consistent with the requirements for entities applying IAS 16, prior to an amendment made to IAS 16 in May 2020 ("*Property, Plant and Equipment - Proceeds before Intended Use (Amendments to IAS 16)*"), but this is now an area of difference between Section 17 and IAS 16. See 2.6 above for further discussion.

It will be a matter of judgement as to when the asset is in the location and condition intended by management, but capitalisation (including the recording of income as a credit to the cost of the asset) ceases when the asset is fully operational, regardless of whether it is yet achieving its targeted levels of production or profitability.

If the asset is already in the location and condition necessary for it to be capable of being used in the manner intended by management then capitalisation must cease and depreciation must start. In these circumstances all income earned from using the asset must be recognised as revenue in profit or loss and the related costs must include an element of depreciation of the asset.

3.3.2.A Income received during the construction of property

One issue that commonly arises is whether rental and similar income generated by existing tenants in a property development may be capitalised and offset against the cost of developing that property.

The relevant question is whether the leasing arrangements with the existing tenants are a necessary activity to bring the development property to the location and condition necessary for it to be capable of operating in the manner intended by management. The building could be developed even if it was vacant (i.e., there were no existing tenants) and therefore the leasing arrangement is not a necessary activity.

Therefore, rental and similar income from existing tenants is incidental to the development and must not be capitalised. Rather rental and similar income must be recognised in profit or loss in accordance with the requirements of Section 20 together with related expenses.

3.3.2.B Liquidated damages during construction

Income may arise in other ways, for example, liquidated damages received as a result of delays by a contractor constructing an asset.

Normally, purchasing PP&E does not give rise to income. Therefore, in the absence of specific reference to compensating for losses in a liquidated damage clause, the liquidated damages received are treated as a reduction in the cost of the related assets.

The rationale for this approach is consistent with the conclusion that, rather than damages for delay, the contract provides for an additional payment in the event of early completion. For example, a contract having a value of £1,000 in which the supplier incurs a £100 penalty for late delivery after 1 January 20X0 is in substance the same as a contract with a value of £900 in which the supplier is entitled to an additional payment of £100 for an early completion before 1 January 20X0. Therefore, the cost of the asset is the total price paid to acquire it, including the premium for early completion (i.e., £1,000 if finished before 1 January 20X0 and £900 if finished after 1 January 20X0). This gives the same result as with liquidated damages.

However, when the liquidated damages clause in a contract refers to compensating the affected party for any revenue lost or reimbursement of specific costs incurred because of delay in the completion of the project, then recognising as income or deducting against specifically reimbursed costs is more consistent with the purpose of the liquidated damages clause.

How we see it

Normally, such damages received must be set off against the asset cost - the purchase price of the asset is reduced to compensate for delays in delivery. However, if the agreement specifically provides liquidated damages to compensate for loss of revenue arising because of contract delays, and the basis is clearly related to income lost, then the damages received are recognised as income.

3.3.3 Accounting for changes in decommissioning and restoration costs

Section 17 requires the initial estimate of the costs of dismantling and removing an item of PP&E and restoring the site on which it is located to be included as part of the item's cost. This applies whether the obligation is incurred when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period (see 3.3.1.K above). [FRS 102.17.10(c)]. However, Section 17 does not address the extent to which an item's carrying amount must be affected by changes in the estimated amount of dismantling and site restoration costs that occur after the estimate made upon initial measurement. Accordingly, an entity may consider the approach applied by IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* (see Chapter 24 at 3.11.1). IFRIC 1 applies to any decommissioning, restoration or similar liability that has been both included as part of the cost of an asset measured in accordance with IAS 16 (or Section 17) and recognised as a liability in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (or Section 21). [IFRIC 1.2]. It deals with the impact of events that change the measurement of an existing decommissioning, restoration or similar liability. Events include a change in the estimated cash flows, a change in the discount rate and the unwinding of the discount. [IFRIC 1.3].

Detailed discussion and requirements of IFRIC 1 can be found in the most recent version of the EY publication, International GAAP®.

The effects of climate change may have implications for an entity's decommissioning liabilities. If the useful life of an item of PP&E is shorter than previously expected (see 3.5.3 below), this would result in earlier decommissioning and would (assuming a positive discount rate) increase both the decommissioning provision and the decommissioning component of the asset as a result of the discounting effect. In addition, it must be noted that IFRIC 1 creates profit and loss volatility in the case of end-of-life assets which have a carrying amount that is small compared to the potential movements in the decommissioning liability.

3.3.4 Exchanges of assets

An entity might swap an asset it does not require in a particular area, for one it does from another area - the opposite being the case for the counterparty. Such exchanges are common in the telecommunications, media and leisure businesses, particularly after an acquisition, as well as in extractive industries. Governmental competition rules sometimes require such exchanges. The question arises whether such transactions give rise to a gain in circumstances where the carrying value of the outgoing facility is less than the fair value of the incoming one. This can occur when carrying values are less than market values, although it is possible that a transaction with no real commercial substance could be arranged solely to boost apparent profits.

Section 17 requires all acquisitions of PP&E in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value, unless:

(a) The exchange transaction lacks commercial substance.

Or

(b) The fair value of neither the asset received nor the asset given up is reliably measurable.

In that case, the asset's cost is measured at the carrying amount of the asset given up. [FRS 102.17.14].

The recognition of income from an exchange of assets does not depend on whether the assets exchanged are dissimilar. If fair value cannot be reliably measured for either asset, then the exchange is measured at the carrying value of the asset the entity no longer owns. For example, if the new asset's fair value is higher than the carrying amount of the old asset, a gain may be recognised.

This requirement is qualified by a 'commercial substance' test (see 3.3.4.A below). If it is not possible to demonstrate that the transaction has commercial substance, assets received in exchange transactions will be recorded at the carrying value of the asset given up. [FRS 102.17.14]. Accordingly, there is no gain on such a transaction.

If the transaction passes the 'commercial substance' test, then the exchanged asset is to be recorded at its fair value as shown in Illustration 3-5 below:

Illustration 3-5: Exchange of assets

An entity has land and office buildings with an aggregate carrying value of £600,000 and a fair value of £750,000. It exchanges the land and buildings for land and buildings (a manufacturing facility) in another location with a fair value of £1 million and makes an additional cash payment of £250,000. The transaction has commercial substance.

The entity must recognise the land and buildings received at a cost of £1 million (its fair value) and must recognise a profit on disposal of the land and buildings of £150,000, calculated as shown below:

Fair value of asset received	1,000,000
Less:	
Carrying value of asset given up	(600,000)
Cash paid	(250,000)
Gain on disposal	150,000

As discussed in 3.7 below, Section 17 requires gains or losses on items that have been derecognised to be included in profit or loss in the period of derecognition but does not allow gains on derecognition to be classified as revenue (except for certain assets previously held for rental - see 3.7.1 below). [FRS 102.17.28]. However, where a gain arises on the exchange of one item of PP&E for another, under current UK law, this gain is likely to be an unrealised profit if the asset received is still held by the entity at the balance sheet date. It must therefore be included in other comprehensive income (OCI) since only profits realised at the balance sheet date are to be included in the profit and loss account. [1 Sch 13(a)]. For further guidance on the distributable reserves implications of asset swaps, see the ICAEW's guidance on realised and distributable profits under the Companies Act 2006, TECH 02/17BL, paragraphs 10.44-10.51. For consolidated financial statements, the gain is also recognised in OCI if the new asset acquired is an interest in another entity (see Chapter 8). [FRS 102.9.31(c)].

3.3.4.A Commercial substance

Section 17 does not provide further guidance on 'commercial substance' and therefore the application of this term will involve judgement and careful consideration of facts and circumstances. In addition, an entity may also consider the guidance provided under IFRS - the commercial substance test was put in place as an anti-abuse provision to prevent gains in income being recognised when the transaction had no discernible effect on the entity's economics. [IAS 16.BC21]. Under IAS 16 the commercial substance of an exchange is to be determined by forecasting and comparing the future cash flows budgeted to be generated by the incoming and outgoing assets. For there to be commercial substance, there must be a significant difference between the two forecasts. IAS 16 sets out this requirement as follows:

"An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

- (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
- (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and
- (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged." [IAS 16.25].

As set out in the definitions of IAS 16, entity-specific value is the net present value of the future predicted cash flows from continuing use and disposal of the asset. Post-tax cash flows must be used for this calculation. IAS 16 contains no guidance on the discount rate to be used for this exercise, nor on any of the other parameters involved, but it does suggest that the result of these analyses might be clear without having to perform detailed calculations. [IAS 16.25].

Particular care will have to be taken to ensure that the transaction has commercial substance if an entity receives a similar item of PP&E in exchange for a similar asset of its own. Commercial substance may be difficult to demonstrate if the entity is exchanging an asset for a similar one in a similar location. In many cases, the risk, timing and amount of cash flows associated with similar assets in similar locations would not be significantly different. Similarly, it would be unusual if the entity-specific values of similar assets differed enough in any arm's length exchange transaction to meet condition (c). However, the risk, timing and amount of cash flows could differ if one asset was available for sale and the entity intended to sell it whereas the previous asset could not be realised by sale or only sold over a much longer timescale. It is feasible that such a transaction could meet the conditions (a) and (c) above.

Other types of exchange are more likely to pass the 'commercial substance' test, for example exchanging an interest in an investment property for one that the entity uses for its own purposes. The entity has exchanged a rental stream and instead has an asset that contributes to the cash flows of the cash-generating unit of which it is a part. In this case it is probable that the risk, timing and amount of the cash flows of the asset received would differ from the configuration of the cash flows of the asset transferred.

3.3.4.B Reliably measurable

In the context of asset exchanges, Section 17 does not contain guidance on the reliable determination of fair values. However, once again, entities may consider guidance provided under IFRS which states:

"The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value." [IAS 16.26].

This is similar to requirements set out in Section 2A *Fair Value Measurement*:

Extract from Section 2A

- 2A.21** A fair value selected from within a range of reasonable valuations is a reliable measure of the fair value if:
- (a) the range of reasonable fair value measures is not significant; or
 - (b) the probabilities of the various measures within the range can be reasonably assessed and used to select the most appropriate fair value.

The 'reliable measurement' test for using fair value serves to minimise the risk that entities could 'manufacture' gains by attributing inflated values to the assets exchanged.

If the fair value of neither the asset given up nor the asset received can be measured reliably (i.e., neither (a) nor (b) above are met), the cost of the asset is measured at the carrying amount of the asset given up; this means there is no gain on the transaction. [FRS 102.17.14].

3.3.5 Assets held under leases

Section 20 requires lessees to initially measure the right-of-use asset at cost, which comprises the amount of the initial measurement of the lease liability, any lease payments made at or before the commencement date, lease incentives received, initial direct costs and an estimate of restoration, removal and dismantling costs. The requirements of Section 20 are discussed in detail in Chapter 23.

3.4 Subsequent measurement: accounting policy choice

Section 17 allows one of two alternatives to be chosen as the accounting policy for measurement of PP&E after initial recognition. The choice made must be applied to an entire class of PP&E, which means that not all classes are required to have the same policy. [FRS 102.17.15].

The first alternative is the cost model whereby the item is carried at cost less any accumulated depreciation and less any accumulated impairment losses. [FRS 102.17.15A]. The other alternative is the revaluation model, whereby PP&E is initially recognised at cost and subsequently measured at fair value less subsequent accumulated depreciation and impairment losses. [FRS 102.17.15B].

Whichever model is used after initial recognition, the provisions discussed in 3.5 below are applicable.

3.5 Subsequent measurement: depreciation

Section 17 requires the depreciable amount of an asset to be allocated on a systematic basis over its useful life. [FRS 102.17.18]. This systematic allocation of the depreciable amount of an asset over its life is referred to as 'depreciation'. [FRS 102 Appendix I]. The key concepts of 'depreciable amount' and 'useful life' are discussed at 3.5.2 and 3.5.3 respectively.

Depreciation must be charged on all items of PP&E. This requirement applies even to PP&E measured under the revaluation model. This is the case even if the fair value of the asset at the year-end is higher than the carrying amount, as long as the residual value of the item is lower than the carrying amount. If the residual value exceeds the carrying amount, no depreciation is charged until the residual value once again decreases to less than the carrying amount. Repair and maintenance of an asset does not negate the need to depreciate it.

The depreciation charge for each period is recognised in profit or loss unless it forms part of the cost of another asset. For example, the depreciation of manufacturing PP&E is included in the costs of inventories (see Chapter 16). [FRS 102.17.17]. Similarly, depreciation of PP&E used for development activities may be included in the cost of an intangible asset recognised in accordance with Section 18 (see Chapter 21 at 3.2.3.C).

3.5.1 Depreciation by component of an item of PP&E

Section 17 links its recognition concept of a component of an asset, discussed at 3.2.2 above, with the analysis of assets for the purpose of depreciation. Each major component of an item of PP&E with significantly different patterns of consumption of economic benefits must be depreciated separately over its useful life, which means that the initial cost must be allocated between the major components by the entity. Other assets are depreciated over their useful lives as a single asset. [FRS 102.17.16]. Components are identified by their patterns of consumption of economic benefits, and they may have the same useful lives and depreciation method. Practically, they could be grouped for the purposes of calculating depreciation charge.

Section 17 does not provide guidance for depreciating the remainder of an asset that has not separately been identified into components. These may consist of other components that are individually not significant. An entity may consider the approach in IAS 16 and thus, the entity may use estimation techniques to calculate an appropriate depreciation method for all of these parts. [IAS 16.46]. An entity may also depreciate separately components that are not significant in relation to the whole.

3.5.2 Depreciable amount and residual values

The depreciable amount of an item of PP&E is its cost or valuation less its estimated residual value. The residual value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. [FRS 102 Appendix I].

Factors such as a change in how an asset is used, significant unexpected wear and tear, technological advancement, and changes in market prices may indicate that the residual value or useful life of an asset has changed since the most recent annual reporting date. Entities must assess if such indicators exist. If such indicators are present, an entity must review its previous estimates and, if current expectations differ, amend the residual value, depreciation method or useful life. The entity must account for the change in residual value, depreciation method or useful life as a change in an accounting estimate in accordance with paragraphs 14D to 18 of Section 10 (see Chapter 9). [FRS 102.17.19]. This requirement applies to all items of PP&E and therefore is applicable to all components of them.

The residual value of an item of PP&E today is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and condition it will be in at the end of its useful life. Therefore, Section 17 contains an element of continuous updating of residual values because it is the current disposal amount (e.g., value at financial reporting date) of an asset's future state (i.e., asset's condition in the future when the entity expects to dispose of it). This means that price changes (e.g., due to inflation) would only be taken into account up to the reporting date and that future changes in residual value other than the effects of expected wear and tear are not taken into account.

Climate change has the potential to affect the residual value of PP&E and such considerations should, form a part of an entity's continuous assessment of residual values. For example, while residual values of PP&E assets are generally fairly predictable, this is not necessarily the case if there are relatively few buyers of second-hand PP&E assets that use technologies that are being phased out before a legal deadline.

As any change in the residual value directly affects the depreciable amount, it may also affect the depreciation charge. This is because the depreciable amount (i.e., the amount actually charged to profit or loss over the life of the asset) is calculated by deducting the residual value from the cost (or other amount substituted for cost, such as valuation) of the asset. In periods of rising prices, the residual value for assets may appreciate in value. If it does, the residual value is capped at the asset's carrying amount. Where residual value rises over time the depreciation charge on an asset is likely to decline and may cease altogether when the residual value exceeds the asset's carrying value.

Many items of PP&E have a negligible residual value. This is usually because they are kept for substantially all of their economic lives, such that the useful life as assessed under Section 17 is consistent with the assets' total economic life. Residual values are of no relevance if the entity intends to keep the asset until it is of no use to anyone else. If an entity uses residual values based on prices obtained in the market for a type of asset that it holds, it must also demonstrate an intention to dispose of that asset before the end of its economic life.

The requirement concerning the residual values of assets highlights how important it is that residual values are considered and reviewed in conjunction with the review of useful lives. The useful life is the period over which the entity expects to use the asset, not the asset's economic life.

As discussed above, the residual value of an item of PP&E is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal. Section 17 does not define 'costs of disposal'. The term also is not defined under IAS 16. For many entities the estimated cost of disposal will be immaterial, but an entity that incurs more significant costs associated with disposing PP&E will need to apply judgement in determining the appropriate costs to include. Entities may apply the hierarchy in Section 10 to develop an appropriate policy in this area. This may be particularly relevant to certain types of entity, such as leasing companies that incur significant selling costs in routinely disposing of assets previously held for rental.

3.5.3 Useful lives

One of the critical assumptions on which the depreciation charge depends is the useful life of the asset. Useful life is defined as either:

- The period over which an asset is expected to be available for use by an entity.
 - Or
 - The number of production or similar units expected to be obtained from the asset by an entity.
- [FRS 102 Appendix I].

As discussed at 3.5.2 above, the asset's useful life must be estimated on a realistic basis and reviewed at the end of each reporting period for indicators that would suggest it has changed. The effects of changes in useful life are recognised prospectively, over the remaining useful life of the asset. [FRS 102.17.19].

The useful life is the period over which the present owner will benefit and not the total potential life of the asset; the two will often not be the same.

It is quite possible for an asset's useful life to be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets. Many entities have an asset management policy of disposing of assets when they still have a residual value, which means that another user can benefit from the asset. This is particularly common with property and motor vehicles, where there are effective second-hand markets, but less usual for plant and machinery. For example, an entity may have a policy of replacing all its motor vehicles after three years, so this will be their estimated useful life for depreciation purposes. The entity will depreciate them over this period down to the estimated residual value. The residual values of motor vehicles are often easy to obtain and the entity will be able to reassess these residuals in line with the requirements of the standard.

Judgement is necessary in determining the useful life of an asset. The future economic benefits embodied in an asset are consumed principally through usage. However, other factors must be taken into account, such as technical or commercial obsolescence and wear and tear while an asset remains idle, because they often result in the diminution of the economic benefits expected to be obtained from the asset by the entity. Consequently, Section 17 provides the following guidance about the factors to be considered when determining the useful life of an asset:

- (a) The expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
- (b) Expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle (see 3.5.3.A below).
- (c) Technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset (see 3.5.3.C below).
- (d) Legal or similar limits on the use of the asset, such as the expiry dates of related leases. [FRS 102.17.21].

3.5.3.A Repairs and maintenance

The initial assessment of the useful life of the asset will take into account the expected routine spending on repairs and expenditure necessary for it to achieve that life. [FRS 102.17.21(b)]. Although Section 17 implies that this refers to an item of plant and machinery, care and maintenance programmes are relevant to assessing the useful lives of many other types of asset. For example, an entity may assess the useful life of a railway engine at thirty-five years on the assumption that it has a major overhaul every seven years. Without this expenditure, the life of the engine would be much less certain and could be much shorter. Maintenance necessary to support the fabric of a building and its service potential is also taken into account in assessing its useful life. Eventually, it will always become uneconomic for the entity to continue to maintain the asset so, while the expenditure may lengthen the useful life, it is unlikely to make it indefinite. Note that this applies whether the expenditure is capitalised because it is regarded as a 'major inspection' accounted for in accordance with the requirements in paragraph 7 of Section 17 (see 3.2.3.B above) or if it is repairs and maintenance that is expensed as incurred.

3.5.3.B Land

As discussed in 3.2.2.B above, land and buildings are separable assets and must be accounted for separately, even when they are acquired together. [FRS 102.17.8]. Land, which generally has an unlimited life, is not usually depreciated. [FRS 102.17.16]. A building is a depreciable asset and its useful life is not affected by an increase in the value of the land on which it stands.

Although land generally has an unlimited useful life, there may be circumstances in which depreciation could be applied to land. In those instances, in which land has a finite life (e.g., land that is used either for extractive purposes such as a quarry or mine, or for some purpose such as landfill), it will be depreciated in an appropriate manner that reflects the benefits to be derived from it by the entity. Further, the cost of such land may include an element for site dismantlement or restoration, e.g., the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, and any subsequent changes thereto (see 3.3.3 above). Any such element will have to be separated from the land element and depreciated over an appropriate period (i.e., the period of benefits obtained by incurring these costs), which will often be the estimated useful life of the site for its purpose and function. An entity engaged in landfill on a new site may make a provision for restoring it as soon as it starts preparation by removing the overburden. It will separate the land from the 'restoration asset' and depreciate the restoration asset over the landfill site's estimated useful life. If the land has an infinite useful life, an appropriate depreciation basis must be chosen that reflects the period of benefits obtained from the restoration asset.

While FRS 102 provides no specific guidance related to revision of estimated dismantling costs, an entity may consider the approach applied by IFRIC 1 (see 3.3.3 above and Chapter 24 at 3.11.1). Accordingly, if the estimated costs are revised, in accordance with IFRIC 1, the adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability will be recognised in profit or loss as they occur, irrespective of whether the entity applies the cost or revaluation model. [IFRIC 1.7].

3.5.3.C Technological change

A current or expected future reduction in the market demand for the product or service output of an asset may be evidence of technical or commercial obsolescence. Expected future reductions in the selling price of an item that was produced using an asset could also indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset. If an entity anticipates technical or commercial obsolescence, it must reassess the residual value of an asset, its useful life or the pattern of consumption of future economic benefits.

[FRS 102.17.19]. In such cases, it might be more appropriate to use a diminishing balance method of depreciation to reflect the pattern of consumption (see 3.5.5.B below).

The effects of technological change are often underestimated. It affects many assets, not only high technology plant and equipment such as computer systems. For example, many offices that have been purpose-built can become obsolete long before their fabric has physically deteriorated, for reasons such as the difficulty of introducing computer network infrastructures or air conditioning, poor environmental performance or an inability to meet new legislative requirements such as access for people with disabilities. Another example might be climate-related factors driving technological change. Therefore, the estimation of an asset's useful life is a matter of judgement and the possibility of technological change must be taken into account.

3.5.3.D Depreciation period of leasehold improvements

As explained at 3.5.3 above, Section 17 sets out factors an entity must consider in determining the useful life of an asset. Factor (d) states that the 'expiry dates of related leases' is considered when determining the asset's useful life. [FRS 102.17.21]. Generally, the useful life of the leasehold improvement is the same or less than the lease term, as defined by Section 20 (see Chapter 23).

The interaction between the useful life of leasehold improvements and the term of the associated lease is not further addressed in FRS 102, but was discussed by the IFRS Interpretations Committee ('IFRS IC') in November 2019¹⁰¹. Similar principles to those discussed by the IFRS IC are expected to apply to FRS 102 reporters as paragraph 21 of Section 17 sets out similar factors to those referred to in paragraph 56 of IAS 16 and the term 'useful life' is defined in the same way in FRS 102 as it is in IAS 16.

In applying the definition of 'useful life', the useful life is based on the utility of an asset to the entity, and therefore, an asset's useful life under Section 17 may be shorter than its economic life. If the lease term of the related lease is shorter than the economic life of the associated leasehold improvements, in order to determine the useful life of the leasehold improvements, the entity needs to consider whether it expects to use the leasehold improvements beyond that lease term - that is, whether the leasehold improvements will continue to have utility to the entity beyond the end of the lease term. This may be because the leasehold improvements are removable and will have an alternative use by the entity after the lease is terminated or because the entity expects (but is not reasonably certain to) extend the lease beyond the lease term. If the leasehold improvements are not expected to be used beyond the lease term, then applying the definition of useful life in FRS 102 we would expect an entity to conclude that the useful life of the leasehold improvements is the same as the lease term.

However, if the leasehold improvements are expected to be used beyond the lease term, we believe two approaches to determine the useful life of the leasehold improvements are acceptable.

How we see it

The relevant requirements in respect of useful life and its interaction with lease term may be subject to two different interpretations. Hence, when leasehold improvements are expected to be used beyond the lease term, it is acceptable to depreciate the leasehold improvements either over (i) the shorter lease term or (ii) their expected useful life.

The two approaches are shown in Illustration 3-6 below. The entity must adopt one of the approaches to determine the useful life of the leasehold improvement. This approach must be applied consistently to similar leasehold improvements with similar fact patterns.

101 [IFRIC Update](#), November 2019, available on the IFRS Foundation's website.

Illustration 3-6: Depreciation period of leasehold improvements

A lessee enters into a lease for an office property. The lease has a non-cancellable term of 5 years and contains an option for the lessee to extend the lease for a further 5 years. The rentals for the period under the extension option (i.e., years 6-10) are at market rates.

Upon commencement of the lease term, the lessee incurs £100,000 constructing immoveable leasehold improvements specific to the property. The useful life of the leasehold improvement is 7 years. At the commencement date of the lease, the lessee expects, but is not reasonably certain, to exercise the extension option. At the commencement date of the lease, the lessee appropriately considered the potential economic penalty associated with abandoning the leasehold improvements when determining the lease term is 5 years.

In our fact pattern, the lessee's investment in the leasehold improvement does not create a significant economic penalty that would affect the lease term for accounting purposes. That is, the economic penalty of abandoning the leasehold improvement at the end of the non-cancellable term of the lease is not so significant as to make exercise of the renewal option reasonably certain.

The relevant requirements may be subject to two different interpretations:

Approach (1):

The lessee may depreciate the leasehold improvements over a period that is the shorter of the lease term or the assets' useful life (i.e., the lessee depreciates the leasehold improvement over the lease term of 5 years in the fact pattern).

This approach is based on the following interpretation: In this fact pattern, at the commencement date of the lease, the lessee appropriately considered all relevant facts and circumstances (including the economic penalty associated with abandoning the leasehold improvements) and concluded it expects but is not reasonably certain to exercise the option to extend the lease. Therefore, for the purpose of Section 20 of FRS 102, the lease term is 5 years. [FRS 102 Appendix I]. One of the factors in determining the useful life of the leasehold improvement is the expiry date of the related lease. [FRS 102 Appendix I, FRS 102.17.21(d)]. The expected utility of the leasehold improvement must be consistent with the lease term as determined in accordance with Section 20. Therefore, the useful life of the leasehold improvements is 5 years.

Approach (2):

The lessee may depreciate the leasehold improvements over the expected useful life of the leasehold improvement (i.e., the lessee depreciates the leasehold improvement over 7 years in the fact pattern).

While paragraph 21(d) of Section 17 must be considered when determining the asset's useful life, the factor regarding "expected usage of the asset ..." in paragraph 21(a) of Section 17 is equally relevant. The condition contained in paragraph 21(d) reflects the necessity to consider the existence of legal or other externally imposed limitations on an asset's useful life. However, in the fact pattern, the ability to extend the lease term is within the control of the lessee and is at market rates so there are no significant costs or impediments to renewal.

In this fact pattern, after considering the potential economic penalty associated with the loss of the leasehold improvements, the lease term as determined in accordance with Section 20 does not include the extension period because, at the commencement date of the lease, the lessee determined it is not reasonably certain it will exercise the renewal option. However, a different threshold (i.e., the expected usage of the asset) is used for the determination of the useful life of an asset in the scope of Section 20 (i.e., the leasehold improvement).

The term 'expected usage of the asset' for the determination of useful life of an asset indicates a lower threshold than the 'reasonably certain' threshold for including the extension period in the lease term for accounting purposes. As a result, although the accounting lease term is 5 years, the leasehold improvement is depreciated over the period over which the lessee expects to use the asset (as it expects to extend the lease to 10 years), which is 7 years.

The determination of the useful life and lease term may require significant judgement. Hence, it is important to ensure that all facts and circumstances are taken into account when determining the useful life of the leasehold improvement and the lease term based on the relevant guidance under Section 17 and Section 20 respectively and each conclusion needs to be supported with appropriate evidence.

For instance, if approach (2) is adopted in Illustration 3-6 above, the entity would have to carefully evaluate the reason to construct leasehold improvements with significant expected economic value at the end of 5 years, and yet conclude that the economic penalty associated with abandoning such assets at the end of year 5 is not so significant that it renders the renewal option reasonably certain of exercise.

In an example where the leasehold improvements are non-removable, the useful life of the leasehold improvement generally would not exceed the total of the non-cancellable period and the period covered by renewal option(s) (i.e., 10 years in the fact pattern).

3.5.3.E The effects of climate change

Climate change, including associated legislation, may affect how and for how long items of PP&E are used. Entities will need to consider climate-related factors when determining the expected useful life of their assets. An entity would need to assess whether it expects, for example, the early closure of fossil-fuel producing assets (e.g., coal producing assets) or continued use of carbon-emitting assets (e.g., high emission ships). Similarly, an entity would need to consider if its PP&E assets could be indirectly affected if, for example, it is used to provide services to customers in high emission industries.

3.5.4 When depreciation starts and ceases

Section 17 is clear on when depreciation must start and finish, and sets out the requirements as follows:

- Depreciation of an item of PP&E begins when it is available for use, which is defined as occurring when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management. This is the point at which capitalisation of costs relating to the asset ceases. In contrast, depreciation of a right-of-use asset begins from the commencement date of the lease. [FRS 102.20.58].
- Depreciation of an asset ceases when the asset is derecognised. [FRS 102.17.20].

Therefore, an entity does not stop depreciating an asset merely because it has become idle or has been retired from active use, unless the asset is fully depreciated. However, if the entity is using a usage method of depreciation (e.g., the units of production method) the depreciation charge can be zero while there is no production. [FRS 102.17.20]. Of course, a prolonged period in which there is no production may raise questions as to whether the asset is impaired: an asset becoming idle is a specific example of an indication of impairment in Section 27 (see Chapter 29). [FRS 102.17.26, FRS 102.27.9(f)].

3.5.5 Depreciation methods

There are a variety of depreciation methods that can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life, and Section 17 does not prescribe a particular method. It simply states that “an entity must select the depreciation method that reflects the pattern in which it expects to consume the asset’s future economic benefits”, mentioning straight-line, diminishing balance and units of production methods as possibilities. [FRS 102.17.22]. The overriding requirement is that the depreciation charge reflects the pattern of consumption of the benefits the asset brings over its useful life, and is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits. [FRS 102.17.22, FRS 102.17.23].

The essence of choosing a fair depreciation method is to reflect the consumption of economic benefits provided by the asset concerned. In most cases the straight-line basis will give perfectly acceptable results, and the majority of entities use this method. There are instances, such as the extraction of a known proportion of a mineral resource, or the use of a certain amount of the total available number of working hours of a machine, where it may be that a unit of production method will give fairer results. When assessing the appropriateness of any method, entities must consider how the economic benefits of a particular asset are consumed, for example, through wear and tear, output produced or other factors such as technological obsolescence.

Section 17 contains an explicit requirement that the depreciation method be reviewed if there is an indication that there has been a significant change since the last annual reporting date in the pattern by which an entity expects to consume an asset’s future economic benefits. [FRS 102.17.23]. This could mean, for example, concluding that the straight-line method was no longer appropriate and changing to a diminishing balance method. If there has been such a change, the depreciation method must be changed to reflect it. Under paragraphs 14D to 18 of Section 10 (see Chapter 9), this change is a change in accounting estimate and not a change in accounting policy. [FRS 102.17.23]. This means that the consequent depreciation adjustment must be made prospectively, i.e., the asset’s depreciable amount must be written off over current and future periods. [FRS 102.10.16].

Some industries use revenue as a practical basis to depreciate PP&E. These industries argue that there is a linear relationship between revenue and the units of production method (discussed below at 3.5.5.C). Unlike IFRS, FRS 102 does not explicitly prohibit the use of revenue as the basis to depreciate assets. However, it is important to remain mindful that the depreciation method selected must reflect the pattern

in which the entity expects to consume the asset's future economic benefits. Revenue reflects the output of the asset, but may also reflect other factors that do not affect depreciation, such as changes in sales volumes and selling prices, the effects of selling activities and other inputs and processes. Therefore, a revenue-based method of depreciation may not faithfully reflect how the asset is used or consumed.

3.5.5.A Straight-line method

The straight-line method of depreciation is well-known and understood. Its simplicity makes it the most commonly-used method in practice. The method is time-based and involves the use of a fixed percentage of the original cost of the asset in spreading the depreciable amount evenly over the useful life of the asset resulting in a constant depreciation charge over such period. It is considered the most appropriate method to use when the pattern of consumption of future economic benefits of an asset is expected to be constant year-on-year or when such pattern cannot be readily determined. Depreciation on a straight-line basis is explained in Illustration 3-7:

Illustration 3-7: Straight-line depreciation

An asset costs CU12,000 and has a useful life of five years and a residual value of CU1,000. The depreciable amount is CU11,000 (CU12,000 - CU1,000). The annual depreciation charge under the straight-line method is calculated at 2,200 (CU11,000/5).

		CU
Year 1	Cost	12,000
	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	9,800
Year 2	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	7,600
Year 3	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	5,400
Year 4	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	3,200
Year 5	Depreciation at 1/5 of 11,000	(2,200)
	Net book value	1,000

3.5.5.B Diminishing balance method

The diminishing balance method involves determining a percentage depreciation that will write off the asset's depreciable amount over its useful life. This involves calculating a rate that will reduce the asset's carrying amount to its residual value at the end of the useful life. One approach to applying the diminishing balance method is shown in Illustration 3-8:

Illustration 3-8: Diminishing balance depreciation

An asset costs £6,000 and has a life of four years and a residual value of £1,500. It calculates that the appropriate depreciation rate on the declining balance is 29% and that the depreciation charge in years 1-4 will be as follows:

		£
Year 1	Cost	6,000
	Depreciation at 29.3% of £6,000	1,757
	Carrying amount	4,243
Year 2	Depreciation at 29.3% of £4,243	1,243
	Carrying amount	3,000
Year 3	Depreciation at 29.3% of £3,000	879
	Carrying amount	2,121
Year 4	Depreciation at 29.3% of £2,121	621
	Carrying amount	1,500

The sum of digits method is another form of the diminishing balance method, and is a method that can easily be applied if the asset has a residual value. If an asset has an estimated useful life of four years then the digits 1, 2, 3, and 4 are added together, giving a total of 10. Depreciation of four-tenths, three-tenths and so on, of the cost of the asset, less any residual value, will be charged in the respective years. The method is sometimes called the 'rule of 78', 78 being the sum of the digits 1 to 12. Illustration 3-9 demonstrate the application of the sum of digits method:

Illustration 3-9: Sum of the digits depreciation

An asset costs £10,000 and is expected to be sold for £2,000 after four years. The depreciable amount is £8,000 (£10,000 - £2,000). Depreciation is to be provided over four years using the sum of the digits method.

		£
Year 1	Cost	10,000
	Depreciation at 4/10 of £8,000	3,200
	Carrying amount	6,800
Year 2	Depreciation at 3/10 of £8,000	2,400
	Carrying amount	4,400
Year 3	Depreciation at 2/10 of £8,000	1,600
	Carrying amount	2,800
Year 4	Depreciation at 1/10 of £8,000	800
	Carrying amount	2,000

3.5.5.C Units of production method

Under this method, the asset is written off in line with its estimated total output. By relating depreciation to the proportion of productive capacity utilised to date, it reflects the fact that the useful economic life of certain assets, principally machinery, is more closely linked to its usage and output than to time. This method is often used in extractive industries, for example, to amortise the costs of development of productive oil and gas facilities.

3.5.6 Impairment

All items of PP&E accounted for under Section 17 are subject to the impairment requirements of Section 27. That section explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises or reverses an impairment loss. [FRS 102.17.24]. Impairment is discussed in Chapter 29.

FRS 102 does not require items of PP&E that have indefinite lives to be subject to automatic annual impairment testing.

3.5.6.A Compensation for impairment

The question has arisen about the treatment of any compensation an entity may be due to receive as a result of an asset being impaired. For example, an asset that is insured might be destroyed in a fire, so repayment from an insurance company might be expected. These events - the impairment or losses of items of PP&E, the related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets - are separate economic events and must be accounted for separately as follows:

- Impairments of PP&E are recognised in accordance with Section 27 (see Chapter 29).
 - Derecognition of items retired or disposed of must be recognised in accordance with Section 17 (derecognition is discussed at 3.7 below).
- And
- Compensation from third parties for PP&E that is impaired, lost or given up is included in profit and loss only when the compensation is virtually certain. [FRS 102.17.25].

The cost of items of PP&E restored, purchased or constructed as replacements is determined in accordance with Section 17 (see sections 3.2 and 3.3 above)

3.5.6.B PP&E held for sale

An entity's plan to dispose of an asset before the previously expected date is an indicator of impairment that triggers the calculation of the asset's recoverable amount for the purpose of determining whether the asset is impaired. [FRS 102.17.26, FRS 102.27.9(f)]. If the asset is impaired, then the carrying amount of the asset must be written down to its recoverable amount.

Although the entity plans to dispose of the asset, depreciation must continue until the asset is disposed. In addition, the plan to dispose an asset might indicate that the residual value or the remaining life of the asset needs adjustment even if there is no impairment.

PP&E held for sale is an area of difference between FRS 102 and IFRS, as discussed at 2.1 above.

3.6 Measurement after initial recognition: revaluation model

As discussed at section 3.4 above, after initial recognition, an accounting policy choice exists which is available to all entities (by class of asset) to measure PP&E using either the cost model or the revaluation model at the end of subsequent reporting periods. If the revaluation model is adopted, PP&E is initially recognised at cost and subsequently measured at a revalued amount, being its fair value (if it can be measured reliably) at the date of the revaluation, less subsequent accumulated depreciation and impairment losses. [FRS 102.17.15B]. Fair value is determined in accordance with the requirements of Section 2A and is usually the market value of the items of PP&E. [FRS 102.17.15C]. The meaning of fair value is discussed further at section 3.6.1 below.

The use of the revaluation model can result in deferred taxation complexities. Examples in this chapter ignore the effects of deferred tax. See Chapter 31 at 7.2 for guidance on recognition of deferred tax in respect of assets carried at fair value or revalued amount.

In practice, 'fair value' will usually be the market value of the asset. There is no requirement for a professional external valuation or even for a professionally qualified valuer to perform the appraisal, although in practice professional advice is often sought.

Section 17 does not prescribe the frequency of revaluations and simply states that revaluations are to be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at the end of the reporting period. [FRS 102.17.15B]. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. As some items of PP&E have frequent and volatile changes in fair value, these would need to be revalued more frequently (e.g., annually).

If the revaluation model is adopted, all items within a class of assets are to be revalued simultaneously. This prevents selective revaluations particularly choosing to revalue only those assets that have significantly increased in value. A class of PP&E is a grouping of assets of a similar nature, function or use in an entity's business. [FRS 102.17.15]. This is not a precise definition. The following could be examples of separate classes of asset:

- Land
- Land and buildings
- Machinery
- Ship
- Aircraft
- Motor vehicles
- Furniture and fixtures
- And
- Office equipment

These are very broad categories of asset and it is possible for them to be classified further into groupings of assets of a similar nature and use. For example, office buildings and factories or hotels and fitness centres, could be separate classes of asset.

If the entity used the same type of asset in two different geographical locations, e.g., clothing manufacturing facilities for similar products or products with similar markets, say in the United Kingdom and the Republic of Ireland, it is likely that these would be seen as part of the same class of asset. However, if the entity manufactured pharmaceuticals and clothing, both in European facilities, then few would argue that these could be assets with a sufficiently different nature and use to be a separate class. Ultimately, it must be a matter of judgement in the context of the specific operations of individual entities.

How we see it

In our view, a rolling valuation of a class of assets could be made provided that the class is revalued over a short period of time and the valuations are kept up to date. This approach is explicitly permitted under IAS 16. [IAS 16.38]. In practice, a rolling valuation is usually performed if the value of the assets changes very insignificantly (in which case the valuations may only be performed less frequently) because if a significant change is revealed then a new revaluation for the entire class is required to keep the valuation up to date.

3.6.1 The meaning of fair value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of FRS 102, the guidance in Section 2A must be used in determining fair value (see Chapter 10). [FRS 102 Appendix I]. Section 2A does not prescribe when to measure fair value but provides guidance on how to measure it when fair value is required or permitted by FRS 102.

Section 17 describes the process of determining fair value for assets within its scope. For land and buildings, fair value is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers (although income or depreciated replacement cost approaches are permitted if no such evidence is available because of the specialised nature of the item of PP&E - see 3.6.2 below). For other items of PP&E, the fair value is usually their market value determined by appraisal. [FRS 102.17.15C, FRS 102.17.15D]. Section 17 does not imply that fair value and market value are synonymous, although it states that the fair value of items of PP&E is usually their market value determined by appraisal. [FRS 102.17.15C].

Section 2A specifies that “fair value is a market-based measurement, not an entity-specific measurement ...”. [FRS 102.2A.3]. The following sections consider some of the key considerations when measuring the fair value of an item of PP&E under Section 2A, including the concept of highest and best use and the focus of the methodology on the inputs used in valuation techniques.

3.6.1.A Highest and best use

Extract from Section 2A

2A.9 A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

This evaluation will include uses that are “physically possible, legally permissible and financially feasible”. [FRS 102.2A.10].

The highest and best use is determined from the perspective of market participants that would be acquiring the asset, but the starting point is the asset's current use. It is presumed that an entity's current use of the asset is the asset's highest and best use, unless market or other factors suggest that a different use of the asset by market participants would maximise its value. [FRS 102.2A.11].

As discussed above, Section 17 itself does not imply that fair value and market value are synonymous, and prior to the introduction of Section 2A (which was introduced as part of the 2024 Periodic Review amendments), FRS 102 may have allowed a broader meaning of the term ‘fair value’. The term could have been interpreted as encompassing the following two commonly used, market derived, valuation bases:

- Market value in existing use, an entry value for property in continuing use in the business which is based on the concept of net current replacement cost.
- Or
- Open market value, which is an exit value and based on the amount that a property that is surplus to requirements could reach when sold.

Both of these bases are market-derived, yet they can differ for a variety of reasons. A property may have a higher value on the open market if it could be redeployed to a more valuable use. On the other hand, the present owner may enjoy some benefits that could not be passed on in a sale, such as planning consents that are personal to the present occupier. Market value in existing use will be presumed to be fair value under Section 2A for many types of business property unless market or other factors suggest that open market value is higher (i.e., open market value represents highest and best use). For most retail sites market value in existing use will be fair value. However, if there is market evidence that certain types of

property have an alternative use with a higher value, e.g., pubs or warehouses that can be converted to residential use, this will have to be taken into account. In summary, the introduction of Section 2A makes clear that fair value is an exit price, and for non-financial assets such as PP&E, must take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use.

The fair value of an item of PP&E will either be measured based on the value it would derive on a stand-alone basis or, if the highest and best use of the item is or would be achieved through its use in combination with other assets (and liabilities) as a group, the fair value measurement of the item of PP&E must reflect that use, by assuming that a market participant already holds the complementary assets and the associated liabilities. [FRS 102.2A.12].

The following Illustration is derived from IFRS 13, upon which Section 2A is based, and shows highest and best use in establishing fair value. [IFRS 13.IE7, IFRS 13.IE8].

Illustration 3-10: Highest and best use

An entity acquires land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest evidence for a different use.

Scenario (1):

In the particular jurisdiction, it can be difficult to obtain consents to change use from industrial to residential use for the land and there is no evidence that the area is becoming desirable for residential development. The fair value is based on the current industrial use of the land.

Scenario (2):

Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes that facilitated the residential development, the entity determines that the land currently used as a site for a factory could also be developed as a site for residential use because market participants would take into account the potential to develop the site for residential use when pricing the land.

3.6.1.B Valuation approaches

As discussed at 3.6.1 above, Section 17 states that the fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal. [FRS 102.17.15C].

Section 2A then provides further guidance on determining fair value.

Section 2A does not prescribe the types of valuation techniques an entity might use to measure fair value but instead focuses on the types of inputs that will be used. Section 2A requires the entity to use the valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of inputs determined by reference to a market price in an active market. [FRS 102.2A.15].

The objective is that the best available inputs must be used in valuing the assets. These inputs could be used in any valuation technique provided they are consistent with the three valuation approaches in the standard: the market approach, the cost approach and the income approach. [FRS 102.2A.16]. However, as set out previously, Section 17 itself indicates that where there is market-based evidence of fair value, a market approach would be most common for PP&E.

Extract from Section 2A

2A.16 An entity shall use valuation techniques consistent with one or more of these approaches:

- a) the market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities or a group of assets and liabilities, such as a business.
- b) the cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
- c) the income approach reflects expectations of future performance (eg cash flows or income and expenses). Valuation techniques using the income approach include present value techniques, option pricing models, and the multi-period excess earnings method.

Section 2A does not elaborate further on these three approaches, but IFRS 13 does provide some further guidance which an entity may wish to consider.

For PP&E, market techniques will usually involve market transactions in comparable assets or, for certain assets valued as businesses, market multiples derived from comparable transactions. [IFRS 13.B6]. Income or depreciated replacement cost approaches may be required where there is no market-based evidence of fair value, and are discussed further at 3.6.2 below.

Valuation techniques must be applied consistently. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value. A change in a valuation technique is considered a change in an accounting estimate in accordance with Section 10, although an entity need not provide the disclosures required by paragraph 18. [FRS 102.2A.17].

Section 2A sets out a methodology that entities must apply to estimate fair value, based on the fair value hierarchy established in IFRS 13. Under this methodology:

- a) The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date.
- b) When an unadjusted quoted price is not available, the price of a recent orderly transaction between market participants for an identical or comparable asset or liability provides evidence of fair value, although the standard notes that this may not provide a reliable estimate of fair value if there has been a significant change in economic circumstances or a significant period of time has elapsed since the date of the transaction.
- c) If neither (a) nor (b) above are available or reliable, the fair value must be estimated using another valuation technique. [FRS 102.2A.15].

The valuation techniques, referred to above, will use a combination of inputs to determine the fair value of the asset. Land and buildings are the most commonly revalued items of PP&E. These types of assets use a variety of inputs such as other sales, multiples or discounted cash flows.

3.6.2 Fair value in the absence of market-based evidence

If there is no market-based evidence of fair value because of the specialised nature of the item of PP&E and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost (DRC) approach (see 3.6.1.B above and 3.6.2.A and 3.6.2.B below). [FRS 102.17.15D].

The basis underlying the income or DRC approach is that the asset is so specialised that there is no market value for it. There are three main subsets of such assets: (a) those that are only ever sold as part of a business; (b) assets primarily used to provide services to the public (whether on a paying or non-paying basis); and (c) assets that are so specialised by nature of their size or location or similar features that there is no market for them.

Examples of specialised properties include:

- Oil refineries and chemical works where, usually, the buildings are no more than housings or cladding for highly specialised plant.
 - Power stations and dock installations where the building and site engineering works are related directly to the business of the owner, it being highly unlikely that they would have a value to anyone other than a company acquiring the business.
 - Schools, colleges, universities and research establishments where there is no competing market demand from other organisations using these types of property in the locality.
 - Hospitals, other specialised health care premises and leisure centres where there is no competing market demand from other organisations wishing to use these types of property in the locality.
- And
- Museums, libraries, and other similar premises provided by the public sector.

In addition, there may be no market-based evidence for properties of such specialised construction, arrangement, size or specification that it is unlikely that there would be a single purchaser. The same may be the case even for standard properties in geographical areas remote from main business centres, perhaps originally located there for operational or business reasons that no longer exist. This could occur if the buildings were of such an abnormal size for the district that no market for them would exist.

3.6.2.A Income approach to fair value

The income approach reflects expectations of future performance (e.g., cash flows or income and expenses). [FRS 102.2A.16]. Such techniques convert those future cash flows or income and expenses to a single discounted amount. The fair value reflects current market expectations about those future amounts. In the case of PP&E, this will usually mean using a discounted cash flow technique.

Further discussion of this valuation technique can be found at section 4.11.3 in Chapter 10.

3.6.2.B Depreciated replacement cost

DRC is defined as the most economic cost required for the entity to replace the service potential of an asset (including the amount that the entity will receive from its disposal at the end of its useful life) at the reporting date. [FRS 102 Appendix I]. The objective of DRC is to make a realistic estimate of the current cost of constructing an asset that has the same service potential as the existing asset. DRC approaches are often applied to the valuation of plant and machinery, as distinct from property assets, where there is rarely a market from which to derive a fair value.

Neither Section 17 nor Section 2A provide additional guidance on determining DRC, but we note that Section 2A, consistent with IFRS 13, requires that fair value be determined using the assumptions that market participants would use when pricing the asset or liability. Entities may look to the guidance in IFRS 13, which states that, from a market participants perspective, the price that would be received for the asset is based on the cost to a market participant buyer to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. That is because a market participant buyer would not pay more for an asset than the amount for which it could replace the service capacity of that asset.

To ensure that a valuation on a depreciated replacement cost basis is consistent with the requirements of Section 2A, an entity must ensure that both:

- The highest and best use (see 3.6.1.A above) of the assets is consistent with their current use.
- And
- The exit market for the asset (i.e., the principal market or in its absence, the most advantageous market) is the same as the entry market (i.e., the market in which the asset was/will be purchased).

The principal market is the market for the asset that has the greatest volume or level of activity for the asset or liability. The most advantageous market is the one that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after considering transaction costs and transport costs. [FRS 102 Appendix I]. See Chapter 10.

The resulting depreciated replacement cost must also be assessed to ensure market participants would actually transact for the asset in its current condition and location at this price. In particular, an entity must ensure that both:

- The inputs used to determine replacement cost are consistent with what market participant buyers would pay to acquire or construct a substitute asset of comparable utility.
- And
- The replacement cost has been adjusted for obsolescence that market participant buyers would consider so that the adjustment reflects all forms of obsolescence (i.e., physical deterioration, technological (functional) and economic obsolescence and environmental factors), which is broader than depreciation calculated in accordance with Section 17.

3.6.3 Accounting for revaluation surpluses and deficits

The revaluation of PP&E under Section 17 of FRS 102 is an application of the 'alternative accounting rules'. The alternative accounting rules are contained in Schedule 1 of The Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008 ('the Regulations'), and under those rules tangible fixed assets may be included at a market value determined as at the date of their last valuation. [1 Sch 32(2)]. Those rules also set out that the amount of any profit or loss arising from the revaluation of those assets must be credited or (as the case may be) debited to a separate reserve ('the revaluation reserve').

[1 Sch 35(1)].

Accordingly, increases in the carrying amount of PP&E as a result of revaluations are recognised in OCI and accumulated in equity i.e., the revaluation reserve, except to the extent that a revaluation increase of an asset reverses a revaluation decrease of the same asset that was previously recognised as an expense in profit or loss, whereby such increase must be credited to income in profit or loss. [FRS 102.17.15E]. Decreases as a result of revaluation are recognised in OCI to the extent of any previously recognised revaluation increase accumulated in revaluation reserve in respect of the same asset. If a revaluation decrease exceeds

the revaluation gains accumulated in revaluation reserve in respect of that asset, the excess is recognised in profit or loss. [FRS 102.17.15F]. This means that it is not permissible under Section 17 to carry a negative revaluation reserve in respect of any individual item of PP&E.

The same rules apply to impairment losses. Any impairment loss of a revalued asset must be treated as a revaluation decrease in accordance with Section 17. [FRS 102.27.6].

3.6.3.A Depreciation of revalued assets

The fundamental objective of depreciation is to reflect in operating profit the cost of use of an item of PP&E (i.e., the amount of economic benefits consumed) in the period. This requires a charge to operating profit even if the asset has changed in value or has been revalued.

Section 17 is not specific as to the base amount of an item of PP&E to be used when computing the depreciation charge for the period. It might be best to use the average carrying value during the year, or else, the opening or closing balance may be used provided that it is used consistently in each period. In practice, the depreciation charge is generally based on the opening value and the written down asset is revalued as at the end of accounting period. The depreciation charge must be recognised as an expense, unless it qualifies to be capitalised as part of another asset (see discussion at 3.5 above).

Amounts taken to OCI as a result of revaluations are not subsequently recognised in the profit and loss account (a process commonly referred to as 'recycling' under IFRS). However, while not explicitly addressed in Section 17, the revaluation surplus included in OCI may be transferred directly to retained earnings as the surplus is realised. [1 Sch 35(3)]. A revaluation surplus may become realised as a result of the related asset being disposed of in exchange for 'qualifying consideration', or as a result of a realised loss being recognised in respect of the asset, for example as a result of write downs for depreciation and impairment (see TECH 02/17BL, paragraph 3.9).

Accordingly, the revaluation surplus included within equity in respect of an item of PP&E may be transferred directly to retained earnings when the asset is derecognised (i.e., transferring the whole of the surplus when the asset is retired or disposed of). In addition, some of the revaluation surplus may be transferred to retained earnings as the asset is used by an entity. In such a case, the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost may be transferred from the revaluation reserve to retained earnings. This recognises that any depreciation of the revalued part of an asset's carrying value is considered realised by being charged to profit or loss. Thus, a transfer may be made of an equivalent amount from the revaluation surplus to retained earnings. This is shown in Illustration 3-10 below. Any remaining balance may be transferred from revaluation reserve to retained earnings when the asset is derecognised (see 3.7 below). Revaluation gains or losses arising from the disposal of PP&E are not subsequently recognised ('recycled') in profit or loss. Illustration 3-11 shows the effect of depreciation on the revaluation reserve, including the possible transfer directly between the revaluation and the profit and loss reserve:

Illustration 3-11: Effect of depreciation on the revaluation reserve

On 1 January 20X5 an entity acquired an asset for £1,000. The asset has an economic life of ten years and is depreciated on a straight-line basis. The residual value is assumed to be £nil. At 31 December 20X8 (when the cost net of accumulated depreciation is £600) the asset is valued at £900. The entity accounts for the revaluation by debiting the carrying value of the asset (using either of the methods discussed below) £300 and crediting £300 to the revaluation reserve. At 31 December 20X8 the useful life of the asset is considered to be the remainder of its original life (i.e., six years) and its residual value is still considered to be £nil. In the year ended 31 December 20X9 and in later years, the depreciation charged to profit or loss is £150 (£900/6 years remaining).

Accordingly, the treatment thereafter for each of the remaining 6 years of the asset's life, is to transfer £50 (£300/6 years) each year from the revaluation reserve to retained earnings (not through profit or loss). This avoids the revaluation reserve being maintained indefinitely even after the asset ceases to exist, which does not seem sensible. This treatment is also permitted by Companies Act which allows amounts to be transferred to the profit and loss account reserve if the amount has previously been charged in that account or is a realised profit. A transfer is possible because the amount of £50 is a realised profit in terms of the Companies Act. [s841(5), 1 Sch 35(3)].

The effect on taxation, both current and deferred, of a policy of revaluing assets is recognised and disclosed in accordance with Section 29 *Income Tax*. This is dealt with in Chapter 31.

When an item of PP&E is revalued, the carrying amount of that asset is adjusted to the revalued amount. FRS 102 does not provide specific guidance on accounting for accumulated depreciation when an item of PP&E is revalued, but there are two usual methods of adjusting the carrying amount. At the date of revaluation, the asset is treated in one of the following ways:

- The accumulated depreciation is eliminated against gross carrying amount of the asset and the carrying amount is then restated to the revalued amount of the asset.
- The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount of the asset. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses.

The first method available eliminates the amount of accumulated depreciation to the extent of the difference between the revalued amount and the carrying amount of the asset immediately before revaluation. This is shown in Illustration 3-12:

Illustration 3-12: Revaluation by eliminating accumulated depreciation

On 31 December, a building has a carrying amount of £40,000, being the original cost of £70,000 less accumulated depreciation of £30,000. A revaluation is performed and the fair value of the asset is £50,000. The entity would record the following journal entries:

Dr	Accumulated depreciation	£30,000	
	Cr Building		£20,000
	Cr Asset revaluation reserve (through OCI)		£10,000

	Before	After
	£	£
Building at cost	70,000	
Building at valuation		50,000
Accumulated depreciation	30,000	-
Net book value	40,000	50,000

Illustrations 3-13 and 3-14 provide two alternative approaches to recognising the revaluation of the asset by adjusting the gross carrying amount in a manner that is consistent with the revaluation of the carrying amount of the asset. In Illustration 3-13, the gross carrying amount is restated by reference to observable market data:

Illustration 3-13: Revaluation by restating the gross carrying amount by reference to observable market data

As in Illustration 3-12, on 31 December, a building has a carrying amount of £40,000, being the original cost of £70,000 less accumulated depreciation of £30,000. A revaluation is performed, and the fair value of the asset is £50,000.

Rather than accounting for the revaluation by eliminating the accumulated depreciation against gross carrying amount of the asset, the gross carrying amount is restated to £75,000 by reference to observable market data. The accumulated depreciation then has to be adjusted to £25,000 (i.e., the gross carrying amount of £75,000 less the carrying amount adjusted to its revalued amount of £50,000). As such, the entity would record the following journal entry:

Dr	Accumulated depreciation	£5,000	
Dr	Building	£5,000	
	Cr Asset revaluation reserve (through OCI)		£10,000

	Before	After
	£	£
Building at cost	70,000	
Building at valuation		75,000
Accumulated depreciation	30,000	25,000
Net book value	40,000	50,000

Illustration 3-14 provides another possible approach to recognising the revaluation of the asset by adjusting the gross carrying amount in a manner that is consistent with the revaluation of the carrying amount of the asset. In this case, the gross carrying amount is restated proportionately to the change in the carrying amount:

Illustration 3-14: Revaluation by restating the gross proportionately to the change in the carrying amount

As in Illustrations 3-12 and 3-13, on 31 December, a building has a carrying amount of £40,000, being the original cost of £70,000 less accumulated depreciation of £30,000. A revaluation is performed, and the fair value of the asset is £50,000.

In this case, the revaluation is recorded by restating gross carrying amount proportionately to the change in carrying amount. As the fair value of the asset is £50,000 and the carrying amount is £40,000 at the date of the revaluation, this gives rise to a 25% uplift. This method results in the same revaluation gain as the methods in Illustrations 3-12 and 3-13 above but the cost and accumulated depreciation carried forward reflect the gross cost of the asset of £87,500 and accumulated depreciation of £37,500. This method may be used if an asset is revalued using an index to determine its depreciated replacement cost.

As such, the entity would record the following journal entry:

Dr	Building	£17,500	
	Cr	Accumulated depreciation	£7,500
	Cr	Asset revaluation reserve (through OCI)	£10,000

	Before	After
	£	£
Building at cost	70,000	
Building at valuation		87,500
Accumulated depreciation	30,000	37,500
Net book value	40,000	50,000

Notice that the revaluation gain recognised remained at £10,000 whichever method described above is used.

3.6.4 Reversals of downward valuations

Section 17 requires that, if an asset's carrying amount is increased as a result of a revaluation, the increase must be credited directly to OCI and accumulated in equity. However, the increase must be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. [FRS 102.17.15E].

How we see it

If the revalued asset is being depreciated, we consider that the full amount of any reversal is not taken to profit or loss. Rather, the reversal must take account of the depreciation that would have been charged on the previously higher book value.

The text of Section 17 does not specify this treatment, but such treatment is consistent with Section 27, which states:

Extract from Section 27

27.30(c) The reversal of an impairment loss shall not exceed the carrying amount of the asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

The following Illustration demonstrates a way in which this could be applied:

Illustration 3-15 Reversal of a downward valuation

An asset has a cost of £1,000,000, a life of 10 years and a residual value of £nil. At the end of year 3, when the asset's depreciated cost is £700,000, it is revalued to £350,000. This write down below cost of £350,000 is taken through profit or loss.

The entity then depreciates the asset by £50,000 per annum, so as to depreciate the revalued carrying amount of £350,000 over the remaining 7 years.

At the end of year 6, the asset's carrying amount is £200,000 but it is now revalued to £500,000. The effect on the entity's asset is as follows:

	£000
<i>Valuation</i>	
At the beginning of year 6	350
Surplus on revaluation	<u>150</u>
At the end of the year	500
<i>Accumulated depreciation</i>	
At beginning of year 6*	100
Charge for the year	50
Accumulated depreciation written back on revaluation	<u>(150)</u>
At the end of the year	-
Carrying amount at the end of year 6	500
Carrying amount at the beginning of year 6	250

* Two years' depreciation (years 4 and 5) at £50,000 per annum.

Upon the revaluation in year 6 the total uplift in the asset's carrying amount is £300,000 (i.e., £500,000 less £200,000). This is because the reversal recognised in profit and loss is restricted to take account of the depreciation that would have been charged on the previously higher book value, achieving the same overall effect that would have been reached had the original downward revaluation not occurred.

In this case, had the previous downwards revaluation not occurred, the total cumulative charges reported in profit or loss at the end of year 6 would have been CU600,000 (comprising 6 years of depreciation at CU100,000 per annum), and the carrying value of the asset would have been CU400,000.

Instead, a total of CU800,000 has been recognised in profit or loss, reflecting the CU350,000 downwards revaluation and a total of CU450,000 of depreciation (comprising 3 years of depreciation at CU100,000 per annum and 3 years at the reduced amount of CU50,000 per annum). Therefore, the total reversal through profit or loss is restricted to the difference between these two figures of CU200,000. The remaining CU100,000 will be credited to OCI and taken to the revaluation surplus.

From the beginning of year 7 the £500,000 asset value will be written off over the remaining four years at £125,000 per annum.

In Illustration 3-15 above, the amount of the revaluation that is credited to the revaluation surplus in OCI represents the difference between the carrying amount that would have resulted had the asset always been held on a cost basis since initial recognition (£400,000) and the carrying amount on a revalued basis (£500,000).

This might be considered as an extreme example. Most assets that are subject to a policy of revaluation would not show such marked changes in value and it would be expected that there would be valuation movements in the intervening years rather than dramatic losses and gains in years 3 and 6. However, we consider that in principle this is the way in which downward valuations must be recognised.

There may be major practical difficulties for any entity that finds itself in the position of reversing revaluation deficits on depreciating assets, although whether in practice this eventuality often occurs is open to doubt. If there is any chance that it is likely to occur, the business would need to continue to maintain asset registers on the original, pre-write down, basis.

3.6.5 Adopting a policy of revaluation

Although the adoption of a policy of revaluation by an entity that has previously used the cost model is a change in accounting policy, it is not dealt with as a prior year adjustment in accordance with Section 10. Instead, the change is treated as a revaluation during the year, as described at 3.6.3 and 3.6.4 above. [FRS 102.10.10A]. This means that the entity is not required to obtain valuation information about comparative periods.

This is an exception to the general principle in Section 10 of FRS 102 (whereby changes in accounting policy must be recognised retrospectively), and it only applies to a change to a policy of revaluation. If an entity changes its accounting policy from the revaluation model to the cost model, the usual requirements to changes in accounting policies apply, meaning the effect of the change is calculated retrospectively as if the cost model had always been applied. For further discussion of changes in accounting policy, see Chapter 9 at 3.3.

3.6.6 Assets held under leases

Under Section 20 lessees are required to recognise most leases in their statement of financial position as lease liabilities with corresponding right-of-use assets. A lessee subsequently measures the right-of-use asset using a cost model under Section 20 (applying the depreciation requirements in Section 17, but subject to the specific requirements in paragraph 58 of Section 20), unless it applies one of the following measurement models allowed by Section 20 (see Chapter 23 at 6.3.1.B):

- The fair value model in Section 16 applied to right-of-use assets that meet the definition of investment property, unless applying the exemption in paragraph 16.4A(b)(ii).
Or
- If the lessee applies the revaluation model in Section 17 to a class of PP&E, the lessee would also have the option to revalue all the right-of-use assets that relate to that class of PP&E. [FRS 102.20.60, FRS 102.20.61].

3.7 Derecognition

Derecognition i.e., removal of the carrying amount of the item from the financial statements of the entity, occurs when an item of PP&E is either disposed of, or when no further economic benefits are expected to flow from its use or disposal. [FRS 102.17.27]. The disposal of an item of PP&E may occur in a variety of ways (e.g., by sale, by entering into a finance lease or by donation). The actual date of disposal of an item of PP&E is the date the recipient obtains control of that item in accordance with the requirements in Section 23 for determining when a performance obligation is satisfied. Section 20 applies to disposal by way of a sale and leaseback. [FRS 102.17.29]. Revenue recognition under Section 23 is discussed in Chapter 25.

All gains and losses on derecognition must be included in profit and loss for the period (although, except as discussed in 3.7.1 below, gains must not be classified as revenue) when the item is derecognised, unless another standard applies, e.g., under Section 20, a sale and leaseback transaction might not give rise to a gain. [FRS 102.17.28]. See Chapter 23 for more detail.

Gains and losses are to be calculated as the difference between any net disposal proceeds and the carrying value of the item of PP&E. [FRS 102.17.30]. This means that any revaluation surplus relating to the asset disposed of is transferred directly to retained earnings when the asset is derecognised and not reflected in profit or loss.

Replacement of 'parts' of an asset requires derecognition of the carrying value of the original part, even if that part was not being depreciated separately. In these circumstances, it might be acceptable to estimate using the cost of a replacement part to be a guide to the original cost of the replaced part, if that cannot be determined. See discussion at 3.2.3 above.

Section 17 does not provide further guidance on how the disposal proceeds must be determined. Entities may look to the requirements in IAS 16, under which the amount of consideration to be included in the gain or loss arising from the derecognition of an item of PP&E is required to be determined in accordance with the requirements for determining the transaction price in paragraphs 47 to 72 of IFRS 15. Similar requirements in FRS 102 are contained in paragraphs 41 to 64 of Section 23 (see Chapter 25). Similarly, entities could look to IFRS for guidance on the accounting for any subsequent changes to the estimated amount of the consideration. Under IAS 16, subsequent changes to the estimated amount of the consideration included in the gain or loss are accounted for in accordance with the requirements for

changes in the transaction price in paragraphs 87 to 90 of IFRS 15. Similar requirements in FRS 102 are contained in paragraphs 75 to 77 of Section 23 (see Chapter 25).

There could be a few fully depreciated assets still in use. For those fully depreciated assets that are no longer in use, it may be practical to derecognise them, rather than continue to carry them at their gross cost and accumulated depreciation.

3.7.1 Sale of assets held for rental

If an entity, in the course of its ordinary activities, routinely sells PP&E that it has held for rental to others, it must transfer such assets to inventories at their carrying amount when they cease to be rented and are then held for sale. Accordingly, the proceeds from the sale of such assets must be recognised as revenue. While this is not specified in Section 17, this treatment appears reasonable and is consistent with the specific provisions in IAS 16 paragraph 68A. In contrast, the sale of investment property is generally not recognised as revenue.

A number of entities sell assets that have previously been held for rental, for example, car rental companies that may acquire vehicles with the intention of holding them as rental cars for a limited period and then selling them. One issue is whether the sale of such assets, which arguably have a dual purpose of being rented out and then sold, must be presented gross (revenue and cost of sales) or net (gain or loss) in profit or loss.

It would be reasonable to consider the IFRS conclusion in this scenario. The IASB concluded that the presentation of gross revenue, rather than a net gain or loss, would better reflect the ordinary activities of some such entities. [IAS 16.BC35C]. Accordingly, when preparing a statement of cash flows, both (i) the cash payments to manufacture or acquire assets held for rental and subsequently held for sale; and (ii) the cash receipts from rentals and sales of such assets would be presented as from operating activities. [IAS 7.14]. This is intended to avoid initial expenditure on purchases of assets being classified as investing activities while inflows from sales are recorded within operating activities.

3.7.2 Partial disposals and undivided interests

Section 17 requires an entity to derecognise 'an item' of PP&E on disposal or when it expects no future economic benefits from its use or disposal. [FRS 102.17.27].

Items of PP&E are recognised when their costs can be measured reliably, and it is probable that future benefits associated with the asset will flow to the entity. [FRS 102.17.4]. Section 17 does not prescribe the unit of measurement for recognition, i.e., what constitutes an item of PP&E.

However, items that are derecognised were not necessarily items that were identified separately on initial recognition. The item that is being disposed of may be part of a larger 'item' bought in a single transaction that can be subdivided into parts (i.e., separate items) for separate disposal; an obvious example is land or many types of property. The principle is the same as for the replacement of parts, which may only be identified and derecognised so that the cost of the replacement part may be recognised (see 3.2.3 above). The entity needs to identify the cost of the part disposed of by allocating the carrying value on a systematic and appropriate basis.

Section 17 assumes that disposal will be of a physical part (except in the specific case of major inspections and overhauls - see 3.2.3.B above). However, some entities enter into arrangements in which they dispose of part of the benefits that will be derived from the assets.

Although Section 17 defines an asset by reference to the future economic benefits that will be controlled by the entity as a result of the acquisition, it does not address disposals of a proportion of these benefits. An entity may dispose of an undivided interest in the whole asset (sometimes called an ownership 'in common' of the asset). This means that all owners have a proportionate share of the entire asset (e.g., the purchaser of a 25% undivided interest in 100 acres of land owns 25% of the whole 100 acres). These arrangements are common in, but are not restricted to, the extractive and property sectors. Vendors have to determine how to account for the consideration they have received from the purchaser. This will depend on the details of the arrangement and, in particular, whether the entity continues to control the asset or if there is joint control.

3.7.2.A Joint control

In some cases, after a partial disposal of an item of PP&E, there may be joint control over the asset (e.g., sale of an asset to a joint venture), in which case the arrangement will be within scope of Section 15 *Investments in Joint Ventures* which will determine how to account for the disposal and the subsequent accounting. Joint control is discussed in Chapter 18.

The retained interest will be analysed as a jointly controlled operation (JCO), a jointly controlled assets (JCA) or a jointly controlled entity (JCE). Undivided interests cannot be accounted for as joint ventures in the absence of joint control.

3.7.2.B Vendor retains control

If the asset is not jointly controlled in the subsequent arrangement, the vendor might retain control over the asset. The vendor will recognise revenue, or it will be a financing arrangement. If it is the former, then the issue is the period and pattern over which revenue is recognised.

If the vendor retains control, then it will not meet the criteria in Section 23 for treating the transaction as a sale, i.e., recognising revenue at a point in time on entering into the arrangement. As discussed in Chapter 20, Section 23 requires that revenue (and a gain or loss on disposal of a non-current asset not in the ordinary course of business) be recognised upon satisfaction of a performance obligation by transferring a promised good to a customer. A good is transferred when the customer obtains control (see Chapter 25). [FRS 102.23.78].

The arrangement could be akin to a lease, especially if the disposal is for a period of time. However, arrangements are only within the scope of Section 20 if they relate to a specified asset. Generally, a portion of a larger asset that is not physically distinct is not considered to be a specified asset. The related requirements of Section 20 are discussed in Chapter 23.

If it is not a lease and the vendor continues to control the asset, the arrangement might be best characterised as akin to a performance obligation for services to be spread over the term of the arrangement. That is, the initial receipt would be a liability and recognised in profit and loss over time.

Alternatively, it could be a financing-type arrangement, in which case the proceeds would be classified as a financial liability. In effect, the vendor is trading a share of any revenue to which it is entitled in exchange for funding by the purchaser of one or more activities relating to the asset. The purchaser receives a return that is comparable to a lender's rate of return out of the proceeds of production. This could be by receiving a disproportionate share of output until it has recovered its costs (the financing it has provided) as well as the agreed rate of return for the funding. These arrangements are found in the extractive sector, e.g., carried interests and farm-outs (see Chapter 36). In the development stage of a project, the asset in question will be classified as PP&E or as an intangible asset under Section 18. Under a carried interest arrangement the carried party transfers a portion of the risks and rewards of a property, in exchange for a funding commitment from the carrying party.

3.7.2.C Sale or partial sale of a single-asset entity

Certain assets, particularly properties, may be bought and sold by transferring ownership of a separate legal entity formed to hold the asset (a 'single-asset' entity) rather than the asset itself. The asset could be realised through either an outright sale or partial disposal.

In consolidated financial statements, Section 9 *Consolidated and Separate Financial Statements* states that where a parent disposes of an interest in a subsidiary resulting in a loss of control, the gain or loss on disposal is the difference between:

- The proceeds from the disposal.
- And
- The proportion of the carrying amount of the subsidiary's net assets, including any related goodwill, disposed of (or lost) as at the date of disposal. [FRS 102.9.18A].

Therefore, if a single-asset subsidiary is disposed of in its entirety (and no interest in either the entity, or the underlying asset held by the entity, is retained), the gain or loss on disposal in the consolidated financial statements is the difference between the disposal proceeds and the carrying amount of the asset held by the single asset entity. This is consistent with the normal derecognition requirements for PP&E in Section 17 which state that the gain or loss arising from the derecognition of an item of PP&E is calculated as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

[FRS 102.17.30].

A scenario such as this, in which a wholly owned single-asset entity is disposed of in its entirety, may be straight-forward, but scenarios involving a partial disposal of an investment in a single-asset entity that results in a loss of control can give rise to complexities, and the type of investment that is retained will need to be considered in determining the appropriate accounting for the retained interest and the gain or loss on disposal. Possible scenarios which may arise include:

- The retained interest is an investment in either an associate or a jointly controlled entity. In such a case, that retained interest will be accounted for using the equity method under Section 14 *Investments in Associates*. The carrying amount of the net assets attributable to the investment at the date of the disposal is regarded as the cost on initial measurement of the investment in associate or jointly controlled entity, as appropriate. See Chapter 17.
- The retained interest is an investment in an entity that is not an associate or jointly controlled entity. In such a case, that investment will be accounted for as a financial asset in accordance with Section 11 *Basic Financial Instruments* or Section 12 from the date of the partial disposal. The carrying amount of the net assets attributable to the investment at the date of the disposal is regarded as the cost on initial measurement of the financial asset. See Chapter 13. [FRS 102.9.19, FRS 102.15.18].

3.8 Presentation of PP&E

An entity reporting under Schedule 1 using the 'statutory formats' (see Chapter 6) is required to present PP&E on the face of statement of financial position. The main heading must be 'Tangible assets'. The following required subheadings may be shown either on the face of the statement of financial position or in the notes:

- Land and buildings
- Plant and machinery
- Fixtures, fittings, tools and equipment
- And
- Payments on account and assets in course of construction

Subheadings may not be limited to those above.

A Schedule 1 entity using the 'adapted formats' (see Chapter 6) is required to present PP&E as a separate line item on the statement of financial position. FRS 102 also requires that sub-classifications of PP&E that are appropriate to the entity are presented, either on the face of the statement of financial position or in the notes. [FRS 102.4.2B(a)].

FRS 102 does not include the concept in IFRS of non-current assets and disposal groups held for sale, and the 'adapted formats', therefore, do not require separate presentation for such items. FRS 102 also does not address whether items such as PP&E must be reclassified as current if expected to be realised within twelve months after the reporting period.

How we see it

In our view, an entity should generally continue to classify PP&E intended to be disposed of as non-current unless it is expected to be realised within 12 months after the reporting period (in which case it must be classified as current).

However, an entity that, in the course of its ordinary activities, routinely sells items of PP&E that it has held for rental to others, must transfer such assets to inventory when they cease to be rented and become held for sale, consistent with IFRS requirements. [IAS 16.68A]. See 3.7.1 above. The inventory must then be classified as current or non-current in accordance with the definitions set out in Chapter 6, with particular reference to item (a) of the definition of non-current asset.

3.9 Disclosures

The main disclosure requirements of Section 17 are set out at 3.9.1 below. Other disclosures required by other sections of FRS 102 and Companies Act in respect of PP&E are included in 3.9.2 and 3.9.3 below, respectively.

3.9.1 Disclosures required by Section 17

For each class of PP&E the following must be disclosed in the financial statements:

- The measurement bases used for determining the gross carrying amount (e.g., cost or revaluation)
- The depreciation methods used
- The useful lives or the depreciation rates used
- The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period

And

- A reconciliation of the carrying amount at the beginning and end of the reporting period, which need not be presented for prior periods, showing separately the following:
 - Additions
 - Disposals
 - Acquisitions through business combinations
 - Revaluations
 - Transfers to or from investment property
 - Impairment losses recognised or reversed in profit or loss during the period under Section 27
 - Depreciation for the period
- And
- Other changes *[FRS 102.17.31]*

Where an entity has chosen to account for investment properties rented to other group entities using the cost model it should disclose their carrying amount at the end of the reporting period. *[FRS 102.17.31A]*.

An entity should also disclose the following:

- The existence and carrying amounts of PP&E to which the entity has restricted title or that is pledged as security for liabilities.

And

- The amount of contractual commitments for the acquisition of PP&E. *[FRS 102.17.32]*.

In addition to above disclosures, if items of PP&E are stated at revalued amounts, the following should be disclosed:

- The effective date of the revaluation.
- Whether an independent valuer was involved.
- The methods and significant assumptions applied in estimating the items' fair values.

And

- For each revalued class of PP&E, the carrying amount that would have been recognised had the assets been carried under the cost model. *[FRS 102.17.32A]*.

The requirement under the last bullet point above can be quite onerous for entities, as it involves maintaining asset register information in some detail in order to meet it.

When both the cost model and the revaluation model have been used, the gross carrying amount for that basis in each category will have to be disclosed (however the standard requires that if revaluation is adopted the entire class of PP&E must be revalued - see 3.6 above). The selection of the depreciation method, useful lives or depreciation rates used is a matter of judgement and the disclosure must provide information to allow users to review the policies selected by management and to compare them with other entities.

All of the disclosures above (other than those related to fair value measurement) are also relevant to an entity that chooses to measure investment properties rented to another group entity under the cost model. *[FRS 102.17.30A]*.

3.9.2 Disclosures required by other sections of FRS 102 in respect of PP&E

In addition to the above disclosures, other sections of FRS 102 require disclosures of specific information relating to PP&E:

- If, at the reporting date, an entity has a binding sale agreement for a major disposal of assets (i.e., PP&E held for sale), a description of the facts and circumstances of the planned sale, and the carrying amount of the assets, is required to be disclosed. [FRS 102.4.14]. See Chapter 6 for further details.
- In accordance with Section 10, the nature and effect of any changes in accounting estimate (e.g., depreciation methods, useful lives, residual values, estimated cost of dismantling, removing or restoring items of PP&E) that have a material effect on the current or future periods must be disclosed. [FRS 102.10.18]. See Chapter 9 for further details.
- Disclosures required for lessees and lessors in respect of items of PP&E subject to lease agreements are covered by Section 20. See Chapter 23 for details.
- In the case of PP&E that is impaired, disclosures are required by Section 27. See Chapter 29 for further details.
- Disclosures in relation to borrowing costs that are capitalised as part of the cost of an item of PP&E are required by Section 25. See Chapter 27 for details.

3.9.3 Additional disclosures required by the Companies Act and the Regulations

The following disclosures are required by the Companies Act and the Regulations in respect of PP&E in addition to those disclosures required by FRS 102:

- An analysis of freehold, long leasehold and short leasehold in respect of disclosures of land and buildings. [1 Sch 53]. For this purpose, a 'lease' is defined to include an agreement for a lease and a 'long lease' as a lease which has 50 years or more to run at the end of the financial year in question, otherwise, it would be a 'short lease'. [10 Sch 7].
- In addition to the disclosures described at 3.9.1 above, the following information must be given for any PP&E that are measured using the revaluation model (i.e., alternative accounting rules) and that have been valued during the financial year:
 - The year of valuation and the amounts of the revaluation.
 - In the year of valuation, the names of the persons who valued them or particulars of their qualifications for doing so.

And

 - The bases of valuation used by them. [1 Sch 52].
- The treatment for taxation purposes of amounts credited or debited to the revaluation reserve must be disclosed in a note to the accounts. [1 Sch 35(6)].
- Where an entity has determined the purchase price or production cost of any asset for the first time using the value ascribed to it in the earliest available record of its value made on or after its acquisition or production by the company, this fact must be disclosed in the notes to its financial statements. [1 Sch 64(1)].

4 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for PP&E are set out below.

	FRS 102	IFRS
Scope	Applies to all items of PP&E except for biological assets related to agricultural activity, heritage assets, mineral rights and reserves and PP&E classified as held for sale. Investment properties rented to another group entity where (as permitted by paragraph 4A of Section 16) the reporting entity chooses to apply the cost model (see 3.1 and 3.4 above) are within the scope of Section 17. A plan to dispose of an asset (i.e., held-for-sale asset) before the previously expected date is an indicator of impairment (i.e., no reclassification or suspension of depreciation - although see 2.1 above).	Applies to all items of PP&E except PP&E classified as held for sale, biological assets related to agricultural activity, mineral rights and reserves and investment properties held at fair value. Recognition and measurement of exploration and evaluation assets are also excluded from its scope. Entities using the cost model for investment properties (including investment properties under construction) use the cost method as prescribed in IAS 16. PP&E classified as held for sale is accounted for under IFRS 5.
	Section 34 does not make a distinction between biological assets and bearer plants. Therefore, bearer plants are treated as biological assets and accounted for in accordance with Section 34.	Biological assets meeting the definition of 'bearer plants' are within the scope of IAS 16.
Classification of computer software	Section 18 sets out that entities are required to use judgement to assess which element is more significant when an asset incorporates both tangible and intangible elements. Operating systems and software without which a machine could not operate is an integral part of the related hardware and is treated as PP&E. When the software is not an integral part of the related hardware, the software is treated as an intangible asset. (see 3.2.1.D above).	Required to use judgement to assess which element is more significant when an asset incorporates both tangible and intangible elements. Software that is not integral to related hardware is treated as an intangible asset. Software which is not an integral part of the related hardware is treated as an intangible asset. Computer software that is an integral part of the related hardware is treated as PP&E.
Cost	If payment for the asset is deferred beyond normal credit terms, the cost is the present value of all future payments (although expected to be materially similar, it is not the cash price equivalent at the recognition date like in IAS 16).	If payment for the asset is deferred beyond normal credit terms, interest is recognised over the period of credit (unless capitalised per IAS 23 - <i>Borrowing Costs</i>) i.e., the measurement of cost of a PP&E is the cash price equivalent at the recognition date.
	Capitalisation of directly attributable borrowing costs in respect of a qualifying asset is permitted but not required.	Borrowing costs related to a qualifying asset must be capitalised.
	Subject to conditions (e.g., transaction has economic substance, and fair value is reliably measurable), FRS 102	Subject to conditions (e.g., transaction has economic substance, and fair value is reliably measurable), IAS 16 requires

	FRS 102	IFRS
	requires all acquisitions of PP&E in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value. Any resulting gain or loss is likely to be an unrealised profit or loss and would be reported in OCI.	all acquisitions of PP&E in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value. Any resulting gain or loss is reported in the income statement.
	If income is generated wholly and necessarily as a result of the process of bringing the asset into the location and condition for its intended use, for example from the sale of samples produced when testing the equipment concerned to determine whether the asset is functioning properly, then the income must be credited to the cost of the asset. It will be a matter of judgement as to when the asset is in the location and condition intended by management, but capitalisation (including the recording of income as a credit to the cost of the asset) ceases when the asset is fully operational, regardless of whether or not it is yet achieving its targeted levels of production or profitability.	IAS 16 requires that the proceeds from selling items produced whilst bringing an item of PP&E into the location and condition necessary for it to be capable of operating in the manner intended by management, and the cost of those items, are recognised in profit or loss. The cost of those items is determined by applying the measurement requirements of IAS 2 <i>Inventories</i>.
Revaluation model	Section 17 does not have detailed guidance on accumulated depreciation when assets are revalued. However, we expect that FRS 102 adopters will follow the approach similar to IFRS (see 3.6.3.A above).	IAS 16 provides detailed guidance on accumulated depreciation when assets are revalued.
	Section 17 is silent on transfers of a revaluation surplus to retained earnings. However, the Regulations permit such transfers of amounts if the amount represents realised profit (see 3.6.3.A above).	IAS 16 provides detailed guidance on transfers of revaluation surplus to retained earnings - i.e., as the asset is used by an entity or when the related asset is derecognised.
Depreciation of assets/impairment	Depreciation ceases at the end of the useful life or on disposal of the asset.	Depreciation of an asset ceases when the asset is either classified as held for sale or derecognised.
	No equivalent guidance in respect of non-depreciation if an asset's residual value is equal to or exceeds its carrying amount. However, we expect that FRS 102 adopters will follow an approach similar to IFRS (see 3.5 above).	If an asset's residual value is equal to or exceeds its carrying amount the asset is not depreciated until its residual value subsequently decreases to an amount below the assets' carrying amount.
	There is no explicit prohibition of the use of 'revenue expected to be generated' as the basis to depreciate PP&E. However, under Section 17, the depreciation method selected must reflect the pattern in which the asset's	The use of revenue-based depreciation is inappropriate and thus, prohibited.

FRS 102		IFRS
	future economic benefits are expected to be consumed, and whilst revenue reflects the output of the asset, it also reflects other factors that do not affect depreciation. Therefore, despite the fact that revenue-based depreciation is not explicitly prohibited under FRS 102, a revenue-based depreciation method is not appropriate where it does not reflect the consumption of the economic benefits of the asset.	
	Reassessment of depreciation methods and residual values are only required if there is an indication that it has changed since the most recent annual reporting date.	Depreciation methods and residual value must be reassessed at least annually. Depreciation methods are changed if there is a significant change in the expected pattern of consumption.
Disposal of PP&E	Under FRS 102 gains and losses on disposal are to be calculated as the difference between any net disposal proceeds and the carrying value of the item of PP&E. <i>[FRS 102.17.30]</i> . Section 17 does not provide further guidance on how the disposal proceeds must be determined.	IAS 16 requires that the amount of consideration on disposal to be included in the gain or loss on derecognition of PP&E must be determined in accordance with the requirements for determining the transaction price in IFRS 15. In addition, subsequent changes to the estimated amount of consideration included in the gain or loss must be accounted for in accordance with the requirements for changes in transaction price in IFRS 15. <i>[IAS 16.72]</i>
Disclosures	Reconciliation disclosure (i.e., opening balances to ending balances) required only for the current period.	Reconciliation disclosure (i.e., opening balances to ending balances) required for both current and comparative period.
	Where an entity has chosen to account for investment properties rented to other group entities using the cost model it must disclose their carrying amount at the end of the reporting period (see 3.9.1 above).	Disclosure requirement is not applicable as this accounting policy choice is not available under IFRS.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

borrowing costs	Interest and other costs incurred by an entity in connection with the borrowing of funds
carrying amount	The amount at which an asset or liability is recognised in the statement of financial position
depreciable amount	The cost of an asset, or other amount substituted for cost (in the financial statements), less its residual value
depreciated replacement cost	The most economic cost required for the entity to replace the service potential of an asset (including the amount that the entity will receive from its disposal at the end of its useful life) at the reporting date.
depreciation	The systematic allocation of the depreciable amount of an asset over its useful life.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
property, plant and equipment	Tangible assets that: a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and b) are expected to be used during more than one period.
recoverable amount	The higher of an asset's (or cash-generating unit's) fair value less costs to sell and its value in use.
residual value	The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
useful life	The period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by an entity.

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Chapter 21 Intangible assets other than goodwill

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Overview

This chapter deals with the requirements of Section 18 *Intangible Assets other than Goodwill*. Section 18 addresses the nature, recognition and measurement of intangible assets other than goodwill.

Section 18 applies to all intangible assets, other than the following:

- Goodwill
- Intangible assets held for sale in the ordinary course of business
- Assets arising from contracts with customers that are recognised in accordance with Section 23 *Revenue from Contracts with Customers* (see Chapter 25)
- Financial assets
- Heritage assets
- Exploration for and evaluation of mineral resources, such as oil, natural gas and similar non-regenerative resources and expenditure on the development and extraction of such resources
- And
- Deferred acquisition costs and intangible assets arising from contracts in the scope of FRS 103 *Insurance Contracts* (see Chapter 38). However, the disclosure requirements of Section 18 apply to intangible assets arising from contracts in the scope of FRS 103.

What you need to know

- An intangible asset is defined as an identifiable non-monetary asset without physical substance.
- The essential characteristics of intangible assets are therefore that they are identifiable, lack physical substance, are controlled by the entity, and will give rise to future economic benefits for the entity.
- The recognition and measurement rules differ depending on whether an intangible asset is acquired separately, acquired as part of a business combination, or is internally generated by an entity.
- After initial recognition, intangible assets are subsequently measured using either the cost model, or the revaluation model.
- Intangible assets are amortised over a finite useful life. If an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life must not exceed ten years.
- Section 18 specifies that certain costs must be expensed, including start-up costs, training costs, advertising and promotional costs (unless it meets the definition of inventories held for distribution at no or nominal consideration), and relocation and reorganisation costs.
- The accounting for goodwill is addressed in Section 19 *Business Combinations and Goodwill* (see Chapter 22), and the impairment of intangible assets is also outside the scope of Section 18 and is instead dealt with in Section 27 *Impairment of Assets* (see Chapter 29).

1 Introduction

Intangible assets represent a significant class of assets for a wide range of entities. The existence of a corporate identity or brand; intellectual property rights protecting an entity's knowledge, products and processes; or contractual and other rights to exploit both physical and intellectual resources can be as important to an entity's success as its physical asset base and infrastructure. The cost and uncertainty of outcomes associated with developing these types of assets from scratch contribute in part to the premiums paid by acquirers of businesses that already have these attributes. Accordingly, there has for some time been a strong link between accounting for intangible assets and accounting for business combinations.

Section 18 addresses the nature, recognition and measurement of intangible assets other than goodwill. It also sets out the disclosure requirements. The accounting for goodwill is addressed in Section 19 (see Chapter 22). Section 18 does not address the impairment of intangible assets, which is dealt with in Section 27 (see Chapter 29).

There were no major changes introduced by the Periodic Review 2024 to Section 18 (effective 1 January 2026). Certain minor changes and clarifications have been made to reflect amendments made to other sections of FRS 102 or to align FRS 102 more closely with IFRS. For example, guidance has been added to state that an entity uses its judgement to assess whether an asset that incorporates both intangible and tangible elements are within the scope of Section 17 *Property, Plant and Equipment* or Section 18 (see 3.1.2 below). [FRS 102.18.3B]. Guidance was also added to explain the need for judgement in determining whether the acquisition of an intangible asset is the acquisition of an asset or a group of assets, or a business combination (see 3.1 below). [FRS 102.18.3A].

Cloud computing arrangements, which are becoming increasingly common as an alternative to on-site software and computing infrastructure, are discussed at 4.2 below.

There are some differences between the accounting for intangible assets under Section 18 compared to IFRS (see 5 below). The key differences are discussed at 2 below.

2 Comparison between Section 18 and IFRS

2.1 Intangible assets acquired in a business combination

Entities applying FRS 102 are required to recognise fewer intangible assets acquired in a business combination separately from goodwill than under IFRS, although they may voluntarily adopt an accounting policy to separately recognise additional intangible assets in business combinations, provided that this policy is applied consistently to the relevant class of intangible assets.

Under FRS 102, entities must recognise intangible assets in business combinations separately from goodwill when all of the following three conditions are satisfied:

- (a) The recognition criteria in paragraph 4 of Section 18 of the standard are met (see 3.2 below).
 - (b) The intangible asset arises from contractual or other legal rights.
- And
- (c) The intangible asset is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or liability). [FRS 102.18.8].

This requirement is more restrictive than IAS 38 *Intangible Assets* which requires intangible assets to be recognised separately from goodwill where they are either separable or arise from contractual or other legal rights. [IAS 38.33]. However, entities applying FRS 102 can choose to adopt an accounting policy to recognise intangible assets separately from goodwill where the recognition criteria in paragraph 4 of Section 18 of the standard are met and only one of conditions (b) or (c) above is met, [FRS 102.18.8], resulting in an approach closer to that required by IAS 38. The requirements of FRS 102 in respect of intangible assets acquired in a business combination are discussed at 3.2.2.A below.

2.2 Indefinite lived intangible assets

Under FRS 102 all intangible assets are considered to have a finite life. [FRS 102.18.19]. If an entity cannot make a reliable estimate of the useful life of an intangible asset, the life must not exceed ten years. Section 18 explicitly states that an entity is expected to be unable to make a reliable estimate of the useful life of an intangible asset only 'in exceptional cases'. [FRS 102.18.20].

IAS 38 requires an intangible asset to be regarded as having an indefinite life when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. [IAS 38.88]. Intangible assets with indefinite useful lives are not amortised. [IAS 38.107].

2.3 Development costs

Section 18 allows an entity to capitalise expenditure incurred in developing an intangible asset, provided certain criteria are met. [FRS 102.18.8H]. Alternatively, an entity may choose to expense development expenditure as incurred. The policy adopted must be applied consistently to all development projects. [FRS 102.18.8K].

IAS 38 does not allow an accounting policy choice as to whether development costs can be capitalised or expensed. An intangible asset arising from the development phase of a project must be capitalised if certain criteria (the same as those in Section 18) are met. [IAS 38.57].

2.4 Advertising and promotional activities

Under FRS 102, promotional stocks, such as catalogues and other promotional material may be recognised as an asset if they meet the definition of inventories held for distribution at no or nominal consideration (see Chapter 16 at 3.2.11). [FRS 102.18.8C].

IAS 38 does not allow entities to capitalise expenditure on advertising and promotional activities, including mail order catalogues. [IAS 38.69(c)].

2.5 Intangible assets acquired by way of government grant

Section 18 requires intangible assets acquired by way of a grant to be recorded at fair value at the date the grant is received or receivable. *[FRS 102.18.12]*.

IAS 38, in contrast, permits an accounting policy choice between recognising the intangible asset at fair value or at a nominal amount. *[IAS 38.44, IAS 20.23]*.

2.6 Disclosures

There are some differences between the disclosure requirements of Section 18 and IFRS. These are discussed at 5 below.

3 Requirements of Section 18 for intangible assets other than goodwill

3.1 Scope and definition

Section 18 applies to all intangible assets, other than the following:

- Goodwill (dealt with by Section 19). [FRS 102.18.1]. See Chapter 22.
- Intangible assets held for sale in the ordinary course of business (dealt with by Section 13 *Inventories* and assets arising from contracts with customers that are recognised in accordance with Section 23). [FRS 102.18.1]. See Chapter 16 and Chapter 25 respectively.
- Financial assets (dealt with by Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*). [FRS 102.18.3(a)]. See Chapters 11, 12, 13 and 14.
- Heritage assets (dealt with by Section 34 *Specialised Activities*). [FRS 102.18.3(b)]. See Chapter 36.
- Exploration for and evaluation of mineral resources, such as oil, natural gas and similar non-regenerative resources (dealt with by Section 34) and expenditure on the development and extraction of such resources. [FRS 102.18.3(c)]. See Chapter 36.

And

- Deferred acquisition costs and intangible assets arising from contracts in the scope of FRS 103. However, the disclosure requirements of Section 18 apply to intangible assets arising from contracts in the scope of FRS 103. [FRS 102.18.3(d)]. See Chapter 38.

FRS 102 defines an intangible asset as “an identifiable non-monetary asset without physical substance”. [FRS 102 Appendix I]. For the purposes of this section, an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [FRS 102.18.4A]. The essential characteristics of intangible assets are therefore that they:

- Are identifiable (see 3.1.1 below)
- Lack physical substance (see 3.1.2 below)
- Are controlled by the entity (see 3.1.3 below)

And

- Will give rise to future economic benefits for the entity (see 3.1.4 below)

However, in order to determine whether an intangible asset that meets all of these criteria is required to be recognised, an entity must also consider whether it satisfies the applicable recognition criteria set out within Section 18. The principles for the recognition of intangible assets are discussed at 3.2 below.

An entity may also need to use its judgement to determine whether the acquisition of an intangible asset is the acquisition of an asset or a group of assets, or a business combination within the scope of Section 19 (see Chapter 22). The separate application of both sections is required in determining whether a specific transaction meets the definition of a business combination as defined in Section 19 and includes an intangible asset as defined in this section. [FRS 102.18.3A].

3.1.1 Identifiability

An asset is identifiable when it:

- (a) Is separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability.

Or

- (b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. [FRS 102 Appendix I].

Applying this definition means that assets arising from contractual rights alone may meet the definition of an intangible asset under FRS 102. One example of such an asset is a licence that, legally, is not transferable except by sale of the entity as a whole. However, preparers must not restrict their search for intangible assets to those embodied in contractual or other legal rights. Non-contractual rights may also meet the definition of an intangible asset if the right could be sold, transferred, licensed, rented or exchanged.

3.1.2 Lack of physical substance

The definition of an intangible asset requires that it lacks physical substance. However, some intangible assets may be contained in or on a physical substance. In determining whether an asset that incorporates both intangible and tangible elements is within the scope of Section 17 or this section, an entity uses judgement to assess which element is more significant. FRS 102 provides the following examples:

[FRS 102.18.3B]

- Software without which a machine could not operate is an integral part of the related hardware and it is treated as property, plant and equipment.
- The operating system of a computer or mobile device is normally integral to the computer or mobile device and is included in property, plant and equipment.
- Software which is not an integral part of the related hardware is treated as an intangible asset.

IAS 38 also provides guidance in relation to research and development activities which may be relevant to FRS 102 reporters in applying the judgement discussed above. Paragraph 5 of IAS 38 notes that research and development expenditure may result in an asset with physical substance (e.g., a prototype), but as the physical element is secondary to its intangible component, the related knowledge, it is treated as an intangible asset. [IAS 38.5].

The 'parts approach' in Section 17 requires an entity to account for significant components of an asset separately if they have significantly different patterns of consumption of economic benefits. [FRS 102.17.6]. This raises 'boundary' problems between Section 17 and Section 18 when software and similar expenditure is involved.

How we see it

Where Section 17 requires an entity to identify parts of an asset and account for them separately, the entity needs to evaluate whether any intangible-type part is integral to the larger asset or whether it is really a separate asset. The intangible part is more likely to be an asset if it was developed separately or if it can be used independently of the item of property, plant and equipment of which it apparently forms a part of.

3.1.3 Control

In the context of intangible assets, control normally results from legal rights, in the way that copyright, a restraint of trade agreement or a legal duty on employees to maintain confidentiality would protect the economic benefits arising from market and technical knowledge. While it will be more difficult to demonstrate control in the absence of legal rights, legal enforceability of a right is not a necessary condition for control. An entity may be able to control the future economic benefits in some other way, for example, through custody. However, determining that this is the case in the absence of observable contractual or other legal rights requires the exercise of judgement based on an understanding of the specific facts and circumstances involved.

For example, an entity usually has insufficient control over the future economic benefits arising from an assembled workforce (i.e., a team of skilled workers, or specific management or technical talent) or from training for these items to meet the definition of an intangible asset. There would have to be other legal rights before control could be demonstrated.

Similarly, an entity would not usually be able to recognise an asset for an assembled portfolio of customers or a market share. In the absence of legal rights to protect or other ways to control the relationships with customers or the loyalty of its customers, the entity usually has insufficient control over the expected economic benefits from these items to meet the definition of an intangible asset.

3.1.4 Future economic benefits

The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Those cash flows may come from using the asset or from disposing of it.

Future economic benefits include not only future revenues from the sale of products or services but also cost savings or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may create future economic benefits by reducing future production costs rather than increasing future revenues.

3.2 Recognition and initial measurement of an intangible asset

An item that meets the definition of an intangible asset (see 3.1 above) is recognised if and only if, certain recognition criteria are satisfied. These requirements are shown in the extract below.

Extract from Section 18

- 18.4** An entity shall recognise an intangible asset as an asset if, and only if:
- (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
 - (b) the cost or value of the asset can be measured reliably. *[FRS 102.18.4]*

The term 'asset' is used in this section in a different way to that in paragraph 33 of section 2 of the standard and the Glossary. For the purposes of this section, an asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

[FRS 102.18.4A].

'Probable' is defined as 'more likely than not'. *[FRS 102 Appendix I]*. In assessing whether expected future economic benefits are probable, the entity must use reasonable and supportable assumptions representing management's best estimate of the set of economic conditions that will exist over the useful life of the asset. *[FRS 102.18.5]*. In making the judgement over the degree of certainty attached to the flow of future economic benefits attributable to the use of the asset, the entity considers the evidence available at the time of initial recognition, giving greater weight to external evidence. *[FRS 102.18.6]*.

The test that the item meets both the definition of an intangible asset and the criteria for recognition is performed at the time of initial recognition of the expenditure. On initial recognition, any intangible asset meeting these criteria must be measured at cost. *[FRS 102.18.9]*. If these criteria are not met at the time the expenditure is incurred, an expense is recognised and it is never reinstated as an asset. *[FRS 102.18.17]*.

The guidance in Section 18 on the recognition and initial measurement of intangible assets takes account of the way in which an entity obtained the asset. Separate rules for recognition and initial measurement apply for intangible assets depending on whether they were:

- Acquired separately (see 3.2.1 below)
 - Acquired as part of a business combination (see 3.2.2 below)
 - Generated internally (see 3.2.3 below)
 - Acquired by way of government grant (see 3.2.4 below)
- Or
- Obtained in an exchange of assets (see 3.2.5 below)

3.2.1 Separately acquired intangible assets

3.2.1.A Recognition of separately acquired intangible assets

Separately acquired intangible rights will normally be recognised as assets, provided that they meet the definition of an intangible asset in Section 18.

The criteria for recognising an intangible asset are set out at 3.2 above. The probability recognition criterion in (a) at 3.2 above is always considered satisfied for intangible assets that are separately acquired. *[FRS 102.18.7]*. It is assumed that the price paid to acquire an intangible asset separately usually reflects expectations about the probability that the future economic benefits embodied in it will flow to the entity. In other words, the entity always expects there to be a flow of economic benefits, even if it is uncertain about the timing or amount. In addition, the cost of a separately acquired intangible asset can usually be measured reliably, as required in recognition criterion (b) at 3.2 above, especially in the case of a monetary purchase consideration.

However, not all external costs incurred to secure intangible rights automatically qualify for capitalisation as separately acquired assets, because they do not meet the definition of an intangible asset in the first place. An entity that subcontracts the development of intangible assets (e.g., development-and-supply contracts or R&D contracts) to other parties (its suppliers) must exercise judgement in determining whether it is acquiring an intangible asset or whether it is obtaining goods and services that are being used in the development of an intangible asset by the entity itself. For example, if the entity pays a supplier upfront or by milestone payments during the course of a project, it will not necessarily recognise an intangible asset on the basis of those payments. Only those costs that are incurred after it becomes probable that economic benefits are expected to flow to the entity will be part of the cost of an intangible asset. If a supplier is working on an internal project for the entity, costs can only be capitalised after the criteria have been met for recognising an internally developed intangible asset (see 3.2.3 below).

In determining whether a supplier is providing services to develop an internally generated intangible asset, it can be useful to consider the terms of the supply agreement, in particular whether the supplier is bearing a significant proportion of the risks associated with a failure of the project. For example, if the supplier is always compensated under a development-and-supply contract for development services and tool costs irrespective of the project's outcome, the entity on whose behalf the development is undertaken should account for those activities as its own.

3.2.1.B Initial measurement of separately acquired intangible assets

The standard sets out what comprises the cost of a separately acquired intangible asset as follows:

Extract from Section 18

- 18.10** The cost of a separately acquired intangible asset comprises:
- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
 - (b) any directly attributable cost of preparing the asset for its intended use. [FRS 102.18.10]

Section 18 does not elaborate on what costs may be directly attributable to preparing a separately acquired intangible asset for its intended use. However, based on the guidance included in paragraph 28 of IAS 38, examples may include:

- Costs of employee benefits arising directly from bringing the asset to its working condition.
- Professional fees arising directly from bringing the asset to its working condition.

And

- Costs of testing whether the asset is functioning properly.

Consistent with the requirements in paragraph 32 of IAS 38, capitalisation of expenditure must cease when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. This may well be before the date on which it is brought into use.

3.2.1.C Variable and contingent consideration

The purchase price of an intangible asset (or component thereof) might include variable or contingent amounts. The final purchase price of the intangible asset is not known when the terms include a variable or contingent amount that is linked to future events that cannot be determined at the date of acquisition. The total consideration could vary based on the performance of an asset - for example, the revenue or EBITDA generated, for a specified future period, by the asset or a business in which the asset is used. Some arrangements can contain more than one source of variability.

Generally, where the payment of variable or contingent consideration is outside the control of both the buyer and the seller, we expect that the obligation to make the payment(s) would meet the definition of a financial liability, to be accounted for by applying Section 12 and shall be recognised when the intangible asset is purchased. [FRS 102.22.3A]. This means that any measurement changes to that liability would be recorded in the statement of profit or loss. However, in some instances contracts are more complex and it can be argued that the subsequent changes to the initial estimate of the purchase price should be capitalised as part of the cost of the asset. Further, many consider that these are executory payments that are not recognised until incurred.

How we see it

In the absence of specific guidance, an entity develops an accounting policy for variable consideration relating to the purchase of an intangible asset in accordance with the hierarchy in Section 10 *Accounting Policies, Estimates and Errors*. An entity must exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in its particular circumstances.

In practice, there are different approaches for treating the estimated future variable payments. Some entities do not capitalise these amounts upon initial recognition of the asset and then either expense or capitalise any payments as they are incurred. Other entities include an estimate of future amounts payable on initial recognition with a corresponding liability being recorded. Under this approach subsequent changes in the liability are either capitalised or expensed.

3.2.2 Intangible assets acquired as part of a business combination

3.2.2.A Recognition of intangible assets acquired as part of a business combination

An entity must use judgement to determine whether the acquisition of an intangible asset is the acquisition of an asset or a group of assets, or a business combination within the scope of Section 19. *[FRS 102.18.3A]*.

FRS 102 states:

Extract from Section 18

- 18.8** Intangible assets that are acquired in a business combination must be recognised separately from goodwill when all of the following three conditions are met:
- (a) the recognition criteria in paragraph 4 of Section 18 are met (see 3.2 above);
 - (b) the intangible asset arises from contractual or other legal rights; and
 - (c) the intangible asset is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licenced, rented or exchanged either individually or together with a related contract, asset or liability). *[FRS 102.18.8]*

In addition, an entity can choose to recognise intangible assets separately from goodwill for which the recognition criteria in paragraph 4 of Section 18 of the standard are satisfied and only one of conditions (b) or (c) above is met. *[FRS 102.18.8]*.

Where an entity chooses to recognise such additional intangible assets, this policy must be applied to all intangible assets in the same class (i.e., having a similar nature, function or use in the business), and must be applied consistently to all business combinations. Section 18 adds that licences are an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business. *[FRS 102.18.8]*. When this accounting policy choice is adopted, the acquirer is required to disclose the nature of those additional intangible assets and to explain why they have been separated from goodwill. *[FRS 102.18.28A]*.

If an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. *[FRS 102.18.11]*. As the fair value of an intangible asset must reflect expectations about the probability that the future economic benefits embodied in it will flow to the entity, the probability criterion is always assumed to be satisfied for intangible assets acquired as part of a business combination. In other words, the existence of a fair value means that an inflow of economic benefits is considered to be probable, in spite of any uncertainties about timing or amount.

The analysis of technical issues in Part B of the Basis for Conclusions provides examples of intangible assets that would normally satisfy all three criteria for separate recognition in a business combination. These include licences, copyrights, trademarks, internet domain names, patented technology and legally protected trade secrets. Examples of intangible assets that would not normally satisfy all three criteria include customer lists, customer relationships and unprotected trade secrets (such as recipes or formulae), as no contractual or legal right exists that would give rise to expected future economic benefits. *[FRS 102.BC.B18.10]*.

The separability criterion of Section 18 requires an acquired intangible asset to be 'capable' of being separated or divided from the acquiree. *[FRS 102.18.8(c)]*. This is regardless of the intentions of the acquirer. An intangible asset that is not individually separable from the acquiree or combined entity can still be recognised separately from goodwill if it could be separable in combination with a related contract, identifiable asset or liability. *[FRS 102.18.8(c)]*. For example, an acquiree owns a registered trademark and documented but unpatented technical expertise used to manufacture the trademarked product. The entity could not transfer ownership of the trademark without everything else necessary for the new owner to produce an identical product or service. Because the unpatented technical expertise must be transferred if the related trademark is sold, it is separable. In this example, the asset is separable but not contractual, such that the unpatented technical expertise would only be recognised separately from goodwill under FRS 102 where the acquirer applies a policy of recognising intangible assets separately from goodwill for which the recognition criteria in paragraph 4 of Section 18 of the standard are satisfied and only one of the conditions (b) or (c) above are met.

The process of identifying intangible assets in a business combination might involve, for example:

- Determining whether the entity has chosen to recognise additional intangible assets, or to restrict recognition only to those that meet all three recognition criteria noted above.
- Reviewing the list of items that the FRC believes would usually meet the recognition criteria for an intangible asset referred to above.
- Examining documents such as those related to the acquisition, other internal documents produced by the entity, public filings, press releases, analysts' reports, and other externally available documents.

And

- Comparing the acquired business to similar businesses and their intangible assets

Intangible assets differ considerably between industries and between individual entities. Therefore, considerable expertise and careful judgement is required in determining whether there are intangible assets that need to be recognised and valued separately.

3.2.2.B Initial measurement of intangible assets acquired as part of a business combination

The cost of an intangible asset acquired in a business combination is its fair value at the acquisition date. [FRS 102.18.11]. Section 18 provides no specific guidance on how to determine the fair value of intangible assets acquired in a business combination. Therefore, the requirements in Section 2A *Fair Value Measurement* must be applied. [FRS 102 Appendix I]. The requirements in Section 2A are discussed in Chapter 10, and specific recognition and initial measurement requirements for intangible assets acquired in a business combination are discussed further in Chapter 22 at 2.8.

3.2.3 Internally generated intangible assets

It may be difficult to decide whether an internally generated intangible asset qualifies for recognition because of problems in:

- (a) Confirming whether and when there is an identifiable asset that will generate expected future economic benefits.

And

- (b) Determining the cost of the asset reliably, especially in cases where the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

To avoid the inappropriate recognition of an asset, Section 18 requires that internally generated intangible assets are not only tested against the general requirements for recognition and initial measurement (discussed at 3.1 above), but also meet criteria which confirm that the related activity or project is at a sufficiently advanced stage of development, is both technically and commercially viable and includes only directly attributable costs. Those criteria comprise guidance on accounting for intangible assets in the research phase (see 3.2.3.A below), the development phase (see 3.2.3.B below) and on measurement of an internally generated intangible asset (see 3.2.3.C below).

To assess whether an internally generated asset meets the criteria for recognition, an entity classifies the generation of the asset into a research phase and a development phase. [FRS 102.18.8A]. If an entity cannot distinguish the research phase from the development phase, then all expenditure is treated as research and is recognised as an expense when it is incurred. [FRS 102.18.8B].

3.2.3.A Research

Section 18 provides the following examples of research activities:

Extract from Section 18

18.8G Examples of research activities are:

- (a) Activities aimed at obtaining new knowledge.
- (b) The search for, evaluation and final selection of, applications of research findings and other knowledge.
- (c) The search for alternatives for materials, devices, products, processes, systems or services.
- (d) The formulation, design, evaluation and final selection of possible alternatives for new or improved material, devices, projects, processes, systems or services. [FRS 102.18.8G]

An entity cannot recognise an intangible asset arising from research or from the research phase of an internal project. Instead, any expenditure on research or the research phase of an internal project must be expensed as incurred. [FRS 102.18.8E]. In the research phase of an internal project, the entity cannot demonstrate that there is an intangible asset that will generate probable future economic benefits. [FRS 102.18.8F].

If an entity cannot distinguish the research phase from the development phase, it must treat the expenditure on that project as if it were incurred in the research phase only and recognise an expense accordingly. [FRS 102.18.8B].

3.2.3.B Development

Section 18 provides the following examples of development activities:

Extract from Section 18

18.8J Examples of development activities are:

- (a) The design, construction and testing of pre-production or pre-use prototypes and models.
- (b) The design of tools, jigs, moulds and dies involving new technology.
- (c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.
- (d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services. [FRS 102.18.8J]

In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase. [FRS 102.18.8I].

Entities have an accounting policy choice of whether or not to capitalise qualifying development expenditure. Entities must either recognise an internally generated intangible asset arising from the development phase of a project (provided that specific recognition criteria are met, see below) or recognise the expenditure in profit or loss as incurred. Where an entity adopts a policy of capitalising expenditure in the development phase, the policy must be applied consistently to all expenditure that meets the recognition criteria set out in Section 18. Expenditure that does not meet the conditions for capitalisation must be expensed as incurred. [FRS 102.18.8K].

An intangible asset arising from development can be recognised if, and only if, the entity is able to demonstrate that all of the following criteria set out in the extract from the standard below have been met.

Extract from Section 18

18.8H An entity may recognise an intangible asset arising from development (or from the development phase of an internal project) if, and only if, an entity can demonstrate all of the following:

- (a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- (b) Its intention to complete the intangible asset and use or sell it.
- (c) Its ability to use or sell the intangible asset.
- (d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- (e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- (f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development. [FRS 102.18.8H]

It may be challenging to demonstrate each of the above conditions because:

- Condition (b) relies on management intent.
And
- Conditions (c), (e) and (f) are entity-specific, i.e., whether development expenditure meets any of these conditions depends both on the nature of the development activity itself and the financial position of the entity.

Evidence demonstrating the availability of resources to complete, use and sell the intangible asset may be available in the form of:

- A business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources.
- A lender's indication of its willingness to fund the plan confirming the availability of external finance.
And
- Detailed project information demonstrating that an entity's costing systems can measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

In any case, an entity must maintain books and records in sufficient detail that allow it to prove whether it meets the conditions set out in (a) to (f) above. Certain types of products (e.g., pharmaceuticals, aircraft and electrical equipment) require regulatory approval before they can be sold. Regulatory approval is not one of the criteria for recognition and therefore entities are not prohibited from capitalising development costs in advance of approval. However, in some industries regulatory approval is vital to commercial success and its absence indicates significant uncertainty around the possible future economic benefits. This is the case in the pharmaceuticals industry, where it is rarely possible to determine whether a new drug will secure regulatory approval until it is actually granted. Accordingly, it is common practice in this industry for costs to be expensed until such approval is obtained.

3.2.3.C Measurement of internally generated intangible assets

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria in Section 18 set out at 3.2 above and the conditions for capitalising development costs set out at 3.2.3.B above. [FRS 102.18.10A].

Costs incurred before these criteria are met are expensed and cannot be reinstated retrospectively. [FRS 102.18.17].

The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are: [FRS 102.18.10B]

- (a) Costs of materials and services used or consumed in generating the intangible asset
- (b) Costs of employee benefits arising from the generation of the intangible asset
- (c) Fees to register a legal right
And

- (d) Amortisation of patents and licences that are used to generate the intangible asset.

Borrowing costs eligible for capitalisation under Section 25 *Borrowing Costs* may be recognised as an element of the cost of an internally generated intangible asset, provided the entity adopts an accounting policy of capitalising eligible borrowing costs. See Chapter 27.

Paragraph 67 of IAS 38 specifically prohibits recognition of the following items as a component of cost because they are not directly attributable costs:

- (a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use.
- (b) Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance.
And
- (c) Expenditure on training staff to operate the asset.

These costs would also not be considered directly attributable costs eligible for recognition as part of the cost of an internally generated intangible asset under Section 18.

An example of indirect and other general overhead expenditure that may be considered directly attributable to preparing an asset for use would be the depreciation of a research and development facility and the associated overheads such as electricity or insurance, if this facility was used in the creation of internally generated intangible assets.

3.2.3.D Expenditure that does not qualify for recognition as an internally generated intangible asset

In some cases, expenditure is incurred that does not meet the criteria for recognition as part of an internally generated intangible asset, for example because there is no intangible asset that can be recognised in accordance with the criteria set out at 3.2.3.B above or because the costs cannot be distinguished from the cost of developing the business as a whole. Expenditure on the following items must be recognised as an expense and must not be recognised as intangible assets: *[FRS 102.18.8C]*

- (a) Internally generated brands, logos, publishing titles, customer lists and items similar in substance.
 - (b) Start-up activities (i.e., start-up costs), which include establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (i.e., pre-opening costs) and expenditure for starting new operations or launching new products or processes (i.e., pre-operating costs).
 - (c) Training activities.
 - (d) Advertising and promotional activities (unless it meets the definition of inventories held for distribution at no or nominal consideration. See 3.2.3.E below).
 - (e) Relocating or reorganising part or all of an entity.
- And
- (f) Internally generated goodwill.

For these purposes no distinction is made between costs that are incurred directly by the entity and those that relate to services provided by third parties. However, Section 18 does not prevent an entity from recording a prepayment as an asset if it pays for the delivery of goods before obtaining a right to access those goods. Similarly, a prepayment can be recognised when payment is made before services are received. *[FRS 102.18.8D]*.

3.2.3.E Measurement of intangible assets: income from incidental operations while an asset is being developed

When an entity generates income while it is developing or constructing an asset, the question arises as to whether this income reduces the initial carrying value of the asset being developed or must be recognised in profit or loss. Section 18 is silent on this issue. For IFRS reporters, IAS 38 requires the entity to consider whether the activity giving rise to income is necessary to bring the asset to the condition necessary for it to be capable of operating in the manner intended by management, or not. Entities reporting under FRS 102 may consider applying a similar assessment using the GAAP hierarchy in Section 10. IAS 38 requires the income and related expenses of incidental operations (being those not necessary to develop the asset for its intended use) be recognised immediately in profit or loss and included in their respective classifications of income and expense. *[IAS 38.31]*.

Whilst IAS 38 is not explicit on the matter, it follows that when the activity is determined to be necessary to bring the intangible asset into its intended use, any income must be deducted from the cost of the asset. An example would be where income is generated from the sale of samples produced during the testing of a new process or from the sale of a production prototype. However, care must be taken to confirm whether the incidence of income indicates that the intangible asset is ready for its intended use, in which case capitalisation of costs would cease, income would be recognised in profit or loss and the related costs of the activity would include a measure of amortisation of the asset.

3.2.3.F Advertising and promotional expenditure

As set out at 3.2.3.D above, FRS 102 generally requires expenditure on advertising and promotional activities to be recognised as an expense as incurred. However, Section 18 gives an exception for advertising and promotional activities that meet the definition of inventories held for distribution at no or nominal consideration. *[FRS 102.18.8C(d)]*.

Items covered by this definition may include stocks of brochures and other marketing material. Advertising and promotional expenditure that meets the definition of inventories held for distribution at no or nominal consideration must be included within inventories. This is discussed further in Chapter 16 at 3.2.11.

3.2.4 Intangible assets acquired by way of a grant

An intangible asset may sometimes be acquired free of charge, or for nominal consideration, by way of a government grant. Governments frequently allocate airport-landing rights, licences to operate radio or television stations, emission rights, import licences or quotas, or rights to access other restricted resources.

Section 18 does not set out any separate recognition criteria for intangible assets acquired by way of a grant. The recognition criteria for government grants are set out in Section 24 *Government Grants* (see Chapter 26).

The cost of an intangible asset acquired by way of a grant is its fair value at the date the grant is received or receivable in accordance with Section 24 *Government Grants* in respect of government grants or, for public benefit entities, Section 34 (see Chapter 36) in respect of incoming resources from non-exchange transactions as appropriate. [FRS 102.18.12]. Some permits allocated by government, such as milk quotas, are freely traded and therefore have a readily ascertainable fair value. However, it may be difficult to reliably measure the fair value of every kind of permit allocated by government because they may have been allocated for nil consideration, may not be transferable and may only be bought and sold as part of a business. Despite this, FRS 102 does not permit entities to recognise intangible assets acquired by way of government grant at a nominal value.

3.2.5 Exchanges of assets

An entity might swap certain intangible assets that it does not require or is no longer allowed to use for those of a counterparty that has other surplus assets. For example, it is not uncommon for airlines and media groups to exchange landing slots and newspaper titles, respectively, to meet demands of competition authorities.

Section 18 requires intangible assets acquired in exchange for non-monetary assets, or a combination of monetary and non-monetary assets, to be measured at fair value unless: [FRS 102.18.13]

(a) The exchange transaction lacks commercial substance.

Or

(b) The fair value of neither the asset received, nor the asset given up is reliably measurable.

If the fair value of neither the asset received, nor the asset given up, can be measured reliably the acquired intangible asset is measured at the carrying amount of the asset given up. [FRS 102.18.13(b)].

The acquired intangible asset must also be measured at the carrying amount of the asset given up if the exchange transaction lacks commercial substance. This is because it would not be appropriate to recognise a gain or loss on a transaction that lacks commercial substance. FRS 102 provides no guidance to assist entities in assessing whether a transaction has commercial substance. Under IFRS, IAS 38 requires that an entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. [IAS 38.46]. A similar assessment may need to be made under Section 18. In some cases, the assessment may be clear without an entity having to perform detailed calculations.

3.3 Subsequent measurement

Section 18 permits an entity to choose between two alternative treatments for the subsequent measurement of intangible assets: [FRS 102.18.18]

- The cost model

Or

- The revaluation model

When the revaluation model is selected, it must be applied to all intangible assets in the same class of asset. If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset is carried at its cost less any accumulated amortisation and impairment losses. [FRS 102.18.18]. A class of assets is a grouping of assets of a similar nature and use in an entity's operations. [FRS 102 Appendix I]. Examples of separate classes of intangible asset may include:

- (a) Brand names
- (b) Mastheads and publishing titles
- (c) Computer software
- (d) Licences and franchises

- (e) Copyrights, patents and other industrial property rights, service and operating rights
- (f) Recipes, formulae, models, designs and prototypes
- And
- (g) Intangible assets under development

3.3.1 Cost model for measurement of intangible assets

Under the cost model, an entity must measure its intangible assets at cost less accumulated amortisation and any accumulated impairment losses. *[FRS 102.18.18A]*. The rules on amortisation of intangible assets are discussed at 3.3.3 below and impairment is discussed at 3.3.5 below.

3.3.2 Revaluation model for measurement of intangible assets

The revaluation model is only available if there is an active market for the intangible asset. *[FRS 102.18.18B]*. This will only rarely be the case (see 3.3.2.A below). Accordingly, Section 18 does not allow fair value to be determined indirectly, for example by using the same valuation techniques applied to estimate the fair value of intangible assets acquired in a business combination.

After initial recognition an intangible asset must be carried at a revalued amount, which is its fair value at the date of the revaluation less any subsequent accumulated amortisation and subsequent accumulated impairment losses. *[FRS 102.18.18B]*. To prevent an entity from circumventing the recognition rules of Section 18, the revaluation model does not allow: *[FRS 102.18.18C]*

- The revaluation of intangible assets that have not previously been recognised as assets.

Or

- The initial recognition of intangible assets at amounts other than cost.

These rules are designed to prevent an entity from recognising at a 'revalued' amount an intangible asset that was never recorded because its costs were expensed as they did not, at the time, meet the recognition criteria. Section 18 does not permit recognition of past expenses as an intangible asset at a later date.

[FRS 102.18.17].

However, an entity is permitted to apply the revaluation model to the whole of an intangible asset even if only part of its cost was originally recognised as an asset because it did not meet the criteria for recognition until part of the way through the development process. *[FRS 102.18.18F]*.

Where the revaluation model is applied, assets in the same class must be revalued at the same time. To do otherwise would allow selective revaluation of assets and the reporting of a mixture of costs and values as at different dates within the same asset class.

3.3.2.A Revaluation is allowed only if there is an active market

An entity can only elect to apply the revaluation model if the fair value can be determined by reference to an active market for the intangible asset. *[FRS 102.18.18B]*. An active market is a market in which all the transactions for the asset or liabilities take place with sufficient frequency and volume to provide pricing information on an ongoing basis. *[FRS 102 Appendix I]*.

Few intangible assets will be eligible for revaluation as such an active market would be uncommon. By their very nature most intangible assets are unique or entity specific. Intangible assets such as brands, newspaper mastheads, music and film publishing rights, patents or trademarks are ineligible for revaluation because each such asset is unique. The existence of a previous sale and purchase transaction is not sufficient evidence for the market to be regarded as active because of the requirement in the definition for a sufficient frequency and volume of transactions to allow the provision of ongoing pricing information. In addition, if prices are not available to the public, this is evidence that an active market does not exist.

If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for that particular asset, the asset must be carried at its cost less any accumulated amortisation and impairment losses. *[FRS 102.18.18J]*.

If the fair value of a previously revalued intangible asset can no longer be determined by reference to an active market, the valuation is 'frozen' at the date of the last revaluation by reference to the active market. The carrying amount of the asset is reduced thereafter by subsequent accumulated amortisation and any subsequent accumulated impairment losses. *[FRS 102.18.18E]*.

3.3.2.B Frequency of revaluations

If there is an active market, Section 18 requires revaluation to be performed “with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period”. [FRS 102.18.18D]. Section 18 lets entities judge for themselves the frequency of revaluations depending on the volatility of the fair values of the underlying intangible assets. Significant and volatile movements in quoted prices may necessitate annual revaluation, whereas a less frequent update would be required for intangibles whose price is subject only to insignificant movements. Nevertheless, since an entity can only revalue assets for which a price is quoted in an active market, there is no impediment to updating that valuation at each reporting date. As noted at 3.3.2 above, where the revaluation model is applied, assets in the same class must be revalued at the same time.

3.3.2.C Accounting for gains and losses on revaluations

Increases in an intangible asset’s carrying amount as a result of a revaluation must be recognised in other comprehensive income and accumulated in equity, except to the extent that the revaluation reverses previous revaluation decreases of the same asset that were recognised in profit or loss. In this case, the increases must be recognised in profit or loss. [FRS 102.18.18G]. Conversely, decreases in an intangible asset’s carrying amount as a result of a revaluation must be recognised in other comprehensive income to the extent of any previous revaluation increases of the same asset that are accumulated in equity. Any excess revaluation loss must be recognised in profit or loss. [FRS 102.18.18H].

For UK entities, the Regulations require that revaluation surpluses, net of provisions for amortisation or impairment, must be shown in the balance sheet within a separate reserve (the revaluation reserve) and not within retained earnings. [1 Sch 35].

3.3.3 Amortisation of intangible assets

After initial recognition, Section 18 requires an entity to allocate the depreciable amount of an intangible asset on a systematic basis over its useful life. [FRS 102.18.21]. Depreciable amount is the cost, or other amount substituted for cost, of the intangible asset, less its residual value. [FRS 102 Appendix I]. The amortisation charge for each period depends on the useful life of the intangible asset, the amortisation method applied and the residual value of the intangible asset. These factors are discussed at 3.3.3.A, 3.3.3.B and 3.3.3.C below.

The amortisation charge for each period must be recognised in profit or loss, unless another section of FRS 102 requires the cost to be recognised as part of the cost of an asset. For example, the amortisation of an intangible asset must be included in the costs of inventories or property, plant and equipment.

[FRS 102.18.21].

Amortisation must be charged on all intangible assets. This requirement applies even to intangible assets measured under the revaluation model. For guidance on depreciation of revalued assets see Chapter 20 at 3.7.3.A.

3.3.3.A Assessing the useful life of an intangible asset

The useful life of an intangible asset is: [FRS 102 Appendix I]

(a) The period over which an asset is expected to be available for use by an entity.

Or

(b) The number of production or similar units expected to be obtained from the asset by an entity.

Thus, if appropriate, the useful life of an intangible asset is expressed as a number of production or similar units rather than a period of time.

For the purposes of FRS 102, all intangible assets including those under the revaluation model, must be considered to have a finite useful life. [FRS 102.18.19].

Where an intangible asset arises from contractual or other legal rights, its useful life is the shorter of:

- The period of the contractual or other legal rights.
- And
- The period over which the entity expects to use the asset. [FRS 102.18.19].

If the contractual or other legal rights can be renewed, the useful life of the intangible asset will include the renewal period only if there is evidence to support renewal by the entity without significant cost.

[FRS 102.18.19]. An entity needs to exercise judgement in assessing what it regards as a significant cost. The following factors that are set out in paragraph 96 of IAS 38 may indicate that an entity is able to renew the contractual or other legal rights without significant cost: [IAS 38.96]

- (a) There is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent.
- (b) There is evidence that any conditions necessary to obtain renewal will be satisfied.

And

- (c) The cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.

If there is no evidence to support renewal of the contractual or legal rights by the entity without significant cost, then the useful life of the intangible asset must not include the renewal period. In this case, the original asset's useful life ends at the contractual renewal date. If the rights are then renewed at the renewal date, we would expect the renewal cost to be treated as the cost to acquire a new intangible asset.

How we see it

In our view, a number of factors may be considered in estimating the useful life of an intangible asset, including:

- (a) The expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team.
- (b) Typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way.
- (c) Technical, technological, commercial or other types of obsolescence.
- (d) The stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset.
- (e) Expected actions by competitors or potential competitors.
- (f) The level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level.
- (g) The period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases.

And

- (h) Whether the useful life of the asset is dependent on the useful life of other assets of the entity.

If an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life must not exceed ten years. [FRS 102.18.20]. However, this must not be considered an automatic default. Entities must not underestimate the useful life of an intangible asset on the basis of this requirement. Similarly, it must not be used to justify a useful life of ten years for an intangible asset for which a shorter useful life may be appropriate. Section 18 states that an entity is only expected to be unable to make a reliable estimate of the useful life of an intangible asset 'in exceptional cases'. [FRS 102.18.20].

Where an intangible asset is acquired in a business combination, but the acquiring entity does not intend to use it to generate future cash flows, it is unlikely that it could have anything other than a finite useful life.

How we see it

In our view, where an intangible asset is acquired in a business combination, but the acquiring entity does not intend to use it to generate future cash flows, an entity would not recognise an immediate impairment loss on acquisition. However, the estimated useful life of the asset is likely to be relatively short.

3.3.3.B Amortisation method

An entity must choose an amortisation method that reflects the pattern in which it expects to consume the asset's future economic benefits. If the entity cannot determine that pattern reliably, it must use the straight-line method. [FRS 102.18.22]. A variety of amortisation methods may be used to depreciate an intangible asset on a systematic basis over its useful life. The straight-line method is the most common seen in practice. The unit of production method or reducing balance method are also sometimes seen. Whilst an amortisation method based on estimated total output (a unit of production method) may be appropriate, an amortisation method based on the pattern of expected revenues is not. This is because a revenue-based method reflects a pattern of generation of economic benefits from operating the business (of which the asset is a part), rather than the consumption of the economic benefits embodied in the asset itself. The difference is more obvious when unit prices are expected to increase over time.

In selecting an appropriate amortisation method for intangible assets acquired in a business combination, entities must ensure consistency with any assumptions that were used in determining the fair value of the asset. For example, a customer relationship asset may be valued by taking into account an assumed churn-rate that implies a higher level of customer relationships ending in the earlier periods following the business combination. These factors may indicate that a straight-line method of amortisation is not the most appropriate method to reflect the pattern of consumption of the economic benefits that the intangible asset provides, as the valuation assumed that benefit to be frontloaded.

Amortisation begins when the intangible asset is available for use, i.e., when it is in the location and condition necessary for it to be usable in the manner intended by management. Therefore, even if an entity is not using the asset, it must still be amortised if it is available for use. Amortisation will cease when the asset is derecognised (see 3.3.6 below). [FRS 102.18.22].

3.3.3.C Residual value

Section 18 requires entities to assume a residual value of zero for an intangible asset, unless there is a commitment by a third party to purchase the asset at the end of its useful life or there is an active market for the asset from which to determine its residual value and it is probable that such a market will exist at the end of the asset's useful life. [FRS 102.18.23].

Given the definition of 'active market' (see 3.3.2.A above) it seems unlikely that an entity will be able to prove that the residual value of an intangible asset is other than zero.

3.3.3.D Amortisation of intangible assets with a residual value

The Note on Legal Requirements to FRS 102 provides guidance on the amortisation of intangible assets which have a residual value. When an intangible asset has a residual value, it is the depreciable amount that is amortised. [FRS 102.A3.37A]. See 3.3.3 above. As noted at 3.3.3.C above, the FRC believes that it is uncommon for an intangible asset to have a residual value and FRS 102 requires an entity to assume that the residual value is zero unless there is a commitment by a third party to purchase the asset at the end of its useful life or there is an active market for the asset from which to determine its residual value and it is probable that such a market will exist at the end of the asset's useful life. [FRS 102.18.23].

However, in those cases where an intangible asset does have a residual value that is not zero, the amortisation of the depreciable amount of the asset over its useful economic life is a departure from the requirements of paragraph 22 of Schedule 1 to the Regulations (and its equivalents in Schedules 2 and 3 to the Regulations and to the LLP Regulations respectively) since the regulations require intangible assets to be written off over their useful economic lives. In those circumstances, the FRC states that entities must invoke a true and fair override and make the disclosures required by paragraph 10(2) of Schedule 1 to the Regulations for the use of a true and fair override. [FRS 102.A3.37A].

3.3.3.E Review of amortisation period and amortisation method

Factors such as a change in how an intangible asset is used, technological advancement, or changes in market prices may indicate that the residual value or useful life of an intangible asset has changed since the most recent annual reporting date. If such indicators are present, management must review previous estimates and, if current expectations differ, amend the residual value, amortisation method or useful life to reflect current expectations. [FRS 102.18.24].

Changes in residual value, amortisation method or useful life must be accounted for prospectively as a change in accounting estimate in accordance with Section 10 of FRS 102. [FRS 102.18.24].

If the residual value of an intangible asset increases to an amount greater than the asset's carrying amount, the asset's amortisation charge would be zero until its residual value decreases to an amount below the asset's carrying amount.

3.3.4 Subsequent expenditure

Entities may sometimes incur expenditure on an acquired intangible asset after its initial recognition or on an internally generated intangible asset after its completion.

Section 18 provides no separate rules on the recognition of subsequent expenditure on intangible assets. Instead, subsequent expenditure that meets the general recognition criteria for intangible assets, discussed at 3.2 above, may be recognised as an addition to an intangible asset. Paragraph 20 of IAS 38 notes that in practice, most subsequent expenditure on intangible assets will maintain the expected future economic benefits embodied in the existing intangible asset and will not satisfy the recognition criteria in IAS 38. In addition, this paragraph notes that it is often difficult to attribute subsequent expenditure directly to an individual intangible asset rather than to the whole business. The same challenges equally apply under Section 18 and therefore, only rarely would we expect subsequent expenditure to be recognised in the carrying amount of an asset.

3.3.5 Impairment losses

Entities must refer to the requirements of Section 27 to determine whether an intangible asset is impaired. [FRS 102.18.25]. See Chapter 29.

Section 27 requires entities to assess at each reporting date whether there is any indication that an intangible asset may be impaired. If there are indicators of impairment, the entity must estimate the recoverable amount of the intangible asset. [FRS 102.27.7]. Section 27 explains how the entity does this and when it recognises or reverses an impairment loss. [FRS 102.18.25].

If there are indicators that an intangible asset is impaired, this could indicate that the entity must review the remaining useful life, amortisation method or residual value of the intangible asset, even if no impairment loss is recognised for the asset. [FRS 102.27.10].

3.3.6 Retirements and disposals

An intangible asset must be derecognised on disposal or when no future economic benefits are expected from its use or disposal. [FRS 102.18.26].

The gain or loss on derecognition, being the difference between the net disposal proceeds and the carrying amount of the asset must be accounted for in profit or loss. [FRS 102.18.26]. This means that any revaluation surplus relating to the asset disposed of is transferred directly to retained earnings and not reflected in profit or loss.

3.4 Presentation and disclosure

The main requirements of Section 18 are set out below, but it may be necessary to refer also to the disclosure requirements of Section 27 in the event of an impairment of an intangible asset (see Chapter 29).

3.4.1 Presentation of intangible assets

Entities are required by Schedule 1 of the Regulations to present a separate heading for intangible assets on the face of the balance sheet. Intangible assets must be analysed into the following sub-headings, either on the face of the balance sheet, or within the notes to the accounts:

- Development costs
- Concessions, patents, licenses, trademarks and similar rights and assets
- Goodwill
- And
- Payments on account

However, company law permits all entities to adapt the subheadings set out above to suit the nature of the entity's business. [1 Sch 4(1)].

3.4.2 General disclosures

Section 18 requires certain disclosures to be presented by class of intangible assets.

The extract below, specifies the disclosures for each class of intangible assets identified.

Extract from Section 18

18.27 An entity shall disclose the following for each class of intangible assets:

- (a) the useful lives or the amortisation rates used and the reasons for choosing those periods;
- (b) the amortisation methods used;
- (c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the reporting period;
- (d) the line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which any amortisation of intangible assets is included; and
- (e) a reconciliation of the carrying amount at the beginning and end of the reporting period showing separately:
 - (i) additions, indicating separately those from internal development and those acquired separately;
 - (ii) disposals;
 - (iii) acquisitions through business combinations;
 - (iv) revaluations;
 - (v) amortisation;
 - (vi) impairment losses recognised or reversed in profit or loss in accordance with Section 27 *Impairment of Assets*; and
 - (vii) other changes.
- (f) The reconciliation need not be presented for prior periods. *[FRS 102.18.27]*

In addition to the disclosures required above, any impairment of intangible assets is to be disclosed in accordance with Section 27. *[FRS 102.27.33(d)]*. The nature and effect of any change in useful life, amortisation method or residual value estimates must be disclosed. *[FRS 102.10.18]*.

Entities are also required to provide the information per the extract below, to the extent that it applies:

Extract from Section 18

18.28 An entity shall also disclose:

- (a) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements;
 - (b) for intangible assets acquired by way of a grant and initially recognised at fair value (see paragraph 18.12):
 - (i) the fair value initially recognised for these assets; and
 - (ii) their carrying amounts.
 - (c) the existence and carrying amounts of intangible assets to which the entity has restricted title or that are pledged as security for liabilities; and
 - (d) the amount of contractual commitments for the acquisition of intangible assets.
- [FRS 102.18.28]*

3.4.3 Disclosure of research and development expenditure

Entities must disclose the aggregate amount of research and development expenditure recognised as an expense during the period (i.e., the amount of expenditure incurred internally on research and development that has not been capitalised as an intangible asset or as part of the cost of another asset that meets the recognition criteria of FRS 102). *[FRS 102.18.29]*.

Where an entity has elected to capitalise development costs, company law requires disclosure of:

[1 Sch 21(2)]

(a) The period over which the amount of the costs that were originally capitalised is being written off.

And

(b) The reasons for capitalising the development costs.

Unamortised development costs included as an asset in a company's accounts must be treated as a realised loss for the purpose of calculating a company's distributable profits. However, in special circumstances directors may be able to justify a decision that unamortised development costs included as an asset in a company's accounts must not be treated as a realised loss. In such cases, the circumstances relied upon by the directors in reaching this justification must be disclosed. [s844].

3.4.4 Additional disclosures when the revaluation model is applied

If intangible assets are accounted for at revalued amounts, an entity must disclose the following listed in the extract below:

Extract from Section 18

18.29A If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:

- (a) the effective date of the revaluation;
- (b) whether an independent valuer was involved;
- (c) the methods and significant assumptions applied in estimating the assets' fair values; and
- (d) for each revalued class of intangible assets, the carrying amount that would have been recognised had the assets been carried under the cost model. [FRS 102.18.29A]

UK Company law requires the following additional disclosures:

- (a) The years in which the intangible assets were separately valued (so far as known to the directors) and the separate values. [1 Sch 52].
- (b) For intangible assets that have been revalued in the financial year, the names of the persons who valued them or particulars of their qualifications for doing so, and the basis of valuation used by them. [1 Sch 52]. However, as FRS 102 allows the use of the revaluation model only where fair value can be determined by reference to an active market, this company law requirement is likely to be of limited relevance to FRS 102 reporters.

And

- (c) Separate disclosure of the revaluation reserve on the company balance sheet. [1 Sch 35(2)].

3.4.5 Disclosures for additional intangible assets recognised as part of a business combination

When, as part of a business combination, an acquirer elects to recognise intangible assets separately from goodwill for which the recognition criteria in paragraph 4 of Section 18 are satisfied and only one of condition (b) or (c) above is met (see 3.2.2.A above), the nature of those additional intangible assets and the reason why they have been separated from goodwill must be disclosed. [FRS 102.18.28A].

4 Practical issues

4.1 Website costs

There is no specific guidance on the accounting for website development costs under FRS 102. Given their lack of physical substance, it is likely that these costs would be classified as intangible assets under FRS 102 (see 3.1.2 above). However, certain elements related to developing a website, such as web servers, do have physical substance. Entities may therefore have to exercise judgement in determining whether to apply Section 18 or Section 17 to the elements of a website with physical substance.

Website costs classified as intangible assets would be subject to the specific recognition requirements for internally generated intangible assets within Section 18.

4.2 Cloud computing arrangements

As the use of technology, data and connectivity expands, cloud computing arrangements are becoming more common. Cloud computing arrangements are arrangements in which the customer does not currently have possession of the underlying software used in the arrangement. Rather, the customer accesses and uses the software on an as-needed basis (e.g., through the internet, or via a dedicated line). Examples of cloud computing arrangements include software as a service, platform as a service, infrastructure as a service and other hosting arrangements. FRS 102 does not contain explicit guidance on a customer's accounting for cloud computing arrangements or the costs to implement them.

IFRS IC agenda decisions were issued in March 2019¹⁰² and March 2021¹⁰³ which provided additional guidance for IFRS reporters to apply when accounting for cloud computing arrangements. We do not expect an FRS 102 reporter to automatically refer to an IFRS IC agenda decision on all occasions. Instead, management should firstly assess whether there are any conflicts with the requirements of FRS 102 (including the definitions, recognition criteria, measurement concepts and pervasive principles in Section 2). If no conflict exists, management should consider whether the accounting policy adopted complies with the requirements of FRS 102 in the light of the guidance provided in the agenda decisions. This would include, if necessary, consideration of the hierarchy in the Section 10 of FRS 102, discussed in Chapter 9 at 3.1. Where the hierarchy is being applied to develop an accounting policy based on IFRS, a summary of the applicable guidance and how to apply it, can be found in our publication, *Applying IFRS: Accounting for cloud computing costs*.¹⁰⁴

4.3 Industry specific practical issues

Entities in certain industries may encounter issues in accounting for intangible assets that are common across the industry. Industry specific issues are not explicitly addressed by Section 18. Entities encountering the following industry specific issues may wish to consider guidance in the EY publication, International GAAP® in formulating appropriate accounting policies under FRS 102:

- Research and development in the pharmaceutical industry
- Agile software development
- Rate-regulated activities
- Emission trading schemes
- Accounting for green certificates or renewable energy certificates
- Accounting considerations for voluntary carbon credits
- Accounting for REACH costs
- Crypto-assets
- And
- Television and telecommunications programme and broadcast rights

¹⁰² [IFRIC Update](#), March 2019, available on the IFRS Foundation's website (accessed on 2 October 2025)

¹⁰³ [IFRIC Update](#), March 2021, available on the IFRS Foundation's website (accessed on 2 October 2025)

¹⁰⁴ [Applying IFRS: Accounting for cloud computing costs](#) (accessed on 2 October 2025)

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Cost of separately acquired intangible assets	Comprises purchase price, import duties and non-refundable taxes, trade discounts and rebates; and directly attributable costs of preparing the asset for its intended use. See 3.2.1.B above	Similar to FRS 102, with additional guidance provided.
Intangible assets acquired in a business combination	Required only to recognise separately from goodwill those intangible assets that satisfy the general recognition criteria (see 3.2 above), and both of the following conditions are met: (a) The intangible asset arises from contractual or other legal rights. And (b) The intangible asset is separable. Entities can voluntarily adopt an accounting policy to recognise additional intangible assets of a particular class separately from goodwill where only one of conditions (a) or (b) are met. See 3.3.2.A above.	Must recognise separately from goodwill where the intangible asset meets the general recognition criteria in IAS 38 and either: (a) The intangible asset arises from contractual or other legal rights. Or (b) The intangible asset is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licenced, rented or exchanged either individually or together with a related contract, asset or liability).
Intangible assets acquired by government grant	Cost of the asset is its fair value at the date the grant is received or receivable. See 3.2.4 above.	Accounting policy choice - measure at fair value or a nominal amount.
Advertising and promotional expenditure	Certain advertising and promotional expenditure must be carried as an asset within inventories. See 3.2.3.F above.	Expenditure on advertising and promotional activities is recognised as an expense when it is incurred.
Development expenditure	Accounting policy choice - an entity may recognise an intangible asset arising from development or from the development phase of an internal project if certain criteria are met. See 2.3 above.	An entity must recognise an intangible asset arising from development or from the development phase of an internal project if certain criteria (which are consistent with FRS 102) are met.
Amortisation	Intangible assets are amortised over a finite useful life. If an entity is unable to make a reliable estimate, the useful life must not exceed ten years.	Intangible assets with finite useful lives are amortised over their useful lives. An intangible asset with an indefinite useful life is not amortised.
	Renewal periods are included in the useful life of intangible assets that arise from contractual or legal right conveyed for a finite term only if	Consistent with FRS 102. Additionally, IAS 38 provides examples of indicators that an entity could renew

FRS 102		IFRS
	there is evidence to support renewal by the entity without significant cost.	the contractual or legal rights without significant cost.
	Review the amortisation method, useful life and residual value of intangible assets if there are indicators that any of these have changed. See 3.3.3 above.	Review the amortisation method, useful life and residual value of intangible assets at least at each financial year end.
Impairment reviews	Required if there are indicators of impairment. See 3.3.5 above.	Consistent with FRS 102 except impairment reviews required annually, and whenever indicators of impairment, for indefinite lived intangibles and intangible assets not yet available for use.
Intangible assets acquired in exchange for non-monetary assets	Measured at fair value unless the exchange transaction lacks commercial substance; or the fair value of neither the asset received nor the asset given up is reliably measurable. In that case, the asset's cost is measured at the carrying amount of the asset given up. See 3.2.5 above.	Similar to FRS 102. IAS 38 additionally provides guidance on determining whether a transaction has commercial substance.
Disclosures	The disclosures required by FRS 102 are set out at 3.4 above. The reconciliation table (i.e., opening balances to ending balances) is required only for current period.	Similar to FRS 102. IFRS requires a reconciliation of the carrying amount of intangible assets at the beginning and end of the reporting period for both the current and comparative period. In addition, there are some differences in the items to be included in the reconciliation table

Appendix A - Defined terms

Extracts from FRS 102

Appendix I Glossary

active market	A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on ongoing basis.
amortisation	The systematic allocation of the depreciable amount of an asset over its useful life.
asset	A present economic resource controlled by the entity as a result of past events.
control	The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
class of assets	A grouping of assets of a similar nature and use in an entity's operations.
depreciable amount	The cost of an asset, or other amount substituted for cost (in the financial statements), less its residual value.
development	The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. In the absence of any specific guidance provided in the relevant section of FRS 102, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
identifiable	An asset is identifiable when: (a) it is separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
impairment loss	For assets other than inventories, the amount by which the carrying amount of an asset exceeds its recoverable amount.
intangible asset	An identifiable non-monetary asset without physical substance. Such an asset is identifiable when: (a) it is separable, i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
inventories held for distribution at no or nominal consideration	Assets that are: (a) held for distribution at no or nominal consideration in the ordinary course of operations; (b) in the process of production for distribution at no or nominal consideration in the ordinary course of operations; or (c) in the form of material or supplies to be consumed in the production process or in the rendering of services at no or nominal consideration.

monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
non-exchange transaction	A transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange or gives value to another entity without directly receiving approximately equal value in exchange.
public benefit entity	An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.
research	Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
residual value	The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
useful life	The period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

Chapter 22 Business combinations and goodwill

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Overview

This chapter discusses the principles and requirements that an acquirer applies in accounting for a business combination under Section 19 *Business Combinations and Goodwill*, including the initial recognition and measurement requirements for non-controlling interest and goodwill. A business combination is defined as "...the bringing together of separate entities or businesses into one reporting entity". [FRS 102.19.3, FRS 102 Appendix I]

Section 19 also addresses group reconstructions (as defined) but scopes out the formation of a joint venture in the financial statements of the joint venture itself (which is discussed in Chapter 18 at 3.8 and Chapter 8 at 3.8), and the acquisition of an asset or a group of assets that does not constitute a business (see 3.1 below). In addition, Section 34 *Specialised Activities* addresses public benefit entity combinations (see Chapter 36).

What you need to know

- Section 19 requires an entity to determine whether a transaction or event is a business combination. Judgement may be required to determine whether the transaction or event is the acquisition of a business or a group of assets.
- A business combination (with limited exceptions) is accounted for by applying the purchase method. The exceptions are for group reconstructions meeting specified criteria and for public benefit entity combinations that are in substance a gift or that are a merger.
- The application of the purchase method involves identifying an acquirer; determining the acquisition date; measuring the cost of the business combination; allocating the cost of the business combination to the identifiable assets acquired, and liabilities and provisions for contingent liabilities assumed (by recognising these at acquisition-date fair values, with limited exceptions) and recognising and measuring any non-controlling interest in the acquiree; and recognising and measuring goodwill or negative goodwill.
- Goodwill is amortised on a systematic basis over a finite useful life in line with the principles of Section 18 *Intangible Assets other than Goodwill* and assessed for impairment in line with the principles of Section 27 *Impairment of Assets*.
- If negative goodwill is recognised, it is recognised on the face of the statement of financial position and an amount up to the fair value of the non-monetary assets acquired is recognised in profit or loss in the periods in which the non-monetary assets are recovered. Any negative goodwill in excess of the fair values of non-monetary assets acquired is released in profit and loss in the periods expected to benefit.
- If the assets acquired and liabilities assumed do not constitute a business, the transaction is to be accounted for as an acquisition of a group of assets (see 3.1 below).
- Section 19 also addresses the accounting for group reorganisations. It permits the use of the merger method of accounting for group reorganisations meeting specified criteria.

1 Introduction

Section 19 applies to the accounting for business combinations. A business combination is defined as “...the bringing together of separate entities or businesses into one reporting entity”. [FRS 102.19.3, FRS 102 Appendix I]. While this chapter is written primarily in the context of an entity becoming a subsidiary of another, the guidance also applies to individual financial statements in situations where an entity purchases (or combines with) an unincorporated business, for example, through the acquisition of the trade and net assets, including goodwill, of another entity.

Section 19 requires all business combinations (with limited exceptions) to be accounted for by applying the purchase method. The exceptions are for group reconstructions meeting specified criteria (see 5 below), and for public benefit entity combinations that are in substance a gift or that are a merger (dealt with by Section 34- see Chapter 36 at 6).

Section 19 provides guidance on the most common issues facing preparers in relation to the accounting for business combinations - namely, defining a business combination, identifying the acquirer, determining the acquisition date, measuring the cost of the business combination, and then allocating that cost to the acquirer's interest in the identifiable assets and liabilities (and provisions for contingent liabilities) of the acquiree. It also addresses the initial and subsequent accounting treatment of goodwill or any excess over cost of the acquirer's interest in the identifiable assets and liabilities of the acquiree (negative goodwill).

Section 19 also addresses the accounting for group reorganisations. It permits the use of the merger method of accounting for group reorganisations meeting specified criteria. Group reorganisations generally involve the restructuring of the relationships between companies in a group by, for example, setting up a new holding company, changing the direct ownership of a subsidiary within a group, or transferring businesses from one company to another. Most of these changes have no impact on the consolidated financial statements of the ultimate parent (provided there are no non-controlling interests affected), because they are purely internal and cannot affect the group when it is being portrayed as a single entity.

However, such transactions may impact the consolidated financial statements (if prepared) of a parent (at a lower level in the group) that did not previously control the subsidiaries or businesses transferred. Such transactions can also have a significant impact on the financial statements of the individual companies in the group. This chapter addresses only the accounting in individual financial statements for the transfer of a business from another group company. The accounting in individual financial statements for the transfer of an investment in subsidiary is addressed in Chapter 8 at 4.2 to 4.4.

Section 9 *Consolidated and Separate Financial Statements*, which is dealt with in Chapter 8 of this publication, addresses the preparation of consolidated financial statements by parents. Its focus is on matters such as when consolidated financial statements must be prepared, what entities are considered to be part of the group for the purposes of inclusion therein, and the mechanics of how such entities must be dealt with in the consolidated financial statements. It also deals with the accounting for the loss of control of subsidiaries, and increases/decreases of interests in existing subsidiaries of the group (with no loss of control). Section 9 specifically addresses the accounting in the consolidated financial statements where a reporting entity exchanges a business (or other non-monetary assets) for an interest in another entity that thereby becomes a subsidiary, jointly-controlled entity or associate of the reporting entity (see Chapter 8 at 3.8). [FRS 102.9.31, FRS 102.9.32].

2 Key differences between Section 19 and IFRS

2.1 Method of accounting

IFRS 3 *Business Combinations* requires all business combinations within its scope to be accounted for using the purchase method and excludes business combinations under common control, whereas FRS 102 specifically caters for group reconstructions (allowing group reconstructions meeting specified criteria to be accounted for using the merger method of accounting). Appendix B of IFRS 3, however, provides further guidance to determine when a business combination is regarded as a business combination under common control. What constitutes a 'business combination under common control' under IFRS 3, however, is different from what meets the definition of a 'group reconstruction' under FRS 102 (see 5.1 below). Additionally, IFRS 3 makes no special provisions for business combinations involving public benefit entities. Another difference is that the 'purchase method' required by FRS 102 is conceptually different from that in IFRS 3. FRS 102 is a 'cost-based' approach, whereby the cost of the business combination is allocated to the acquirer's interest in the identifiable assets acquired and liabilities (and provisions for contingent liabilities) assumed. In contrast, IFRS 3 adopts an approach whereby the various components of a business combination are measured at their acquisition-date fair values (albeit with a number of exceptions). This results in a number of the differences, which are identified below.

2.2 Definition of a business combination

The definition of a business combination in FRS 102 is "the bringing together of separate entities or businesses into one reporting entity". [FRS 102.19.3, FRS 102 Appendix I].

IFRS 3 defines a business combination as: "A transaction or other event in which an acquirer obtains control of one or more businesses". [IFRS 3 Appendix A]. It is notable that the Basis of Conclusions accompanying IFRS 3 identifies that the definition is intended to include all the types of transactions and other events initially included in the scope of the predecessor standard, IFRS 3 *Business Combinations* (as issued in 2004). [IFRS 3.BC11].

FRS 102's definition is identical to that in IFRS 3 *Business Combinations* (as issued in 2004), so it follows that there are not likely to be differences in practice as a result of the differing definitions of a 'business combination'. However, differences could arise as a result of the definition of a 'business' which are discussed below.

2.3 Definition of a business

Like FRS 102, IFRS 3 includes an explicit definition of what constitutes a business. However, by inclusion of the additional italicised words in the definition of a business - "An integrated set of activities and assets *that is capable of being* conducted and managed ..." (emphasis added) [IFRS 3 Appendix A] - IFRS 3's definition of a business is wider than that in FRS 102.

Additionally, FRS 102 indicates that a business generally consists of three different elements - (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs which are, or will be, used to generate revenues. [FRS 102 Appendix I].

IFRS 3 further defines these elements and clarifies that a business would be required to have only the first two of these three elements (i.e., inputs and processes), which together have the ability to create outputs. Furthermore, a business does not need to include all the inputs and processes but, to be considered a business, an integrated set of activities and assets must include as a minimum an input and a substantive process that together significantly contribute to the ability to create output. [IFRS 3.B7, IFRS 3.B8]. As such, although businesses usually have outputs, under IFRS 3 they would not need to be present for an integrated set of activities and assets to be a business.

Furthermore, under IFRS 3, there is an optional 'concentration test' designed to simplify the evaluation of whether an integrated set of activities and assets constitutes a business. An integrated set of activities and assets is not a business if substantially all of the fair value of the gross assets acquired (excluding cash and cash equivalents, deferred tax assets and goodwill resulting from the effects of deferred tax liabilities) is concentrated in a single identifiable asset or group of similar identifiable assets. If this concentration test, which is optional on a transaction-by-transaction basis, is applied and the set of activities and assets is determined not to be a business, no further assessment is needed. [IFRS 3.B7-IFRS 3.B12D].

Consequently, there are scenarios in which the definition of a business differs between IFRS 3 and FRS 102. In addition, IFRS 3 contains application guidance on the definition of a business, which FRS 102 does not.

2.4 Identifying an acquirer

FRS 102 includes as an explicit step in applying the purchase method ‘identifying an acquirer’, [FRS 102.19.7(a)], and states that the acquirer is the combining entity that obtains control of the other combining entities or businesses. [FRS 102.19.8].

In identifying the acquirer, Section 19 in the first instance refers to the guidance in Section 9 (see 3.4 below and Chapter 8 at 3.2), and failing a clear indication from Section 9, sets out specific factors to consider in the Appendix to Section 19 *Guidance on identifying the acquirer*. [FRS 102.19.10, FRS 102.19A.1-FRS 102.19A.6].

IFRS 3 likewise explicitly requires that, for each business combination, one of the combining entities be identified as the acquirer, i.e., the entity that obtains control of another entity, the acquiree. [IFRS 3.6]. As for guidance on identifying that acquirer, IFRS 3 in the first instance similarly refers to the guidance in IFRS 10 *Consolidated Financial Statements*; and failing a clear indication from IFRS 10, sets out specific factors to be considered. [IFRS 3.6, IFRS 3.7, IFRS 3.B14-IFRS 3.B18].

The overriding requirement of both Section 19 and IFRS 3 is to determine which entity (if any) has control; however, the definition of control under Section 9 and IFRS 10 differs. The difference in the definition of control (and the related application guidance discussed below) means that there could be circumstances when an entity is controlled by a parent under FRS 102 and not controlled under IFRS 10 (and *vice versa*). Likely areas of difference include potential voting rights, where control is exercised through an agent, control of special purpose entities, interests held as trustee or fiduciary and *de facto* control. See Chapter 8 at 2.3.

Since the amendments to FRS 102 as part of the Periodic Review 2024, there is now a high degree of consistency between the guidance on identifying an acquirer contained in the Appendix to Section 19 of FRS 102 and in IFRS 3. However, differences in the guidance include:

- The application guidance in FRS 102 states that if a new entity is formed to issue equity instruments to effect a business combination it is likely that the acquirer is one of the pre-existing combining entities, whereas paragraph B18 of IFRS 3 states that one of the pre-existing combining entities “shall be identified as the acquirer” by applying the guidance in paragraphs B13 to B17 of IFRS 3. Both FRS 102 and IFRS 3 recognise that a new entity transferring cash or other assets or incurring liabilities could be the acquirer. [FRS 102.19A.5, IFRS 3.B18].
- The application guidance in FRS 102 states that an acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. IFRS 3 has the same guidance but expands on this to say that an entity must consider the existence of any unusual or special voting arrangements and option, warrants or convertible securities. [FRS 102.19A.2(a), IFRS 3.B15(a)]. According to IFRS 10, potential voting rights are considered only if the rights are substantive. [IFRS 10.B47]. Although the application guidance in FRS 102 does not mention potential voting rights, paragraph 9.6 of FRS 102 states that control can be achieved by having currently exercisable options or convertible instruments. [FRS 102.9.6]. There may be a difference in what is deemed to be a ‘currently exercisable’ option under FRS 102 and a right that is deemed to be ‘substantive’ under IFRS 10.

And

- While FRS 102 acknowledges that an acquirer may be the entity whose equity instruments are acquired (the legal acquiree), also known as a ‘reverse acquisition’, IFRS 3 contains specific accounting guidance about reverse acquisition accounting and provides an example illustrating the accounting for a reverse acquisition. [FRS 102.19A.6, IFRS 3.B19-B27, IFRS 3.IE1-IE15].

2.5 Cost of a business combination

2.5.1 Acquisition expenses

The inclusion of directly attributable costs within the cost of a business combination (effectively reflecting them within goodwill) under FRS 102 differs significantly from IFRS 3, which requires that acquisition-related transaction costs are expensed. [FRS 102.19.11(b), IFRS 3.53].

2.5.2 Contingent consideration

FRS 102 requires recognition of any contingent consideration to be made at the acquisition date if the adjustment is “probable and can be measured reliably”. [FRS 102.19.12]. If the potential adjustment is not recognised at the acquisition date, but subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment to the cost of the combination. [FRS 102.19.13]. Similarly, if the future events that, at the acquisition date, were expected to occur do not occur, or the estimate needs to be revised, the cost of the business combination is adjusted accordingly. [FRS 102.19.13A]. Any subsequent adjustments in respect of contingent consideration will consequently be reflected in the carrying amount of goodwill.

In contrast, under IFRS 3, the acquisition-date fair value of any contingent consideration is recognised as part of the consideration transferred in acquiring the business - regardless of whether payment is probable or can be measured reliably. The obligation for the contingent consideration is classified as equity or a financial liability based on the definition of an equity instrument and a financial liability in IAS 32 *Financial Instruments: Presentation*. Contingent consideration that is classified as equity is not remeasured. [IFRS 3.58]. This contrasts with FRS 102, under which, we believe that contingent consideration classified as equity would be adjusted for the number of equity instruments issued but not changes to their fair value, i.e., the share price (see 3.6.2.A below).

Under IFRS 3, subsequent changes in the fair value of the contingent consideration classified as a financial liability are not accounted for as adjustments to the consideration transferred but are reflected in profit or loss - they therefore do not result in changes to goodwill as they would under FRS 102. [IFRS 3.58].

2.5.3 Contingent payments to employees or selling shareholders (and other transactions separate from the business combination)

FRS 102, along with IFRS 3, specifically identifies a transaction that remunerates employees or former owners of the acquiree for future services as not part of the cost of the business combination. [FRS 102.19.11B, IFRS 3.52(b)]. Therefore, where selling shareholders are also continuing employees, it is necessary to determine whether payments are made to them in their capacity as selling shareholders or as employees. Whether contingent payments are contingent consideration or separate transactions (e.g., remuneration) depends on the nature of the arrangements. Understanding the reasons, who initiated the arrangement and when the parties entered into it can be helpful in making the assessment. [FRS 102.19.11B, FRS 102.19.15, IFRS 3.50, IFRS 3.51, IFRS 3.B52]. FRS 102 makes clear that the substance of the arrangement must be considered when determining what is part of the cost of the business combination. [FRS 102.19.11B]. IFRS 3 contains more extensive application guidance to assist in the determination of whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions. [IFRS 3.B54, IFRS 3.B55]. Furthermore, IFRS 3 specifically states that: “A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services”. [IFRS 3.B55(a)]. FRS 102 does not contain such a requirement.

Both FRS 102 and IFRS 3 acknowledge that there may be arrangements that are not part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination which need to be accounted for separately from the business combination. IFRS 3 explains that a transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer (or combined entity), is likely to be a separate transaction. IFRS 3 includes, as examples of separate transactions, a transaction that in effect settles pre-existing relationships between the acquirer and acquiree, a transaction that remunerates employees or former owners of the acquiree for future services (as discussed above), and a transaction that reimburses the acquiree or its former owners for paying the acquirer’s acquisition-related costs. IFRS 3 includes extensive application guidance on determining what is part of a business combination. [FRS 102.19.15, IFRS 3.51, IFRS 3.52, IFRS 3.B50-B62]. Further discussion on this can be found at 3.6.2.B, 3.6.2.C and 3.6.3 below.

2.6 Measurement period

Under FRS 102, provisional amounts in the first post-acquisition financial statements are to be finalised within twelve months after the acquisition date. If amendments are required to those provisional amounts, they are made retrospectively by restating comparatives, i.e., by accounting for them as if they were made at the acquisition date. Beyond twelve months after the acquisition date, retrospective adjustments to the initial accounting are recognised only to correct a material error in accordance with Section 10 *Accounting Policies, Estimates and Errors*. [FRS 102.19.19].

These FRS 102 provisions are broadly consistent with IFRS 3; one nuance being the measurement period afforded by IFRS 3 ends at the sooner of: (i) one year from the acquisition date; and (ii) when the acquirer receives the information it was seeking about the facts and circumstances that existed as of the acquisition date or learns that it cannot obtain more information. [IFRS 3.45]. This distinction may have little practical difference.

2.7 Initial measurement of acquiree's assets, liabilities and contingent liabilities

FRS 102 requires the acquiree's identifiable assets and liabilities and a provision for those contingent liabilities, that satisfy the recognition criteria, to be measured at their acquisition-date fair values (except for deferred tax, employee benefit arrangements and share-based payments, which are to be recognised and measured in accordance with the respective section of FRS 102). [FRS 102.19.14]. There is also specific recognition and measurement guidance on leases in which the acquiree is the lessee, provisions and contingencies and the recognition of intangibles (see 2.8 below for more detail on the recognition of intangibles). [FRS 102.19.15D, FRS 102.19.15E, FRS 102.19.15F, FRS 102.19.15G, FRS 102.19.19A].

IFRS 3 includes a similar requirement to measure the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. [IFRS 3.18]. Consistent with FRS 102, there is specific recognition and/or measurement guidance for deferred tax, employee benefits, share-based payments, leases in which the acquiree is the lessee, and provisions and contingencies. [IFRS 3.21]. However, unlike FRS 102, IFRS 3 additionally includes specific guidance on the recognition and/or measurement of indemnification assets, [IFRS 3.27, IFRS 3.28], re-acquired rights, [IFRS 3.29], assets held for sale, [IFRS 3.31], insurance contracts, [IFRS 3.31A], and intangible assets (see 2.8 below). [IFRS 3.14, IFRS 3.B31, IFRS 3.B40].

Section 19 offers no guidance on how to derive the acquisition date fair values. FRS 102 Appendix I defines fair value as: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A *Fair Value Measurement* shall be used in determining fair value". [FRS 102 Appendix I]. Fair value measurement under FRS 102 must be reliable, otherwise recognition of the identifiable asset, liability or provision for contingent liability is not permitted. [FRS 102.19.15].

For the purpose of IFRS 3, the definition of 'fair value' is that in IFRS 13 *Fair Value Measurement*, being "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." [IFRS 13.9]. Where IFRS 3 requires assets and liabilities to be measured at fair value, the guidance in IFRS 13 would be applied. Unlike FRS 102, IFRS 3 only prohibits recognition of contingent liabilities on the grounds that the fair value cannot be measured with sufficient reliability. [IFRS 3.23]. In practice, the bar for determining that a fair value measurement is not reliably measurable is relatively high, but one area it does impact under FRS 102 is the recognition of intangible assets which is discussed in 2.8 below.

2.8 Recognising intangible assets separately from goodwill

Under FRS 102, an intangible asset acquired in a business combination is separately recognised if it:

- (a) Meets the recognition criteria (i.e., it is probable that the expected future economic benefits attributable to the asset will flow, and that the fair value of the intangible asset can be measured reliably).
 - (b) Arises from contractual or legal rights.
- And
- (c) Is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, asset or liability).

In addition, an entity may choose to recognise additional intangible assets acquired in a business combination separately from goodwill for which (a) is satisfied and only one of (b) or (c) is met. However, where an entity chooses to recognise such additional intangible assets, this policy must be applied to all intangible assets in the same class (i.e., having a similar nature, function and use in the business) and consistently to all business combinations. [FRS 102.18.8]. See 3.7.3.A below.

IFRS 3, in contrast, requires identifiable intangible assets, i.e., those meeting either the separable or contractual-legal criterion (so either (b) or (c) above) to be recognised separately from goodwill. [IFRS 3.14, IFRS 3.B3, IFRS 3.B34]. In addition, the probability and the reliable measurement criterion is always considered to be satisfied for intangible assets in a business combination. [IAS 38.33]. Consequently, FRS 102 does not require intangible assets to be recognised separately in as many situations as IFRS, although entities applying FRS 102 do have a policy choice as to whether to recognise more intangible assets.

The Illustrative Examples accompanying IFRS 3 provide a large number of examples of identifiable intangible assets acquired in a business combination. [IFRS 3.IE16-IFRS 3.IE44].

In the Basis of Conclusions to FRS 102, the FRC has provided examples of intangible assets that would normally meet all three criteria (a) to (c) above, and those that would not. Customer relationships are given as an example of an intangible asset that would not normally satisfy all three criteria “as no contractual or legal right exists that would give rise to expected future economic benefits.” [FRS 102.BC.B18.10]. This is a potential area of difference from IFRS 3, which contains examples of customer relationships that are considered to meet the contractual-legal criterion. [IFRS 3.IE23-IE30]. However, the option under FRS 102 to recognise additional intangible assets satisfying (a) and either (b) or (c) of the criteria above could be used to mitigate any potential difference with IFRS 3 in this regard.

2.9 Deferred tax

FRS 102 requires that when the tax base (i.e., the amount that can be deducted for tax) of an asset (other than goodwill) that is recognised in a business combination is less (more) than the value at which it is recognised, a deferred tax liability (asset) is recognised for the additional tax that will be paid (avoided) in respect of that difference. Similarly, a deferred tax asset (liability) is recognised for the additional tax that will be avoided (paid) because of a difference between the value at which a liability is recognised and its tax base (i.e., the amount that will be assessed for tax). The amount attributed to goodwill is adjusted by the amount of deferred tax recognised. [FRS 102.29.11].

The treatment under FRS 102 in a business combination is largely consistent with the requirements of IAS 12 *Income Taxes*, except in relation to the recognition of deferred taxes on goodwill. Whilst IAS 12 explicitly prohibits the recognition of a deferred tax liability relating to the initial recognition of goodwill, [IAS 12.15(a)], Section 29 prohibits the recognition of both a deferred tax liability and a deferred tax asset on goodwill arising in a business combination. [FRS 102.29.11]. Accordingly, in the (albeit rare) situation where goodwill is tax deductible and the deductible amount exceeds the value recognised in the financial statements no asset would be recognised under FRS 102, whereas a deductible temporary difference may qualify for recognition as a deferred tax asset under IAS 12. See further discussion in Chapter 31 at 2.2.

2.10 Step acquisitions

Where a parent acquires control of a subsidiary following a series of transactions, the cost of the business combination is the aggregate of the fair values of the assets given, liabilities assumed, and equity instruments issued by the acquirer at the date of each transaction in the series, [FRS 102.19.11A]. The accounting for the business combination does not include the recycling of any amounts that were previously taken to other comprehensive income. The ‘normal’ rules on allocating the cost of the business combination to the acquisition-date fair value of the identifiable assets, liabilities and contingent liabilities apply. [FRS 102.19.14].

This approach differs to the requirements under IFRS 3, whereby the acquirer remeasures any previously held equity investment in the acquiree immediately before obtaining control at its acquisition-date fair value and recognises any resulting gain or loss in profit or loss or other comprehensive income, as appropriate. In addition, any change in the value of the acquirer’s equity interest in the acquiree recognised in other comprehensive income is reclassified on the same basis that would be required if the acquirer had directly disposed of the previously held equity investment. [IFRS 3.42]. The acquisition-date fair value of the previously held equity interest is included in the computation of goodwill or gain on bargain purchase recognised under IFRS 3. [IFRS 3.32, IFRS 3.34].

2.11 Non-controlling interests in a business combination

FRS 102 requires that, at the acquisition date, any non-controlling interest in the acquiree is stated at the non-controlling interest's share in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with Section 19. [FRS 102.9.13(d), FRS 102.19.14A].

This differs from IFRS 3 where, for those non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, there is a choice of two methods in measuring non-controlling interests arising in a business combination:

- Option 1, to measure the non-controlling interest at its acquisition date fair value.
- Or
- Option 2, to measure the non-controlling interest at the present ownership instruments' proportionate share of the recognised value of net identifiable assets acquired.

All other non-controlling interests (for example, preference shares not entitled to a *pro rata* share of net assets upon liquidation, the equity component of convertible debt and other compound financial instruments, share warrants, etc.) are measured at their acquisition-date fair value (unless another measurement basis is required by IFRS). [IFRS 3.19]. FRS 102 is silent on the measurement of such components of non-controlling interests, the implication being they are valued at nil if they are not entitled to a present ownership interest.

2.12 Subsequent accounting for goodwill

FRS 102 requires goodwill acquired in a business combination to be recognised as an asset and amortised on a systematic basis over its useful life. FRS 102 mandates that goodwill must have a finite useful life, and further, if in exceptional circumstances the entity is unable to make a reliable estimate of the useful life of goodwill, the life must not exceed 10 years. [FRS 102.19.23].

This contrasts with IFRS 3, under which goodwill is not amortised, but instead subjected to (at least) annual impairment tests under IAS 36 *Impairment of Assets*. [IFRS 3.B63(a)]. FRS 102 requires, instead, a review for impairment indicators at each reporting date, with impairment tests performed only where indications of such impairment exist. [FRS 102.19.23, FRS 102.27.7].

Where negative goodwill arises, FRS 102 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. Having undertaken that reassessment, any negative goodwill remaining after that reassessment is required to be recognised and separately disclosed on the face of the statement of financial position on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the negative goodwill. Subsequently, negative goodwill up to the fair value of non-monetary assets acquired is recognised in profit or loss in the periods in which the non-monetary assets are recovered. Any negative goodwill in excess of the fair value of non-monetary assets acquired is recognised in profit or loss in the periods expected to benefit. [FRS 102.19.24].

This treatment differs to IFRS 3 whereby any excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost (i.e., negative goodwill) is recognised by the acquirer immediately in profit or loss. [IFRS 3.34].

2.13 Disclosures

The FRS 102 disclosure requirements set out in Section 19 are considerably less extensive than those under IFRS 3; for example, IFRS 3 requires specific disclosures in respect of the following areas that are not included in FRS 102: [IFRS 3.B64]

- A qualitative description of the factors that make up the goodwill recognised
- The acquisition-date fair value of each major class of consideration (FRS 102 asks for a description of the components of the cost of the combination, such as cash, equity instruments and debt instruments)
- Indemnification assets
- Acquired receivables
- The total amount of goodwill that is expected to be deductible for tax purposes
- Transactions recognised separately from the business combination, including acquisition-related costs
- Bargain purchases
- Non-controlling interests (valuation techniques used for each non-controlling interest measured at fair value - this option is not relevant under FRS 102)

- Business combinations achieved in stages
 - Revenue and profit of the combined entity as though the acquisition date of all business combinations had been at the beginning of the year (FRS 102 requires only revenue and profit or loss of the acquiree since the acquisition date)
 - Provisional amounts and measurement period adjustments (FRS 102 requires disclosure of the fact there are provisional amounts recognised and the impacted line items, whereas in addition to these, IFRS 3 requires the reasons why the initial accounting is incomplete, and the nature and amount of any measurement period adjustments recognised during the reporting period. *[IFRS 3.B67(a), FRS 102.19.25B]*. However, as any subsequent adjustments will be accounted for retrospectively by restating comparatives, we would expect disclosure in FRS 102 financial statements that such adjustments have been made, and the reasons). *[1 Sch 7, 6 Sch 1]*.
 - Adjustments to contingent consideration in subsequent periods *[IFRS 3.B67(b)]*
- And
- An explanation of significant gains or losses relating to the identifiable assets acquired and liabilities assumed in a business combination in the current or previous reporting period *[IFRS 3.B67(e)]*.

There is a requirement in FRS 102 to provide a qualitative description of the nature of intangible assets included in goodwill. *[FRS 102.19.25(fA)]*. This is similar in nature to the requirement in IFRS 3 above, which requires a qualitative description of the factors that make up goodwill. However, the FRS 102 requirement is more specific in actually referring to intangible assets included in goodwill.

FRS 102 also requires disclosure of the useful life of goodwill and, if in exceptional cases, this could not be reliably estimated, reasons for the period chosen in the period of acquisition and future periods. *[FRS 102.19.25(g), FRS 102.19.26B]*. Obviously, this requirement is not applicable under IFRS 3 as goodwill is not amortised. Similarly, not applicable under IFRS 3, is the requirement under FRS 102 to disclose the periods in which the excess recognised as negative goodwill is recognised in profit and loss and a reconciliation of the carrying amount of negative goodwill from the beginning of the reporting period to the end. *[FRS 102.19.25(h), FRS 102.19.26A]*.

For any contingent liabilities not recognised because the fair value cannot be measured reliably, paragraph B64(j)(ii) of IFRS 3 requires the reasons why the liability cannot be measured, to be disclosed. However, this requirement is not included under FRS 102. *[IFRS 3.B64(j)(ii)]*.

IFRS 3 requires disclosure of all of the requirements in paragraph B64 for business combinations effected after the end of the reporting period but before the financial statements are authorised for issue, unless the initial accounting is incomplete, in which case disclosure is required of this fact and the reasons why. *[IFRS 3.B66]*. Section 19 does not have any disclosure requirements for business combinations effected after the end of the accounting period; however non-adjusting event disclosures are specifically required for a major business combination or disposal of a major subsidiary. *[FRS 102.32.11]*. These are less onerous than the disclosure requirements under IFRS 3.

3 Requirements of Section 19 for business combinations and goodwill

A business combination is defined by FRS 102 as “...the bringing together of separate entities or businesses into one reporting entity”. [FRS 102.19.3, FRS 102 Appendix I]. This applies not only when an entity becomes a subsidiary of another, but also when an entity purchases (or combines with) an unincorporated business, for example, through the acquisition of the trade and net assets, including any goodwill, of another entity.

3.1 Scope of Section 19

Extract from FRS 102

Scope of this section

19.1 This section applies to business combinations.

19.2 This section does not apply to:

- (a) the formation of a joint venture, in the financial statements of the joint venture itself; or
- (b) the acquisition of an asset or a group of assets that does not constitute a business.

PBE

19.2A In addition, public benefit entities shall consider the requirements of Section 34 *Specialised Activities* in accounting for public benefit entity combinations.

[FRS 102.19.1, FRS 102.19.2, FRS 102.PBE19.2A]

The first exception above scopes out the requirements of Section 19 for the accounting for the formation of a joint venture in the financial statements of the joint venture itself. In such circumstances, in the financial statements of the newly formed joint venture, that entity would need to determine an appropriate accounting policy to account for the transaction.

If the formation of the joint venture has arisen as a result of the venturer exchanging a business, or other non-monetary asset, for an interest in another entity that becomes a jointly controlled entity of the venturer, the requirements of Section 9 apply to consolidated financial statements prepared by the venturer. As discussed in Chapter 18 at 3.8, these include the requirement to recognise goodwill as the difference between the fair value of the consideration given and the fair value of the reporting entity's share of the pre-transaction identifiable net assets of the other entity. [FRS 102.9.31(b)]. If the formation of the joint venture has not arisen as a result of the venturer exchanging a business, or other non-monetary asset, but the venturer has acquired an investment in a jointly-controlled entity, as discussed in Chapter 18 at 3.6.2, the initial recognition requirements of the equity method apply in terms of accounting for any difference between the cost of acquisition and the investor's share of the fair values of the net identifiable assets of the jointly-controlled entity. [FRS 102.14.8(c)].

The second exception is a truism in that Section 19 applies only to business combinations - if the group of assets is not a business, Section 19 does not apply, nor does it specify how to account for a group of assets. The initial recognition and measurement of the assets acquired will depend on the nature of the particular assets and the requirements of FRS 102 for such assets. Many assets, such as property, plant and equipment, investment property, intangible assets or inventories, are required to be measured initially at cost. Therefore, it will be necessary to make some apportionment of the overall cost of the group of assets to the individual assets.

How we see it

One possible approach to making such an allocation would be to apply the guidance in IFRS 3 for the acquisition of a group of assets that is not a business. In such cases, the acquirer must identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, intangible assets in Section 18) and liabilities assumed and allocate the cost of the group to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase.

There may be other approaches. However, whatever approach is used to allocate the overall cost to the individual assets or liabilities, no goodwill arises since goodwill (positive or negative) is recognised only in a business combination.

When applying the principles of IFRS 3, the IFRS IC noted the requirement of IFRS 3.2(b), as described above, and that other IFRS accounting standards include initial measurement requirements for particular assets and liabilities (e.g., IFRS 9 *Financial Instruments* for financial instruments).

The IFRS IC observed that if an entity initially considers that there might be a difference between the sum of individual fair values of the identifiable assets and liabilities and the transaction price, the entity first reviews the procedures it has used to determine those individual fair values to assess whether such a difference truly exists before allocating the transaction price. The IFRS IC then considered two possible ways of accounting for the acquisition of the group of assets.

Under the first approach an entity:

- Identifies the individual identifiable assets acquired and liabilities assumed that it recognises at the date of the acquisition.
- Determines the individual transaction price for each identifiable asset and liability by allocating the cost of the group based on the relative fair values of those assets and liabilities at the date of the acquisition.

And

- Then applies the initial measurement requirements in applicable standards to each identifiable asset acquired and liability assumed. The entity accounts for any difference between the amount at which the asset or liability is initially measured and its individual transaction price applying the relevant requirements.

Applying the second approach, for any identifiable asset or liability initially measured at an amount other than cost, an entity initially measures that asset or liability at the amount specified by the applicable standard. The entity deducts from the transaction price of the group the amounts allocated to the assets and liabilities initially measured at an amount other than cost, and then allocates the residual transaction price to the remaining identifiable assets and liabilities based on their relative fair values at the date of acquisition.

The IFRS IC concluded that a reasonable reading of the requirements in IFRS 3.2(b) on the acquisition of the group results in one of the two approaches outlined above (i.e., a policy choice) and that an entity would apply its reading of the requirements consistently to all acquisitions of a group of assets that does not constitute a business.¹⁰⁵

If material, disclosure of accounting policy information on acquisition of a group of assets that is not a business and significant judgement made in applying such accounting policy would be required by Section 8. [FRS 102.8.5, FRS 102.8.6].

It may be difficult to determine whether or not an acquired group of assets constitutes a business (see 3.2.1 below for the definition of a business and a business combination), and this decision can have a considerable impact on an entity's reported results and the presentation of its financial statements.

Accounting for a business combination differs considerably from accounting for an asset acquisition in a number of important respects:

- Goodwill (positive or negative) arises only on business combinations.
- Assets acquired and liabilities assumed are generally accounted for at fair value in a business combination, while they are assigned a carrying amount based on an allocation of the overall cost in an asset acquisition.
- Deferred tax assets and liabilities are recognised on the differences between the carrying amounts and tax base of assets (other than goodwill) and liabilities if the transaction is a business combination, but are not recognised if it is an asset acquisition, since a timing difference approach applies to asset acquisitions (see Chapter 31 at 6.6.5). However, tax losses could be recognised in both a business combination and an asset acquisition where the recognition criteria are met.
- Where the consideration is in the form of shares, Section 26 *Share-based Payment* does not apply to a business combination but will apply to an asset acquisition within the scope of Section 26.
- Another difference may arise where the transaction involves contingent consideration. While Section 19 provides guidance on the accounting for contingent consideration in the acquisition of a business (see 3.6.2 below), Section 17 *Property, Plant and Equipment* and Section 18 provide no clear guidance on accounting for contingent consideration in an asset acquisition (see Chapter 20 at 3.4.1.I and Chapter 21 at 3.2.1.C).

And

- Disclosures are more onerous for business combinations than for asset acquisitions.

¹⁰⁵ IFRIC Update, November 2017, available on the IFRS Foundation's website.

3.1.1 Application of the purchase method

Extract from FRS 102

Purchase method

- 19.6** All business combinations shall be accounted for by applying the purchase method, except for:
- (a) group reconstructions which may be accounted for by using the merger accounting method (see paragraphs 19.27 to 19.33); and
 - (b) public benefit entity combinations that are in substance a gift or that are a merger which shall be accounted for in accordance with Section 34.

[FRS 102.19.6]

The remainder of 3 below addresses the accounting for business combinations applying the purchase method, and 4 below addresses the related disclosures.

The definition of and accounting for a group reconstruction under FRS 102 is discussed at 5 below.

Public benefit entity combinations are discussed in Chapter 36. at 6.5.

3.2 Identifying a business combination

3.2.1 Business combination defined

Extract from FRS 102

Business combinations defined

- 19.3** A business combination is the bringing together of separate entities or businesses into one reporting entity. The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree. The acquisition date is the date on which the acquirer obtains control of the acquiree. [FRS 102.19.3].

Appendix I

business An integrated set of activities and assets conducted and managed for the purpose of providing:

- (a) a return to investors; or
- (b) lower costs or other economic benefits directly and proportionately to policyholders or participants.

A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.

[FRS 102.19.3, FRS 102 Appendix I]

3.2.2 Inputs, processes and outputs

FRS 102 does not discuss further the meaning or interaction of inputs, processes or outputs. However, the application guidance to IFRS 3 expands upon them as follows: [IFRS 3.B7]

- **Input:** Any economic resource that creates outputs, or has the ability to contribute to the creation of, outputs when one or more processes are applied to it. Examples of inputs given by IFRS 3 include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.
- **Process:** Any system, standard, protocol, convention or rule is a process if, when applied to an input or inputs, it either creates or has the ability to contribute to the creation of outputs. Examples of processes given by IFRS 3 include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs so their presence or exclusion generally will not affect whether an acquired set of activities and assets is considered a business.

And

- **Output:** The result of inputs and processes applied to those inputs that provide goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

Although businesses generally have outputs, there may be situations where development stage entities qualify as businesses because the inputs and processes will be used to generate outputs, despite outputs not being present at the acquisition date.

As noted at 2.3 above, there are scenarios in which the definition of a business may differ between IFRS 3 and FRS 102.

As discussed at 3.1 above, the acquisition of a group of assets - notwithstanding that it may be held within a separate entity or entities - which do not constitute a business is excluded from the scope of Section 19. In some situations, there may be difficulties in determining whether or not an acquisition of a group of assets constitutes a business, and judgement will need to be exercised based on the particular circumstances.

The following are examples from extractive and real estate industries that illustrate the issues.

Illustration 3-1: Extractive industries - definition of a business (1)

E&P Co A (an oil and gas exploration and production company) acquires a mineral interest from E&P Co B, on which it intends to perform exploration activities to determine if reserves exist. The mineral interest is an unproven property and there have been no exploration activities performed on the property.

Inputs - mineral interest

Processes - none

Output - none

Conclusion

In this scenario, we do not believe E&P Co A acquired a business. While E&P Co A acquired an input (mineral interest), it did not acquire any processes and there were no outputs.

Illustration 3-2: Extractive industries - definition of a business (2)

E&P Co A acquires a property similar to that in Illustration 3-1 above, except that oil and gas production activities are in place and the acquired set also includes a Supervisory Control and Data Acquisition ('SCADA') system. A SCADA system is a control system used to monitor and manage industrial processes and infrastructure in real-time. It consists of physical equipment, including pumps, meters and other assets used to facilitate gathering, processing, storing, and transporting of oil and gas. The target's employees are not part of the transferred set. E&P Co A will take over the operations by using its own employees.

Inputs - oil and gas reserves and SCADA system

Processes - operational processes associated with oil and gas production embodied in the SCADA system

Output - revenues from oil and gas production

Conclusion

In this scenario, we generally consider that E&P Co A acquired a business. The acquired set has all three components of a business (inputs, processes and outputs) and is providing a return to its owners. Although the employees are not being transferred to the acquirer, E&P Co A is able to produce outputs by:

- Supplying the employees necessary to continue production
- And
- Integrating the business with its own operations while continuing to produce outputs

Illustration 3-3: Real estate - definition of a business (1)

Company A acquires land and a vacant building from Company B. No processes, other assets or employees (for example, leases and other contracts, maintenance or security personnel, or a leasing office) are acquired in the transaction.

Inputs - land and vacant building constructed on that land

Processes - none

Output - none

Conclusion

In this scenario, we do not believe Company A acquired a business. While Company A acquired inputs (land and a vacant building), it did not acquire any processes and there were no outputs.

Illustration 3-4: Real estate - definition of a business (2)

Company A acquires an operating hotel, the hotel's employees, the franchise agreement, inventory, a reservations system and all 'back office' operations.

Inputs - non-current assets, franchise agreement, inventory, a reservations system and employees

Processes - operational and resource management processes associated with operating the hotel

Output - revenues from operating the hotel

Conclusion

In this scenario, we generally consider Company A acquired a business. The acquired set has all three components of a business (inputs, processes and outputs) and is providing a return to its owners.

There is a rebuttable presumption that if goodwill arises on the acquisition, the acquisition is a business. [FRS 102 Appendix I]. If, for example, the total fair value of an acquired set of activities and assets is £15 million and the fair value of the net identifiable assets is only £10 million, the existence of value in excess of the fair value of identifiable assets (i.e., goodwill) creates a presumption that the acquired set is a business. However, care needs to be exercised to ensure that all of the identifiable net assets have been identified and measured appropriately.

The absence of goodwill does not lead to a presumption that the acquired activities and assets do not represent a business.

3.2.3 Differing combination structures

FRS 102 indicates that a business combination may be structured in a variety of ways for legal, taxation or other reasons. For example, it may involve: [FRS 102.19.4]

- The purchase by an entity of the equity of another entity
- The purchase of all the net assets of another entity
- The assumption of the liabilities of another entity

Or

- The purchase of some of the net assets of another entity that together form one or more businesses

The business combination may be transacted through the issue of equity instruments, the transfer of cash, cash equivalents or other assets, or a mixture of these. The transaction may be between the shareholders of the combining entities or between one entity and the shareholders of another entity. It may involve the establishment of a new entity to control the combining entities or net assets transferred, or the restructuring of one or more of the combining entities. [FRS 102.19.5]. Whatever the legal structure, if it is a 'business combination' then the requirements of Section 19 apply (unless it is specifically excluded).

As indicated above, a business combination may involve the purchase of the net assets, including any goodwill, of another entity rather than the purchase of the equity of the other entity. Such a combination does not result in a parent-subsidiary relationship. Nevertheless, the acquirer (even if it is a single entity), will account for such a business combination in its individual or separate financial statements and consequently in any consolidated financial statements.

3.3 The purchase method (acquisition accounting)

All business combinations (apart from those excluded from the scope of Section 19 - group reconstructions which may be accounted for by using the merger accounting method and certain public benefit entity combinations) are accounted for by applying the purchase method. [FRS 102.19.6]. The purchase method is commonly referred to as acquisition accounting.

The purchase method views a business combination from the perspective of the combining entity that is identified as the acquirer. The acquirer recognises the assets acquired and liabilities and contingent liabilities assumed, including those not previously recognised by the acquiree.

Applying the purchase method involves the following steps: [FRS 102.19.7]

- Identifying an acquirer (see 3.4 below)
- Determining the acquisition date (see 3.5 below)
- Measuring the cost of the business combination (see 3.6 below)
- Allocating, at the acquisition date, the cost of the business combination to the assets acquired and liabilities and provisions for contingent liabilities assumed (see 3.7 below)

- Recognising and measuring any non-controlling interest (see 3.8 below)
- And
- Recognising and measuring goodwill (see 3.9 below)

3.3.1 Interaction with UK company law

The purchase method as outlined in Section 19 corresponds with the description of the acquisition method in UK company law: [6 Sch 9]

- The identifiable assets and liabilities of the undertaking acquired must be included in the consolidated balance sheet at their fair values as at the date of acquisition.
 - The income and expenditure of the undertaking acquired must be brought into the group accounts only as from the date of the acquisition.
 - There must be set off against the acquisition cost of the interest in the shares of the undertaking held by the parent company and its subsidiary undertakings the interest of the parent company and its subsidiary undertakings in the adjusted capital and reserves of the undertaking acquired.
 - The resulting amount if positive must be treated as goodwill, and if negative as a negative consolidation difference.
- And
- Negative goodwill may be transferred to the consolidated profit and loss account where such a treatment is in accordance with the principles and rules of Part 2 of Schedule 1 to the Regulations.

The accounting for goodwill (positive or negative) under Section 19 is discussed at 3.9 below.

3.4 Identifying an acquirer

Section 19 requires an acquirer to be identified for all business combinations accounted for by applying the purchase method. The acquirer is the combining entity that obtains control of the other combining entities or businesses. [FRS 102.19.8].

Control is defined as "...the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities". [FRS 102.19.9]. Section 19 cross-refers to Section 9 for a description of control of one entity by another in the context of identifying subsidiaries for the purposes of consolidation.

Extract from FRS 102

Requirement to present consolidated financial statements

- 9.5** Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity. That presumption may be overcome in exceptional circumstances if it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity but it has:
- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
 - (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
 - (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
 - (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.
- 9.6** Control can also be achieved by having options or convertible instruments that are currently exercisable or by having an agent with the ability to direct the activities for the benefit of the controlling entity.
- 9.6A** Control can also exist when the parent has the power to exercise, or actually exercises, dominant influence or control over the undertaking or it and the undertaking are managed on a unified basis.

[FRS 102.9.5, FRS 102.9.6, FRS 102.9.6A]

The requirements of Section 9 relating to 'control' are discussed in Chapter 8 at 3.2.

Section 19 notes that if, after applying the requirements of control in Section 9 it is not clear which of the combining entities is the acquirer, then the following factors must be considered: *[FRS 102.19.10]*

- If the business combination is effected primarily through a transfer of cash or other assets or by assuming or incurring liabilities, the entity that transfers the cash or other assets or assumes or incurs the liabilities is usually the acquirer. *[FRS 102.19A.1].*
- If the business combination is effected primarily through exchanging equity instruments, the entity that issues its equity instruments is usually the acquirer. Other pertinent facts and circumstances must also be considered. For example, the acquirer is usually the combining entity: *[FRS 102.19A.2].*
- Whose owners as a group retain or receive the largest portion of voting rights in the combined entity.
 - Whose single owner or organised group of owners hold the largest minority voting interest in the combined entity, if no other owner or organised group of owners has a significant voting interest.
 - Whose owners have the ability to elect or appoint or remove a majority of the members of the governing body of the combined entity.
 - Whose former management dominates the senior management of the combined entity.
- Or
- That pays a premium over the pre-combination fair value of the equity instruments of the other combining entity (or entities).
- The combining entity whose relative size is significantly greater than the other combining entity (or entities) is usually the acquirer. Examples of what can be used to measure size include assets, revenues or profit. *[FRS 102.19A.3].*
- If a business combination involves more than two entities, consideration must be given, among other things, to which of the combining entities initiated the combination as well as the relative size of the combining entities in determining the acquirer. *[FRS 102.19A.4].*

Section 19 is clear that a new entity formed to effect a business combination is not necessarily the acquirer. *[FRS 102.19A.5].* This is discussed in more detail at 3.4.2 below.

Determination of the acquirer may require significant judgement and consideration of the pertinent facts and circumstances is needed. In some cases, application of the above guidance can lead to the legal acquiree being identified as the acquirer for accounting purposes. *[FRS 102.19A.6].* See 3.4.1 below.

3.4.1 Reverse acquisitions

It is recognised that in some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired (the legal acquiree/subsidiary) and the issuing entity is the acquiree. *[FRS 102.19A.6].* The legal subsidiary is the acquirer if it has the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities. See 3.10 below for further discussion on reverse acquisitions.

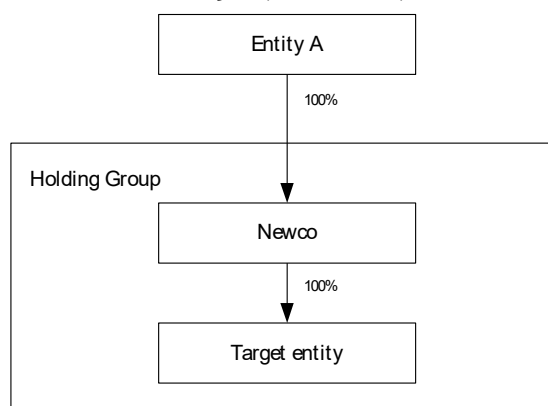
3.4.2 Newly incorporated entities ('Newcos') formed to effect a business combination

Occasionally, a new entity is formed to issue equity instruments to effect a business combination between, for example, two other entities. If this is the case, the new entity formed is not necessarily the acquirer. It is likely that the acquirer is one of the combining entities that existed before the business combination. *[FRS 102.19A.5].* This is because the substance of the transaction is that one of the two other entities has acquired the other, but they have been brought together legally under the new entity rather than one of these entities acquiring the other. The new entity, itself, has little substance other than as a vehicle to hold the shares in the combining entities, and may have been structured in this way for legal, taxation or other reasons. Therefore, in such a transaction, the combination between the new entity and the identified acquirer is effectively the same as if a new entity had been inserted above an existing entity. Such a 'group reconstruction' would be accounted for under merger accounting (see 5.3 below). Reverse acquisition accounting (see 3.4.1 above and 3.10 below) is unlikely to be appropriate in this situation because the definition of a business combination (see 3.2.1 above) generally involves an acquirer obtaining control of a business, *[FRS 102.19.3]*, and a newly formed entity would not meet the definition of a business.

However, that is not to say that a new entity that is established to effect a business combination cannot ever be identified as the acquirer. A new entity that transfers cash, cash equivalents or other assets or assumes or incurs liabilities as consideration may be the acquirer. [FRS 102.19A.5]. For example, there may be situations where a new entity is established and used on behalf of a group of investors or another entity to acquire a controlling interest in a 'target entity' in an arm's length transaction and the consideration is cash or other assets. But there will be other situations where a new entity that transfers cash, cash equivalents or other assets or assumes or incurs liabilities as consideration is not the acquirer.

Illustration 3-5: Business combination effected by a Newco for cash consideration

Entity A intends to acquire the voting shares (and therefore obtain control) of Target Entity. Entity A incorporates Newco and uses this entity to effect the business combination. Entity A provides a loan at commercial interest rates to Newco. The loan funds are used by Newco to acquire 100% of the voting shares of Target Entity in an arm's length transaction. The group structure post-transaction is as follows:



Newco is required to prepare consolidated financial statements for the Holding Group (the reporting entity). In most situations like this, Newco would be exempt from preparing consolidated financial statements - see Chapter 8 at 3.1.

The acquirer is the entity that obtains control of the acquiree.

In this situation, Entity A has obtained control of Target Entity in an arm's length transaction, using Newco to effect the acquisition. The transaction has resulted in a change in control of Target Entity and Newco is in effect an extension of Entity A acting at its direction to obtain control for Entity A. Accordingly, Newco would be identified as the acquirer at the Holding Group level.

It is not appropriate to conclude that Target Entity must be the acquirer and argue that Newco does not have any substance to it, as this ignores the fact that there is a third party involved and that this party is, in substance, the ultimate controlling party in the transaction.

If rather than Entity A establishing Newco, a group of investors had established it as the acquiring vehicle through which they obtained control of Target Entity then, we believe, Newco would be regarded as the acquirer since it is an extension of the group of investors.

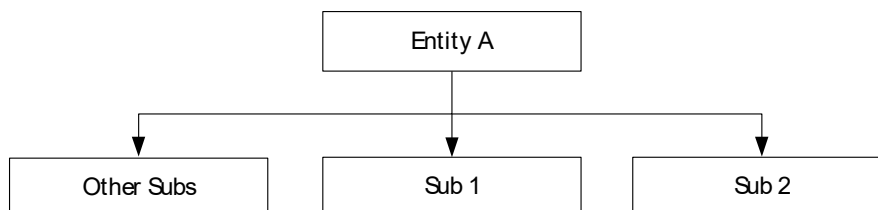
Another specific situation in which a Newco might be identified as the acquirer is illustrated in Illustration 3-6 below, where a parent uses a Newco to facilitate a public flotation of shares in a group of subsidiary companies. In this particular situation, the critical distinguishing factor is that the acquisition of the subsidiaries was conditional on an IPO of Newco. This means that there has been a substantial change in the ownership of the subsidiaries by virtue of the IPO and indicates that the purpose and design of the transaction is to achieve a change in control over the transferred business.

How we see it

Whether a Newco formed to facilitate an IPO is capable of being identified as an acquirer depends on the facts and circumstances and ultimately requires judgement. If, for example, Entity A incorporates Newco and arranges for it to acquire Sub 1 and Sub 2 prior to the IPO proceeding, Newco could be viewed as an extension of Entity A or possibly an extension of Sub 1 or Sub 2. This is because the IPO and the reorganisation are not always seen as being part of one integral transaction, and therefore the transaction would be a combination of entities under common control. In that situation, Newco would not be the acquirer.

Illustration 3-6: Business combination effected by a Newco for cash consideration (spin-off transaction)

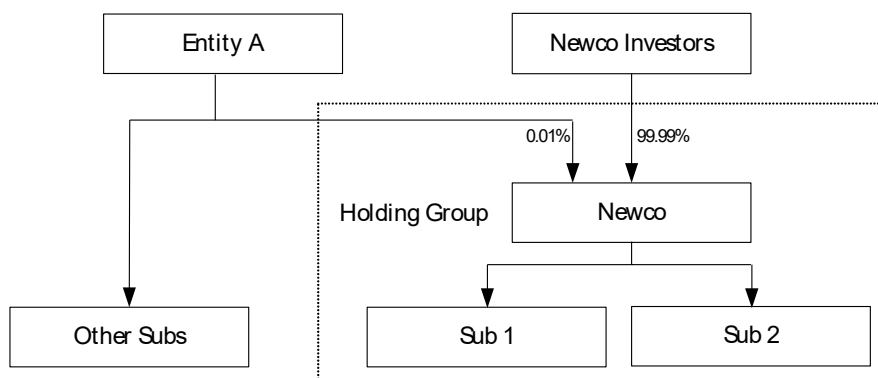
Entity A proposes to spin off two of its existing businesses (currently housed in two separate entities, Sub 1 and Sub 2) as part of an IPO. The existing group structure is as follows:



To facilitate the spin off, Entity A incorporates a new company (Newco) with nominal equity and appoints independent directors to the Board of Newco.

Newco signs an agreement to acquire Sub 1 and Sub 2 from Entity A conditional on the IPO proceeding. Newco issues a prospectus offering to issue shares for cash to provide Newco with funds to acquire Sub 1 and Sub 2. The IPO proceeds and Newco acquires Sub 1 and Sub 2 for cash. Entity A's nominal equity leaves virtually 100% ownership in Newco with the new investors.

Following the IPO, the respective group structures of Entity A and Newco appear as follows:



In this case, it would likely be appropriate to identify Newco as the acquirer. The Newco investors have obtained control and virtually 100% ownership of Sub 1 and Sub 2 in an arm's length transaction, using Newco to effect the acquisition. The transaction has resulted in a change in control of Sub 1 and Sub 2 (i.e., Entity A losing control and Newco investors, via Newco, obtaining control). Newco could in effect be considered as an extension of the Newco investors since:

- The acquisition of Sub 1 and Sub 2 was conditional on the IPO proceeding so that the IPO is an integral part of the transaction as a whole, evidencing that Newco is an extension of new investors to acquire control of Sub 1 and Sub 2.
- And
- There is a substantial change in the ownership of Sub 1 and Sub 2 by virtue of the IPO (i.e., Entity A only retains a negligible ownership interest in Newco).

Accordingly, Newco might be identified as the acquirer at the Holding Group level.

3.5 Determining the acquisition date

The determination of the acquisition date (i.e., the date on which the acquirer contains control of the acquiree), [FRS 102 Appendix 1], is critical to accounting for a business combination, as it is both the date from which the results of the acquiree are incorporated into the financial statements of the acquirer, and the date on which the cost of the business combination is allocated to the fair values of the assets acquired and liabilities and provisions for contingent liabilities assumed. The acquisition date is the date on which the acquirer obtains control of the acquiree. [FRS 102.19.3, FRS 102.19.10A].

Because control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities, it is not necessary for a transaction to be closed or finalised at law before the acquirer obtains control. All pertinent facts and circumstances surrounding a business combination need to be considered in assessing when the acquirer has obtained control. [FRS 102.19.10A].

No further guidance is given in FRS 102 as to how to determine the acquisition date, but it is clearly a matter of fact. It cannot be artificially backdated or otherwise altered, for example, by the inclusion of terms in the agreement indicating that acquisition is to be effective as of an earlier date, with the acquirer being entitled to profits arising after that date, even if the purchase price is based on the net asset position of the acquiree at that date.

The date control is obtained will be dependent on a number of factors, including whether the acquisition arises from a public offer or a private deal, is subject to approval by other parties, or is effected by the issue of shares. For an acquisition by way of a public offer, the acquisition date could be:

- When the offer has become unconditional as a result of a sufficient number of acceptances being received.
- Or
- The date that the offer closes.

Since the nature of public offers can be different depending on the jurisdiction they are in, it is always necessary to consider the impact of the nature and terms of the offer and any other relevant laws or regulations in determining the date of acquisition.

In a private deal, the date would generally be when an unconditional offer has been accepted by the vendors, providing the control criteria in FRS 102 are met.

It can be seen from the above that one of the key factors is that the offer is 'unconditional'. Thus, where an offer is conditional on the approval of the acquiring entity's shareholders then until that approval has been received, it is unlikely that control will have been obtained. Where the offer is conditional upon receiving some form of regulatory approval, then it will depend on the nature of that approval. Where it is a substantive hurdle, such as obtaining the approval of a competition authority, it is unlikely that control could have been obtained prior to that approval. However, where the approval is merely a formality, or 'rubber-stamping' exercise, then this would not preclude control having been obtained at an earlier date, provided that at that earlier date, the acquirer effectively obtains power to direct the relevant activities of the acquiree.

Where the acquisition is effected by the issue of shares, then the date of control will generally be when the exchange of shares takes place.

The acquirer's statement of comprehensive income incorporates the acquiree's profits or losses after the acquisition date by including the acquiree's income and expenses based on the cost of the business combination to the acquirer. Many items will have a fair value on acquisition that will affect subsequent recognition of income and expense. FRS 102 gives the example of depreciation expense, which will be based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date. [FRS 102.19.16].

3.6 Measuring the cost of the business combination

Having identified the acquirer and determined the acquisition date, the next step is for the acquirer to measure the cost of the business combination. Section 19 requires this to be the aggregate of: [FRS 102.19.11]

- The fair values, at the acquisition date, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree (see 3.7 below).
- And
- Any costs directly attributable to the business combination (see 3.6.1 below).

In a step acquisition, i.e., where control is achieved in a series of transactions, the cost of the business combination is the aggregate of the fair values of the assets given, liabilities assumed, and equity instruments issued by the acquirer at the date of each transaction in the series. [FRS 102.19.11A]. The accounting treatment for step acquisitions (including the treatment of directly attributable costs) is discussed further at 3.11 below.

Section 19 requires an entity to consider the substance of an arrangement so that it can determine what is (and, therefore, what is not) part of the cost of the business combination specifically in regard to contingent payments (see 3.6.2 below). [FRS 102.19.11B]. However, in addition to contingent payments, there are other arrangements that can arise that also need to be assessed to determine if they are or are not part of the cost of the business combination. Examples of other arrangements include settlement of pre-existing transactions between the acquirer and acquiree or the acquiree and third parties, and reimbursement of acquiree costs by the acquirer. Determination of whether these costs are a cost of the business combination is discussed in more detail at 3.6.3 below.

Section 19 is clear that the cost of a transaction that remunerates employees or former owners of the acquiree for future services is not part of the cost of a business combination. See 3.6.2.B below for further discussion. [FRS 102.19.11B].

Where equity instruments issued by the acquirer are given as consideration to the selling shareholder, the fair value of those equity instruments is determined based on the guidance in Section 2A of FRS 102. [FRS 102.2A]. It must be noted that while 'merger relief' and 'group reconstruction relief' under the CA 2006 include relief from recognising share premium where certain conditions are met, this affects the accounting considerations for capital and reserves of the issuing entity only, and is not relevant for the purposes of measuring the cost of the combination in connection with application of the purchase method - see 5.5 below for discussion of merger relief and group reconstruction relief.

3.6.1 Costs directly attributable to the combination

The cost of a business combination includes any costs directly attributable to the combination. [FRS 102.19.11(b)].

How we see it

FRS 102 does not indicate what types of costs are directly attributable to the combination, but we consider that they could include costs such as professional fees paid to accountants, legal advisers, valuers and other consultants. General administrative costs, including the costs of maintaining an acquisitions department, and other costs that cannot be directly attributed to the particular combination being accounted for would not be included in the cost of the combination - they are recognised as an expense when incurred.

It may be that an entity engages another party to investigate or assist in identifying a potential target. Whether any fee payable to such party can be included as part of the cost of the business combination will depend on whether the work performed can be regarded as directly attributable to that particular business combination. Where the fee is payable only if the combination takes place, then it must be included as part of the cost.

Transaction costs (for financial instruments) are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability, or the issue of an entity's own equity instrument. [FRS 102 Appendix I]. These costs are not included as costs of the business combination but are accounted for as costs of issuing those instruments. [FRS 102.11.13, FRS 102.22.9]. They, therefore, do not affect the measurement of goodwill in the business combination.

Where professional advisors provide advice on all aspects of the business combination, including the arranging and issuing of financial liabilities and/or issuing equity instruments, it will be necessary for some allocation of the fees payable to be made, possibly by obtaining a breakdown from the relevant advisor.

It may be that an entity, at its balance sheet date, is in the process of acquiring another business and has incurred costs that are considered to be directly attributable to that expected business combination. At the balance sheet date, the entity has not yet obtained control over the business. In this situation how are the costs accounted for?

How we see it

We believe that since directly attributable costs are to be included in the cost of a business combination, then the costs are carried forward as an asset from the date that is considered probable that the business combination will be completed. Any costs incurred prior to the date that it is considered probable that the business combination will be completed are expensed and remain written off regardless of whether the acquisition takes place; they cannot be reinstated and capitalised at a later date.

In the subsequent period when the business combination is completed, the costs carried forward will be reclassified as part of the cost of the business combination (and therefore into goodwill). If in the subsequent period it is no longer considered probable that the business combination will be completed, then the costs initially recognised as an asset will be expensed to the income statement.

3.6.2 Adjustments to the cost of a business combination contingent on future events ('Contingent consideration')

Section 19 recognises that the terms of a business combination agreement may provide for an adjustment to the cost of the combination contingent on future events (generally referred to as 'contingent consideration'). 'Future events' include events that affect the amount of the payment and not just those that affect whether a specified payment is required or not. Thus, any consideration for a business combination where the amount or the timing is not known with certainty is contingent consideration.

The following are three examples of additional payments made to selling shareholders that are contingent on future events:

- An additional payment of £X million if the acquiree's profit in the year after acquisition exceeds £Y million.
- An additional payment of £X million if a drug currently under development receives regulatory approval at a later date.

And

- An additional payment of Z% of actual EBITDA of the acquiree in the year after acquisition.

The first example of an 'earn-out' clause - whereby the acquirer agrees to pay additional amounts if the future earnings of the acquiree exceed specified amounts - is a typical example of contingent consideration relating to the value of the acquiree.

For contingent consideration, the acquirer includes an estimate of that adjustment (reflecting the time value of money, if material) in the cost of the combination at the acquisition date if the adjustment is probable (i.e., more likely than not) and can be measured reliably. [FRS 102.19.12].

An adjustment is more likely to be made in those situations where the contingent consideration is based on the acquiree maintaining a level of profits which it is currently earning (either for a particular period or as an average over a set period) or achieving profits which it is currently budgeting.

If the potential adjustment is not recognised at the acquisition date but subsequently becomes probable and can be measured reliably, the additional consideration is treated as an adjustment (reflecting the time value of money, if material) to the cost of the combination. [FRS 102.19.13]. If the future events that, at the acquisition date, were expected to occur do not occur, or the estimate needs to be revised, the cost of the business combination is adjusted accordingly. [FRS 102.19.13A]. Any subsequent adjustments in respect of contingent consideration will consequently be reflected in the carrying amount of goodwill except that, if contingent consideration is adjusted for the time value of money, the unwinding of any discounting is recognised as a finance cost in profit or loss, in the period it arises. [FRS 102.19.13B]. If an impairment loss has already been recognised in respect of the goodwill (see Chapter 29), subsequent adjustments to goodwill may require a further impairment loss to be recognised.

FRS 102 does not address whether these adjustments must be reflected retrospectively or prospectively.

How we see it

In our view, changes in the probability of an event occurring (or not) that reflect conditions arising after the acquisition date, represent a change in estimate.

Changes in accounting estimates are accounted for prospectively (see Chapter 9 at 3.4).

FRS 102 does not provide guidance on determining the discount rate to be used in respect of contingent consideration.

How we see it

In our view, in determining a discount rate to be used in respect of contingent consideration, an entity can determine an accounting policy, to be applied consistently, either by analogy to financial liabilities at amortised cost or to provisions.

The following Illustration shows how changes to discount rates could be considered.

Illustration 3-7: Discount rate in contingent consideration subsequently adjusted

Entity A acquired Entity B on 31 December 20X6, and the consideration includes £8 million that is contingent on meeting a profit target by 31 December 20X9, three years later.

At the date of acquisition, it was considered probable that the acquiree would meet the profit target, when the appropriate discount rate was 8%. Accordingly, £6,350,658 (see table below) was recognised as part of the cost of the business combination in the financial statements for 31 December 20X6.

At 31 December 20X7, Entity A's assessment remains that payment of £8 million at 31 December 20X9 is probable, so its estimate of cash flows is the same as the prior period end. However, changes in circumstances at 31 December 20X7 mean that the discount rate would be 7%.

Must Entity A adjust its contingent consideration liability for the update in discount rate?

The relevant present values are as follows:

	PV at 8%	PV at 7%
	£	£
31 December 20X6	6,350,658	6,530,383
Interest for 20X7	508,053	457,127
31 December 20X7	6,858,711	6,987,510
Interest for 20X8	548,696	489,126
31 December 20X8	7,407,407	7,476,636
Interest for 20X9	592,593	523,364
31 December 20X9	8,000,000	8,000,000

Whether the discount rate is updated at 31 December 20X7 is not clear from FRS 102. A contingent consideration liability could be considered similar to a financial liability (which would not qualify as a basic instrument under Section 11 *Basic Financial Instruments*) or a provision. However, the accounting by the acquirer for contingent consideration in a business combination is out of scope of both Section 12 *Other Financial Instruments Issues* and Section 21 *Provisions and Contingencies*. [FRS 102.12.3(g), FRS 102.21.1]. If the entity applies the hierarchy in paragraph 5(a) of Section 10 to refer to other relevant guidance within FRS 102 regarding discounted liabilities, then Entity A analogises to the discounting of either a financial liability at amortised cost or a provision. Under an amortised cost model, the discount rate would not be updated. [FRS 102.11.16, FRS 102.11.20]. Analogising to a provisions model, the discount rate would be updated at each reporting date. [FRS 102.21.11].

Therefore, depending on the entity's chosen policy, the liability is discounted at the rate determined at 31 December 20X6 (following an amortised cost model) or 31 December 20X7 (following a provisions model). Following an amortised cost model, the liability accretes at the original discount rate of 8%, interest of £508,053 is recognised in the income statement for 20X7 and no adjustment is made to goodwill. Following a provisions model, the same interest would be recognised in the income statement and an adjustment of £128,799 is made to the cost of the combination (and therefore goodwill) to record the liability at £6,987,510 at 31 December 20X7. This adjustment to goodwill arises from a change in the present value of the estimated cash flows. As a change in estimate, the adjustment is made at the date of change rather than calculated retrospectively. The resulting liability is reassessed at each reporting date thereafter for changes in estimated cash flows (and changes in discount rate when following a provisions model), and any necessary adjustment made to the cost of the combination (and therefore goodwill).

3.6.2.A Contingent consideration to be settled by equity instruments

In some business combination agreements involving contingent consideration, additional consideration is settled not by cash, but by shares.

Section 19 makes no explicit reference to such a situation. Section 11 and Section 12 both scope out from their provisions "Financial instruments that meet the definition of an entity's own equity", [FRS 102.11.7(b), FRS 102.12.3(e)], Section 12 and Section 22 *Liabilities and Equity* both scope out from their respective requirements "Contracts for contingent consideration in a business combination" (this exemption applies only to the acquirer), [FRS 102.12.3(g), FRS 102.22.2(c)], and Section 26 scopes out, "equity instruments issued in a business combination in exchange for control of the acquiree". [FRS 102.26.1B].

In practice, there is a wide variety of share-settled contingent consideration arrangements, but they are generally based on one of two models:

- Arrangements whereby shares are issued to a particular value based on certain conditions being met, e.g., if profits are £A then additional consideration of £M will be given, to be satisfied by shares based on the share price at date of issue.

Or

- Arrangements whereby a particular number of shares are issued if certain conditions are met, e.g., if profits are £A then X shares will be issued, but if profits are £B then Y shares will be issued.

The issues that need to be considered in accounting for such arrangements are:

- If the consideration is recognised, is it classified as a liability or as equity?
- How is the consideration valued, both on initial recognition and if reassessed at a later date?

Illustration 3-8: Share-settled contingent consideration (1)

Entity P acquires a 100% interest in Entity S on 31 December 20X5. As part of the consideration arrangements, additional consideration will be payable on 1 January 20X9, based on Entity S meeting certain profit targets over the three years ended 31 December 20X8, as follows:

<i>Profit target (average profits over 3-year period)</i>	<i>Additional consideration</i>
£1m but less than £1.25m	£5m
£1.25m but less than £1.5m	£6m
£1.5m+	£7.5m

Any additional consideration will be satisfied by issuing the appropriate number of shares with a value equivalent to the additional consideration payable based on Entity P's share price at 1 January 20X9.

At the date of acquisition, Entity P considers that it is probable that Entity S will meet the first profit target, but not the others.

How does Entity P classify the additional consideration in its financial statements for the year ended 31 December 20X5, and what amount must be recognised in respect of it?

As discussed above, contracts for contingent consideration are specifically scoped out of Section 22 and Section 26.

How we see it

In our view, the principles of Section 22 are relevant to determining the appropriate classification of such arrangements. Section 22 classifies a contract that will or may be settled in the entity's own equity instruments as a financial liability if the contract is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments. Therefore, classification as a liability seems appropriate in this situation.

On the basis that the consideration is reflected as a liability then, as with contingent consideration payable in cash, the amount to be recognised at 31 December 20X5 must be the present value of the £5m consideration expected to be payable on 1 January 20X9.

If, at 31 December 20X7, Entity P considers that it is probable that Entity S will now meet the second target, the liability is remeasured at that date to the present value of the £6m that is now expected to be payable on 1 January 20X9 with a corresponding adjustment to goodwill, having reflected the unwinding of the discount on the original £5m in the income statement. In determining the present value as at 31 December 20X7, whether the discount rate is updated at that date or remains the original discount rate calculated at initial recognition depends on the accounting policy adopted by Entity P. This is further explained in Illustration 3-7 above.

In Illustration 3-8 above, the arrangement was of the type where the number of shares issued to settle the consideration were equivalent to a particular value. However, what if the arrangement was of the type where a particular number of shares are to be issued to satisfy the consideration?

Illustration 3-9: Share-settled contingent consideration (2)

Entity P acquires a 100% interest in Entity S on 31 December 20X5. As part of the consideration arrangements, additional consideration will be payable on 1 January 20X9, based on Entity S meeting certain profit targets over the three years ended 31 December 20X8, as follows:

<i>Profit target</i>	<i>Additional consideration</i>
Year ended 31 December 20X6 - £1m+	100,000 shares
Year ended 31 December 20X7 - £1.25m+	150,000 shares
Year ended 31 December 20X8 - £1.5m+	200,000 shares

Each target is non-cumulative. If the target for a particular year is met, the additional consideration will be payable, irrespective of whether the targets for the other years are met or not. If a target for a particular year is not met, no shares will be issued in respect of that year. At the date of acquisition, Entity P considers that it is probable that Entity S will meet the first profit target, but not the others.

How does Entity P classify the additional consideration in its financial statements for the year ended 31 December 20X5, and what amount is recognised in respect of it?

Although Section 22 does not strictly apply, we consider that its principles are relevant to determining whether this type of arrangement is classified as a financial liability or equity.

Section 22 classifies a contract that will or may be settled in the entity's own equity instruments as a financial liability if the contract is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments. [FRS 102.22.3(b)].

How we see it

In this scenario, as each of the targets are independent of one another, this arrangement can be regarded as being three distinct contingent consideration arrangements that are assessed separately. As either zero or the requisite number of shares will be issued if each target is met, the obligation in respect of each arrangement is classified as equity.

If the targets were dependent on each other, for example, if they were based on an average for the three-year period, a specified percentage increase on the previous year's profits, or the later targets were forfeited if the earlier targets were not met, the classification would be assessed on the overall arrangement. As this would mean that a variable number of shares may be delivered, the obligation under such an arrangement would have to be classified as a financial liability.

On the basis that the consideration is reflected as equity, Section 19's requirements are applied in measuring the amount recognised for the consideration, i.e., at the fair value at the acquisition date (31 December 20X5). [FRS 102.19.11(a)]. However, in this situation the fair value of the 'equity instrument' at the date of acquisition would need to take into account, for example, an allowance for any estimated dividends on the shares that will not be payable during the period until they are issued on 1 January 20X9.

One other issue that arises in this situation is whether adjustments must be made to the consideration, and thus goodwill, to reflect subsequent changes in the fair value of the shares such that the consideration is ultimately measured at Entity P's share price at the date the shares are finally issued.

How we see it

Although the requirements for contingent consideration would generally require subsequent changes in the estimate of the consideration that will ultimately be given, to be recognised, we do not believe that such changes in fair value (i.e., the share price) are reflected for equity instruments. Under FRS 102, equity instruments are measured at the fair value of cash or other resources received or receivable on the date of initial recognition. Once an equity instrument has been recognised, changes in the fair value of the equity instrument are not recognised in the financial statements.

At 31 December 20X5, Entity P considers that it is not probable that Entity S will meet the profit target for the year ended 31 December 20X7 and, therefore, no amount is reflected in equity for that profit target. [FRS 102.19.12]. If, at 31 December 20X6, this profit target becomes probable, then the financial statements at that date need to reflect that Entity P now expects to issue an additional 150,000 shares. [FRS 102.19.13]. As discussed above, we do not believe that any change is made to reflect changes in the value of Entity P's shares since the date of exchange (31 December 20X5), and so the additional consideration of 150,000 shares are valued using the same value per share as the original estimated consideration of 100,000 shares, with a consequent adjustment to goodwill.

3.6.2.B Distinguishing 'contingent consideration' from other arrangements

The cost of a business combination is the aggregate of "the fair values, at the acquisition date, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, *in exchange for control of the acquiree*" (*our emphasis added*). [FRS 102.19.11].

It is important to be able to identify those arrangements that represent contingent consideration from those that do not, because contingent consideration generally results in some form of adjustment to the accounting for a business combination (including goodwill). Notwithstanding the structuring of a purchase agreement, which may be for legal, tax, or other reasons, transactions and other events and conditions must be accounted for and presented in accordance with their substance and not merely their legal form. [FRS 102.2.8, FRS 102.19.11B].

The terms of other arrangements and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. These can include agreements not to compete, executory contracts, consulting contracts and property lease agreements. For example, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market rate, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer is required to recognise separately in its post-combination financial statements.

FRS 102 explains that whether a contingent payment arrangement to employees or selling shareholders is contingent consideration or a separate transaction depends on the nature of the arrangement. The following factors (and additional guidance included in IFRS 3) can be helpful in evaluating the nature of the arrangement: [FRS 102.19.11B, IFRS 3.B50]

- The reasons why the agreement includes contingent payments.
Understanding the reasons why the parties to the combination, the acquirer and the acquiree and their owners, directors and managers - and their agents - entered into a particular transaction or arrangement may provide insight into whether it is part of the cost of the business combination and the assets acquired or liabilities assumed. If a transaction is arranged primarily for the benefit of the acquirer or the combined entity rather than for the benefit of the acquiree or its former owners before the combination, that portion of the transaction price paid (and any related assets or liabilities) is less likely to be part of the cost of the business combination for the acquiree. The acquirer would account for that portion separately from the business combination.
- Who initiated the arrangement.
A transaction or other event that is initiated by the acquirer may be entered into for the purpose of providing future economic benefits to the acquirer or combined entity with little or no benefit received by the acquiree or its former owners before the combination. A transaction or arrangement initiated by the acquiree or its former owners is less likely to be for the benefit of the acquirer or the combined entity and more likely to be part of the business combination transaction.
And
- When the parties entered into the arrangement.
A transaction between the acquirer and the acquiree during the negotiations of the terms of a business combination may have been entered into in contemplation of the business combination to provide future economic benefits to the acquirer or the combined entity. If so, the acquiree or its former owners before the business combination are likely to receive little or no benefit from the transaction except for benefits they receive as part of the combined entity.

If the cost of a transaction remunerates employees or former owners of the acquiree for future services, then that cost is not part of the cost of a business combination. This is discussed further in 3.6.2.C below.

The following Illustration shows an arrangement where the additional payments that may be made to the selling shareholders under the business combination agreement are not accounted for as 'contingent consideration' under FRS 102.

Illustration 3-10: Selling shareholder retains a customer relationship with acquiree and is entitled to volume rebates on purchases it makes

Target is a subsidiary of Vendor Entity. Target provides goods and services to Vendor Entity that represent a significant portion of Target's business. Acquirer acquires 100% of the issued shares of Target. The purchase price is considered to represent the fair value of Target.

As part of the business combination agreement, Acquirer agrees to pay Vendor Entity a volume rebate for the next 5 years if Vendor Entity's purchases from Target exceed a specified amount in each of those years. The volume rebate offered is consistent with terms offered to other customers.

The volume rebate agreement with the vendor is not accounted for as contingent consideration because it is not consideration for the acquisition of control in Target. The purchase price paid for the issued shares of Target is considered to represent fair value of Target; and Acquirer will be required to pay the volume rebates only in the event that Vendor Entity's purchases exceed a specified amount. The volume rebate arrangement is merely a means of securing Vendor Entity's custom for the next five years. Therefore, whilst the volume rebate arrangement arises by virtue of Acquirer having acquired Target, it does not represent additional consideration for the acquisition of a controlling interest in Target. Additionally, the contingency does not relate to the value of the business acquired because payment is contingent on Vendor Entity's future purchases exceeding a specified amount.

3.6.2.C Contingent consideration relating to future services

A particular example of a situation where selling shareholders may have a continuing relationship with the acquirer is where they become, or continue to be, key employees of the acquiree subsequent to the acquisition.

Section 19 of FRS 102 specifically identifies a transaction that remunerates employees or former owners of the acquiree for future services and not part of the cost of the business combination. Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration to be included in the business combination (see 3.6.2 above) or are separate transactions to be accounted for as remuneration under Section 26 (if a share-based payment) or Section 28 *Employee Benefits*, will depend on the nature of the arrangements. [FRS 102.19.11B].

Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement and when the parties entered into the arrangement can be helpful in assessing the nature of the arrangement. [FRS 102.19.11B]. Entities will need to apply judgement in evaluating the substance of the contingent consideration. In making such a judgement, entities may consider the requirements and guidance in adopted IFRS dealing with similar or related issues. [FRS 102.10.6]. IFRS 3 contains specific guidance for determining whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions. This includes consideration of a number of indicators relating to:

- Continuing employment
 - Duration of continuing employment
 - Level of other elements of remuneration
 - incremental payments to other non-employee selling shareholders
 - Relative number of shares owned by selling shareholders that remain as key employees (or parties related to them)
 - Linkage of payments to valuation of business
- And
- The formula for additional payments [IFRS 3.B54, IFRS 3.B55]

In making such an evaluation, all terms of the agreement have a critical role in this assessment, and the reasons for structuring the terms of the transaction in a particular way, and the identity of the initiator, must be understood. While IFRS 3 is clear that, "A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services", [IFRS 3.B55(a)], this requirement is not replicated in FRS 102.

How we see it

When an agreement includes employment conditions such that the payments are forfeited upon termination of employment, all or a portion of, the additional payments will generally be classified as employment compensation.

Illustration 3-11: Contingent payments to employees

Entity B appointed a candidate as its new CEO under a ten-year contract. The contract required Entity B to pay the candidate CU5m if Entity B is acquired before the contract expires. Entity A acquires Entity B eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.

In this example, Entity B entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of the CEO. Thus, there is no evidence that the agreement was arranged primarily to benefit Entity A or the combined entity. Therefore, the liability to pay CU5m is accounted for as part of the acquisition of Entity B.

In other circumstances, Entity B might enter into a similar agreement with the CEO at the suggestion of Entity A during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to the CEO, and the agreement may primarily benefit Entity A or the combined entity rather than Entity B or its former owners. In that situation, Entity A accounts for the liability to pay the CEO in its post-combination financial statements separately from the acquisition of Entity B.

If the consideration takes the form of share-based payments, it is necessary to determine how much of the share-based payment relates to the acquisition of control (which forms part of the cost of combination, accounted for under Section 19) and how much relates to the provision of future services (which is a post-combination operating expense accounted for under Section 26). This would be the case if, for example, the selling shareholder of an acquired entity receives a share-based payment for transferring control of the entity and for remaining in continuing employment.

Acquirers often exchange share-based payment awards (i.e., replacement awards) for awards held by employees of the acquiree. These exchanges frequently occur because the acquirer wants to avoid the effect of having non-controlling interests in the acquiree, the acquirer's shares are often more liquid than the shares of the acquired business after the acquisition, and/or to motivate former employees of the acquiree toward the overall performance of the combined, post-acquisition business. The accounting for replacement share-based payment awards issued in a business combinations is dealt with in Chapter 28 at 12.

3.6.3 Assessing what arrangements are included in the cost of the business combination

To be included in the accounting for the business combination, the identifiable assets given, liabilities assumed, and equity instruments issued by the acquirer must be in exchange for control of the acquiree. [FRS 102.19.11].

FRS 102 provides guidance in paragraph 19.11B on the factors to consider when determining whether a contingent payment to employees or selling shareholders is contingent consideration in the business combination and therefore included in the cost of the business combination or is a separate transaction (see 3.6.2 above). However, FRS 102 provides no further guidance in distinguishing between consideration given in exchange for control of the acquiree and payments pertaining to other arrangements, outside of a contingent payment. In practice, the acquirer and the acquiree may have a pre-existing relationship (which could be contractual (e.g., vendor and customer) or non-contractual (such as plaintiff and defendant)) or an other arrangement before the negotiations for the business combination, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer must identify any amounts that are separate from the business combination and thus are not part of the cost of the combination. Examples of pre-existing relationships include unresolved legal claims and disputes, contractual supply contracts, lease contracts, loan arrangements, existing balances between the acquirer and acquiree, and reacquired rights.

How we see it

We believe that the factors identified in paragraph 19.11B of FRS 102, relevant to distinguishing contingent consideration in the business combination from separate transactions, are also relevant factors to consider when assessing other arrangements such as pre-existing relationships or arrangements entered into during the negotiations for the business combination.

IFRS 3 specifically addresses the accounting for a transaction that in effect settles a pre-existing relationship between the acquirer and the acquiree, on which FRS 102 is silent. An entity could look to the requirements in IFRS 3 when developing an accounting policy under the hierarchy in Section 10.

One particular area that could be negotiated between the acquirer and the acquiree, or its former owners, is a restructuring plan relating to the acquiree's activities. Section 19 is clear that unless the acquiree has, at the acquisition date, an existing liability for restructuring, then the acquirer must not recognise liabilities for terminating or reducing the activities of the acquiree as part of the business combination. [FRS 102.19.15D(a)]. See further discussion at 3.7.1.A below.

3.7 Allocating the cost of the business combination to the assets acquired and liabilities and contingent liabilities assumed

Having determined the cost of the business combination, the next stage is to allocate that cost to the assets acquired, and liabilities and contingent liabilities assumed.

The acquirer must, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and a provision for its contingent liabilities at their fair values at that date except for the following: [FRS 102.19.14, FRS 102.19.15]

- The recognition and measurement of deferred tax assets and liabilities (see 3.7.2.A below). [FRS 102.19.15A]
 - The recognition and measurement of assets and liabilities related to employee benefit arrangements (see 3.7.2.B below). [FRS 102.19.15B]
 - The recognition and measurement of share-based payment arrangements (see 3.7.2.C below). [FRS 102.19.15C]
 - The recognition and measurement of provisions and contingent liabilities (see 3.7.1.A below). [FRS 102.19.15D, FRS 102.19.15E, FRS 102.19.15F]
 - The recognition of intangibles separately from goodwill (see 3.7.3.A below). [FRS 102.19.15G]
- And
- The recognition and measurement of leases in which the acquiree is the lessee (see 3.7.2.D below). [FRS 102.19.19A]

Any difference between the cost of the business combination and the acquirer's interest in the net amount of the identifiable assets, liabilities and provisions for contingent liabilities so recognised is accounted for as goodwill or negative goodwill (see 3.9 below). [FRS 102.19.14, FRS 102.19.22, FRS 102.19.23, FRS 102.19.24].

Except as specified in paragraphs 19.15A to 19.15F of FRS 102, the acquirer recognises separately the acquiree's identifiable assets acquired and liabilities assumed at the acquisition date only if: [FRS 102.19.15]

- They meet the assets and liabilities definitions in Section 2 *Concepts and Pervasive Principles* at the acquisition date (see Chapter 4 at 3.5.1 and 3.5.2).
 - Their fair value can be measured reliably.
- And
- They are part of what the acquirer and acquiree exchanged in the business combination rather than as the result of separate transactions (see 3.6.3 above).

No contingent assets must be recognised at the acquisition date. [FRS 102.19.15].

How we see it

Section 21 states that "when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate". [FRS 102.21.13]. As such, we consider that it is reasonable to conclude that a virtually certain asset can be recognised in a business combination. This approach avoids a day 2 gain, which would arise if a virtually certain contingent asset was not recognised in a business combination. Recognition of an asset also reflects that an acquirer would ascribe value to the virtually certain asset which results in a more meaningful residual goodwill.

3.7.1 Recognition exceptions

3.7.1.A Provisions and contingencies

The recognition exception within Section 19 requires an acquirer to apply specific guidance in Section 21 (instead of the definitions in Section 2) to determine whether, at the acquisition date, a present obligation exists as a result of past events. [FRS 102.19.15D, FRS 102.21.4(a), FRS 102.21.4A, FRS 102.21.6]. See Chapter 24 at 3.2.1.

In addition to the guidance in Section 21, Section 19 provides examples of applying Section 21 to business combinations. These are:

- The acquirer must recognise liabilities for terminating or reducing the activities of the acquiree as part of allocating the cost of the combination only to the extent that the acquiree has at the acquisition date, an existing liability for restructuring recognised in accordance with Section 21. *[FRS 102.19.15D(a)]*.
And
- The acquirer, when allocating the cost of the combination, must not recognise liabilities for future losses or other costs expected to be incurred as a result of the business combination. *[FRS 102.19.15D(b)]*.

Section 19 requires that the acquirer recognises, at the acquisition date, a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to the recognition requirements of Section 21 which would apply in the acquiree's financial statements, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that the acquirer will be required to transfer economic benefits in settlement. *[FRS 102.19.15F, FRS 102.21.4]*. If a contingent liability only represents a possible obligation arising from a past event, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, no liability is recognised under FRS 102. In addition, no liability is recognised if the acquisition-date fair value of a contingent liability cannot be measured reliably. *[FRS 102.19.15E, FRS 102.19.15F]*.

Whilst not meeting the recognition criteria under the standard in the financial statements of the acquiree, the contingent liability has a fair value, which reflects market expectations about any uncertainty surrounding the possibility that an outflow of resources will be required to settle the obligation. Accordingly, under FRS 102, the allocation of the cost of the business combination includes the separate recognition of the acquiree's contingent liabilities, if their fair value can be reliably measured.

[FRS 102.19.15F].

Since the recognition of this liability is not in accordance with Section 21, Section 19 includes requirements for the subsequent measurement of such liabilities. Accordingly, after their initial recognition, the acquirer measures contingent liabilities recognised in a business combination at the higher of: *[FRS 102.19.15F, FRS 102.19.24A]*

- (a) The amount that would be recognised in accordance with Section 21.
And

- (b) The amount initially recognised less, if appropriate, the cumulative amount of income recognised in accordance with Section 23 *Revenue from Contracts with Customers*.

The implications of part (a) of this requirement are clear. If the acquiree has to recognise a provision in respect of the former contingent liability, and the best estimate of this liability is higher than the original fair value attributed by the acquirer, then the greater liability will now be recognised by the acquirer with the difference taken to the income statement. It would now be a provision to be measured and recognised in accordance with Section 21. What is less clear is part (b) of the requirement.

How we see it

The reference to "the cumulative amount of income recognised in accordance with the principles of Section 23" in paragraph 19.24A of FRS 102 in (b) above might relate to the recognition of income in respect of those contingent liabilities of the acquiree that have been recognised at fair value at the date of acquisition. The requirement would appear to mean that, unless the recognition of income in accordance with the principles of Section 23 is appropriate, the amount of the liability cannot be reduced below its originally attributed fair value until the liability is settled, cancelled or expires.

Section 19 makes it clear that this requirement does not apply to contracts accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9, where the policy options to apply these standards to the recognition and measurement of financial instruments are taken.

[FRS 102.19.24A, FRS 102.11.2(b), FRS 102.12.2(b), FRS 102.11.2(c), FRS 102.12.2(c)]. This would appear to mean that contracts that are not accounted for in accordance with IAS 39 or IFRS 9 but are accounted for by applying Section 21 will fall within the requirements of paragraph 24A of Section 19, as outlined above. For example, this would include loan commitments accounted for under Section 21 rather than IAS 39 or IFRS 9 (or Sections 11 and 12 of FRS 102), i.e., loan commitments other than those that are commitments to provide loans at below-market interest rates. [FRS 102.21.1B(a)]. Another example would be financial guarantee contracts accounted for under Section 21, rather than under IAS 39 or IFRS 9, [FRS 102.21.1A], or FRS 103 *Insurance Contracts* (see 3.7.3.C below),

One particular area that could be negotiated between the acquirer and the acquiree or its former owners is a restructuring plan relating to the acquiree's activities.

How we see it

In our view, a restructuring plan that is implemented by or at the request of the acquirer is not a liability of the acquiree as at the date of acquisition and cannot be part of the accounting for the business combination under the acquisition method, regardless of whether the combination is contingent on the plan being implemented.

A restructuring plan that is decided upon or put in place between the date the negotiations for the business combination started and the date the business combination is completed is only likely to be accounted for as a pre-combination transaction of the acquiree if there is no evidence that the acquirer initiated the restructuring, and the plan makes commercial sense even if the business combination does not proceed.

If a plan initiated by the acquirer is implemented without an explicit link to the business combination, this may indicate that control has already passed to the acquirer at this earlier date.

3.7.2 Recognition and measurement exceptions

3.7.2.A Deferred tax assets and liabilities

The acquirer must recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in accordance with Section 29 *Income Tax*. [FRS 102.19.15A]. To require the normal fair value treatment on acquisition would have resulted in immediate gains or losses being recognised when the deferred tax assets and liabilities were subsequently measured in accordance with Section 29, for example where fair values reflected the effects of discounting, but measurement under Section 29 would be on an undiscounted basis.

Under Section 29, when the tax base of an asset (other than goodwill) that is recognised in a business combination is less (or more) than the value at which the asset is recognised, a deferred tax liability (or asset) is recognised for the additional tax that will be paid (avoided) in respect of that difference. Similarly, a deferred tax asset (or liability) is recognised for the additional tax that will be avoided (or paid) because of a difference between the value at which a liability is recognised and the tax base of that liability. The amount attributed to goodwill (or negative goodwill) is adjusted by the amount of deferred tax recognised. [FRS 102.29.11].

In this context, the tax base of an asset is the amount that can be deducted for tax, and the tax base of a liability is the amount that will be assessed for tax. [FRS 102 Appendix I]. In determining the tax base of an asset or a liability an entity considers the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of the relevant asset or liability. [FRS 102.29.11A].

The requirement to recognise deferred tax in a business combination, which is discussed further in Chapter 31 at 6.6, is an exception to the general 'timing differences' approach in Section 29.

3.7.2.B Employee benefit assets and liabilities

The acquirer recognises and measures a liability (or asset, if any) related to the acquiree's employee benefit arrangements in accordance with Section 28. [FRS 102.19.15B]. See Chapter 30.

3.7.2.C Share-based payment transactions

The acquirer recognises and measures a share-based payment in accordance with Section 26. [FRS 102.19.15C]. See Chapter 28 at 3.3.3. Guidance on accounting for replacement share awards in a business combination is discussed in Chapter 28 at 12.

Equity instruments granted to the employees of the acquiree in their capacity as employees (e.g., in return for continued service following the business combination) do not form part of the consideration for the business combination and are therefore within the scope of Section 26 as a share-based payment transaction, as are the cancellation, replacement or modification of a share-based payment transaction as the result of a business combination or other equity restructuring. [FRS 102.26.1B]

If a selling shareholder of an acquired business remains as an employee of that business following the business combination and receives a share-based payment for transferring control of the entity and for remaining in continuing employment, it is necessary to determine how much of the share-based payment relates to the acquisition of control (and therefore forms part of the consideration for the business combination) and how much relates to the provision of future services (which is a post-combination operating expense, see 3.6.2.C above).

3.7.2.D Leases in which the acquiree is the lessee

Section 19 requires the acquirer to measure the acquired right-of-use assets and lease liabilities as if the lease contract were a new lease at the acquisition date. That is, the acquirer applies the initial measurement provisions of Section 20 *Leases* to determine the lease liability, using the present value of the remaining lease payments at the acquisition date. [FRS 102.19.19A, FRS 102.20.49]. The acquirer follows the requirements of Section 20 for determining the lease term, lease payments and discount rate as discussed in Chapter 23 at 5.

Section 19 further requires the acquirer to measure the right-of-use asset at an amount equal to the recognised liability, adjusted to reflect the favourable or unfavourable terms of the lease, relative to market terms. [FRS 102.19.19A]. As the off-market nature of the lease is captured in the right-of-use asset, the acquirer does not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market terms.

It might appear unclear as to how this requirement is to be applied to fully or partially prepaid leases acquired in a business combination. The prepaid right to use obtained by the acquirer has a value. The question is whether such right is required to be presented as a separate intangible asset or as an adjustment to the carrying value of the right-of-use asset.

How we see it

We believe that from the perspective of a market participant, an acquired fully or partially prepaid lease in a business combination is not 'at market' since the acquirer obtains the right to use the underlying asset without assuming an obligation to pay the market price for that right. Therefore, the fair value of such right ought to be considered in determining any off-market adjustment to the right-of-use asset at the acquisition date.

Illustration 3-12: Fully prepaid leases acquired in a business combination

Entity A acquires a 100% interest in Entity B for cash. At the acquisition date, Entity B recognised in its statement of financial position a right-of-use asset equal to the unamortised prepayment for the fully prepaid lease for the remaining five years of the lease term; an amount of £120.

If Entity B were to enter the new prepaid lease for the remaining five years at the date of acquisition it would have to pay £110 in advance for the whole period of the lease. The difference between the market price of the new prepaid lease of £110 and the assumed contractual obligation for future lease payments of nil represents the favourable terms of the lease from the perspective of the acquirer.

Consequently, at the date of acquisition, Entity A recognises a right-of-use asset of £110 and does not recognise any lease liability.

Under Section 19, the acquirer is not required to recognise right-of-use assets and lease liabilities for leases with lease terms which end within 12 months of the acquisition date or for which the underlying asset acquired in a business combination is of low value. [FRS 102.19.19A]. The determination of a low value underlying asset is discussed in more detail in Chapter 23 at 6.1.2.

3.7.3 Recognition and measurement of particular identifiable assets and liabilities

3.7.3.A Acquiree's intangible assets

The allocation of the cost of the business combination includes the separate recognition of the acquiree's intangible assets. This is irrespective of whether the asset had been recognised by the acquiree before the business combination. [FRS 102.19.15G].

An intangible asset is defined as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity" [FRS 102.18.4A]. This differs from the definition of an 'asset' under Section 2.

An intangible asset acquired in a business combination is separately recognised if it: [FRS 102.18.4, FRS 102.18.8, FRS 102.19.15G]

- (a) Meets the recognition criteria (i.e., (i) it is probable that the expected future economic benefits that are attributable to the asset will flow; and (ii) that the fair value of the intangible asset can be measured reliably)
- (b) Arises from contractual or legal rights
- And
- (c) Is separable

In addition, an entity may choose to recognise additional intangible assets acquired in a business combination separately from goodwill for which (a) is satisfied and only one of (b) or (c) applies. The decision to recognise such additional intangible assets is a policy choice, to be applied consistently to a class of intangible assets (i.e., having a similar nature, function or use in the business). Licences are given by FRS 102 as an example of a category of intangible asset that may be treated as a separate class, however, further subdivision may be appropriate, for example, where different types of licences have different functions within the business. [FRS 102.18.8].

Where additional intangible assets are recognised, the nature of the intangible assets and the reason why they have been separated from goodwill must be disclosed. [FRS 102.18.28A].

The FRC considers that examples of intangible assets that would normally satisfy all three criteria (a) to (c) include: licences, copyrights, trademarks, internet domain names, patented technology and legally protected trade secrets. Examples of intangible assets that would not normally satisfy all three criteria include customer lists, customer relationships and unprotected trade secrets (such as secret recipes or formulas) as no contractual or legal right exists that would give rise to expected future economic benefits. [FRS 102.BC.B18.10].

The guidance in the Illustrative Examples of IFRS 3 might also be relevant to the identification of specific items although some differences to FRS 102 may arise as explained below the following table. [IFRS 3.IE16-IE44]. The table below summarises the items included in the Illustrative Examples that the IASB regards as meeting the definition of an intangible asset, noting that the examples are not intended to be all-inclusive. It is clear that the IASB envisages a wide range of items meeting the definition of an intangible asset, and therefore potentially being recognised separately from goodwill. The Illustrative Examples provide further explanations about some of these items.

<i>Intangible assets arising from contractual or other legal rights (regardless of being separable)</i>	<i>Other intangible assets that are separable</i>
Marketing-related ▪ Trademarks, trade names, service marks, collective marks and certification marks ▪ Internet domain names ▪ Trade dress (unique colour, shape or package design) ▪ Newspaper mastheads ▪ Non-competition agreements	
Customer-related ▪ Order or production backlogs ▪ Customer contracts and the related customer relationships	▪ Customer lists ▪ Non-contractual customer relationships

<i>Intangible assets arising from contractual or other legal rights (regardless of being separable)</i>	<i>Other intangible assets that are separable</i>
<i>Artistic-related</i> - Plays, operas and ballets - Books, magazines, newspapers and other literary works - Musical works such as compositions, song lyrics and advertising jingles - Pictures and photographs - Video and audio-visual material, including films, music videos and television programmes	
<i>Contract-based</i> - Licensing, royalty and standstill agreements - Advertising, construction, management, service or supply contracts - Construction permits - Franchise agreements - Operating and broadcasting rights - Servicing contracts such as mortgage servicing contracts - Employment contracts - Use rights such as drilling, water, air, timber-cutting and route authorities	
<i>Technology-based</i> - Patented technology - Computer software and mask works - Trade secrets such as secret formulas, processes or recipes	- Unpatented technology - Databases, including title plants

It can be seen from the table that customer relationships can potentially fall under either category. In the IASB's view, "Customer relationships meet the contractual-legal criterion if an entity has a practice of establishing contracts with its customers, regardless of whether a contract exists at the acquisition date." [IFRS 3.1E28]. In such cases, it does not matter whether or not the relationship is separable. It would only be if the relationship did not arise from a contract that recognition depends on the separability criterion.

As noted at 2.8 above, the IASB's view of the contractual nature of customer relationships appears to differ from the FRC's view expressed in the Basis of Conclusions as discussed above. Therefore, IFRS 3's guidance on customer relationships might not be relevant to an entity preparing financial statements under FRS 102.

An acquirer may intend not to use an acquired asset, for example, a brand name or research and development intangible asset or it may intend to use the asset in a way that is different from the way in which other market participants would use it. Section 19 requires the acquirer to recognise all such identifiable assets and measure them at their fair value determined in accordance with their highest and best use by market participants (see Chapter 10 at section 4.8.1). [FRS 102.19.11(a), FRS 102.2A.9, FRS 102 Appendix I]. This means that no immediate impairment loss is reflected if the acquirer does not intend to use the intangible asset to generate its own cash flows, but market participants would.

However, if the entity is not intending to use the intangible asset to generate cash flows, it is likely the expected useful life will be short.

3.7.3.B Assets and liabilities related to contracts with customers

As part of a business combination, an acquirer may assume liabilities or acquire assets recognised by the acquiree in accordance with Section 23, for example, contract assets, receivables or contract liabilities. Under Section 23, if an entity receives consideration from a customer, or consideration is due (i.e., a receivable), before the entity transfers a good or service to the customer, the entity presents a contract liability. [FRS 102.23.125]. An acquirer recognises a contract liability (sometimes referred to as deferred revenue) related to a contract with a customer that it has assumed if the acquiree has received consideration (or the amount is due) from the customer. To determine whether to recognise a contract liability, however, an acquirer may also need to consider the definition of a performance obligation in Section 23. That is, at the acquisition date, the acquirer would identify the remaining promised goods and services in a contract with a customer and evaluate whether the goods and services it must transfer to a customer in the future are an assumed performance obligation for which the acquired entity has received consideration (or the amount is due). This is important because the consideration received (or the amount due) may relate to a satisfied or partially satisfied performance obligation for which no (or not all) revenue was recognised pre-combination (e.g., due to variable consideration being constrained). Since it was not party to the acquiree's performance pre-combination, an acquirer may need to consider how that affects its financial statements. For example, whether any consideration received that relates to the acquiree's pre-combination performance is presented as revenue or other income.

Chapter 25 at 5 provides additional guidance on identifying performance obligations in a contract with a customer. If a contract liability for an assumed performance obligation is recognised, the acquirer derecognises the contract liability and recognises revenue as it provides those goods or services after the acquisition date.

In accordance with the requirements in Section 19, at the date of acquisition, an assumed contract liability is measured at its fair value, which would reflect the acquiree's obligation to transfer some (if the amount paid in advance covers only a portion of consideration for the remaining promised goods and services) or all (if the amount paid in advance covers full consideration for the remaining promised goods and services) of the remaining promised goods and services in a contract with a customer, as at the acquisition date. The fair value is measured in accordance with the requirements in Section 2A and may require significant judgement. One method that might be used in practice to measure fair value of the contract liability is a cost build-up approach. That approach is based on a market participant's estimate of the costs that will be incurred to fulfil the obligation plus a 'normal' profit margin for the level of effort or assumption of risk by the acquirer after the acquisition date. The normal profit margin also is from the perspective of a market participant and will not include any profit related to selling or other efforts completed prior to the acquisition date.

Illustration 3-13: Contract liability of an acquiree

Target is an electronics company that sells contracts to service all types of electronic equipment for an annual fee of £120,000 paid in advance. Acquirer purchases Target in a business combination. At the acquisition date, Target has one service contract outstanding with 6 months remaining and for which a contract liability of £60,000 was recorded in Target's pre-acquisition financial statements.

To fulfil the contract over its remaining 6-month term, Acquirer estimates that a market participant would incur costs of £45,000 and expect a profit margin for that fulfilment effort of 20% (i.e., £9,000) and thus would expect to receive £54,000 for the fulfilment of the remaining performance obligation.

Accordingly, Acquirer will recognise a contract liability of £54,000 in respect of the acquired customer contract.

The acquirer does not recognise a contract liability or a contract asset for a contract with a customer that is an executory contract (see Chapter 24 at 3.1.1.A) at the acquisition date. However, for executory contracts with customers with terms that are favourable or unfavourable relative to the market terms, the acquirer recognises either a liability assumed, or an asset acquired in a business combination (see 3.7.4.F below).

In addition to the contract liability, an acquirer may also assume refund liabilities of the acquiree. Under Section 23, an entity recognises a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, including refund liabilities relating to a sale with a right of return. [FRS 102.23.49]. A refund liability, therefore, is different from a contract liability and might be recognised even if at the acquisition date no contract liability is recognised. Under Section 19, refund liabilities are also measured at their fair value at the acquisition date with fair value determined in accordance with the requirements of Section 2A. The requirements in Section 2A for measuring the fair value of liabilities are discussed in more detail in Chapter 10 at 4.9.

If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity presents a contract as a contract asset, excluding any amounts presented as receivable. [FRS 102.23.126]. Contract assets represent entity's rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (e.g., the entity's future performance). [FRS 102 Appendix I]. A trade receivable is an unconditional right to receive consideration from the customer (see also Chapter 25 at 11.1.1). [FRS 102.23.127].

The value of acquired contracts with customers may be recognised in multiple assets and liabilities (e.g., receivables, contract assets, right of return assets, intangible assets, contract liabilities, refund liabilities).

Under Section 19, all acquired assets related to the contract with customers are measured at their fair value at the date of acquisition, determined under Section 2A. The Section 2A requirements for measuring the fair value of assets are discussed in more detail in Chapter 10 at 4.8.

When measuring the fair value of acquired contracts with customers, an acquirer must verify that all of the components of value have been considered (i.e., an acquirer is required to verify that none of the components of value have been omitted or double counted). An acquirer also must verify that all of the components are appropriately reflected in the fair value measurement. After the date of acquisition, an acquirer applies Section 23 to account for any of the acquiree's assets, liabilities, income and expenses that fall within that standard's scope. Because Section 23 does not measure revenue (or any assets or liabilities within its scope) on a fair value basis, so-called 'day 2' measurement differences may arise post-combination.

How we see it

Neither Section 19 nor Section 23 specify how to account for any 'day 2' measurement differences that may arise when an acquiree's assets, liabilities, income and expenses are within the scope of Section 23. Therefore, the acquirer will need to develop an accounting policy in accordance with Section 10.

3.7.3.C Insurance contracts

Section 19 of FRS 102 requires assets and liabilities acquired or assumed in a business combination to be measured at fair value. [FRS 102.19.14]. Insurance contracts are not exempt from these requirements and FRS 103 explicitly confirms that insurance liabilities assumed and insurance assets acquired in a business combination must be measured at fair value at the acquisition date. [FRS 103.2.27].

However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) A liability measured in accordance with the acquirer's accounting policies for insurance contracts that it issues.
And
- (b) An intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired, and insurance obligations assumed and (ii) the amount described in (a). As an exception to Section 18 of FRS 102, the subsequent measurement of this asset must be consistent with the measurement of the related insurance liabilities. [FRS 103.2.27(a), FRS 103.2.27(b)].

Further discussion on this topic can be found in Chapter 38 at 10.

3.7.4 Determining the acquisition-date fair values

The general principle is that the identifiable assets acquired, and liabilities assumed are measured at their acquisition-date fair values. [FRS 102 Appendix I].

Extract from FRS 102**Appendix I**

Fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.

In the absence of any specific fair value guidance, the guidance in Section 2A is used to determine fair value. This includes the requirement to value non-financial assets at the highest and best use. [FRS 102.2A.9, FRS 102.2A.10, FRS 102.2A.11, FRS 102.2A.12]. See Chapter 10 at 4.8.1 for discussion of this guidance. Some guidance in other sections of FRS 102 relevant to specific assets and liabilities is discussed at 3.7.4.A to 3.7.4.G below.

Section 19 allows some assets and liabilities to be measured at other than fair value on initial recognition, as described in 3.7.2 above.

3.7.4.A Property, plant and equipment

In approaching the recognition and measurement of, for example, property, plant and equipment of the acquiree, the acquirer might look to the revaluation guidance included within Section 17. This refers to the guidance in Section 2A and notes that:

"The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal. ... If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach." [FRS 102.17.15C, FRS 102.17.15D].

Since assets are recognised at their acquisition-date fair values, it follows that the acquirer does not recognise a separate provision or valuation allowance for assets - such as accumulated depreciation.

3.7.4.B Intangible assets

Section 18 provides no guidance on the determination of fair value and so the general guidance in Section 2A is used (see Chapter 10). [FRS 102.2A.15, FRS 102.2A.20].

Extract from FRS 102**Valuation techniques**

- 2A.15** The entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of inputs determined by reference to a market price in an active market. An entity shall use the following methodology to estimate fair value:
- (a) The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date.
 - (b) When an unadjusted quoted price is not available, the price of a recent orderly transaction between market participants for an identical or comparable asset or liability provides evidence of fair value. However, this price may not be a reliable estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of the transaction, and the measurement date.
 - (c) If neither (a) nor (b) above are available or reliable, the fair value shall be estimated using another valuation technique. The objective of using another valuation technique is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date
- 2A.20** Valuation techniques, or the use of multiple techniques, can often produce a range of reasonable valuations. The selection of the most appropriate fair value within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

Under FRS 102, there are three broad approaches to valuation techniques. [FRS 102.2A.16]. These are the market, income and cost approaches.

Income-based approaches are the most commonly used of the three in respect of intangible assets. These involve identifying the expected cash flows or economic benefits to be derived from the ownership of the particular intangible asset and calculating the fair value of an intangible asset at the present value of those cash flows.

Two income-based methods that are commonly used to value intangible assets are:

- The Multi Period Excess Earnings Method ('MEEM')

And

- The Relief from Royalty method

The multi-period excess earnings method is often used to value intangible assets that generate cash independently. The method isolates the contribution of the asset being valued by deducting the cash flows that can be attributed to complementary assets, ensuring that only the excess earnings attributable to the intangible asset are considered. The excess cash flows are then discounted to calculate a present value.

The Relief from Royalty method is often used to calculate the value of a trademark or trade name. This approach is based on the concept that if an entity owns a trademark, it does not have to pay for the use of it and therefore is relieved from paying a royalty. The amount of that theoretical payment is used as a surrogate for income attributable to the trademark. The valuation is arrived at by computing the present value of the after-tax royalty savings, calculated by applying an appropriate royalty rate to the projected revenue, using an appropriate discount rate. Although The Relief from Royalty Method is not explicitly called out as an approach under FRS 102, it is a common income approach for valuing intangible assets and would not be precluded from being utilised if it was the most appropriate valuation technique.

3.7.4.C Inventories

Section 13 *Inventories*, provides no guidance on determination of fair value.

One way of approaching inventory valuation on a business combination is as follows:

- Finished goods are valued using market prices less the costs of disposal and a reasonable profit allowance for the selling effort. All costs must be estimated using market participant assumptions.
- Work in progress is valued using market prices of finished goods less the costs a market participant would have to incur to obtain these market prices i.e., all costs to complete, costs of disposal and a reasonable profit allowance for the completion and selling effort. All costs must be estimated using market participant assumptions.

And

- Raw materials are valued using current replacement costs.

Illustration 3-14: Fair value of work in progress

Entity A, a dairy business, acquires Entity B on 30 June 20X6. Entity B also operates a dairy business and included in its inventory at the date of acquisition was work in progress being inventory of cheddar cheese in cellars of the dairy left to mature for a year. The carrying amount of this inventory, being the costs incurred to the date of acquisition, is £400,000.

The intention is to sell the cheese once it has matured. The market price of fully matured cheese of the same quality at 30 June 20X6 is £900,000. Future storage, marketing and selling expenses required to complete the process and market the product to retailers is estimated at £185,000, using market participant assumptions.

How is the fair value of the work in progress determined?

Based on the guidance above, the work in progress would be valued using market prices of finished goods less the sum of the costs to complete, the costs of disposal and a reasonable profit allowance for the completing and selling effort based on profit for similar finished goods. Judgement is required by entities in calculating a reasonable profit allowance relating to the completing and selling efforts.

One approach would be to use the cost structure of Entity A as a starting point to determine the reasonable profit allowance for subsequent costs to be incurred by a market participant. Accordingly, it may be that Entity A would incur total costs of £585,000 within its current operations. Based on the estimated market price of £900,000, this would result in an overall profit of £315,000. Consequently, the profit allowance to be made for the completing and selling effort would be £100,000 (being $£315,000 \times £185,000 \div £585,000$). On this basis, the fair value of the work in progress would be £615,000 (being $£900,000 - £185,000 - £100,000$).

3.7.4.D Financial instruments

Financial instruments traded in an active market must be valued at their quoted price, which is usually the current bid price.

When unadjusted quoted prices are unavailable, the price of a recent orderly transaction between market participants for an identical or comparable asset or liability is used. However, this price might not be a good estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of transaction and the measurement date.

If fair values established using the above methodologies are not available or not reliable, an entity estimates the fair value by using another valuation technique, with the objective of estimating the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date. *[FRS 102.2A.15]*.

The fair value of a liability reflects the effect of non-performance risk (including but not limited to the acquirer's own credit risk), which is assumed to be the same before and after the transfer of the liability. *[FRS 102.2A.13, FRS 102 Appendix I]*. The fair value of a financial liability that is due on demand is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. *[FRS 102.2A.14]*.

Further guidance on these concepts is provided in Chapter 10 at 4.9.3, which addresses Section 2A.

Under the above guidance, receivables would likely be valued based on the present values of the amounts to be received, determined at appropriate interest rates, less allowances for collectability and collection costs, if necessary. As receivables are recognised and measured at fair value at the acquisition date, any uncertainty about collections and future cash flows are included in the fair value measure - and therefore, the acquirer does not recognise a separate provision or valuation allowance. In other words, an acquirer cannot 'carry over' any provision or valuation allowance already recognised by the acquiree. Generally, discounting is not required for short-term receivables, beneficial contracts and other identifiable assets when the difference between the nominal and discounted amounts is not material.

Similarly, accounts and notes payable, long-term debt, liabilities, accruals and other claims payable would likely be valued using the present values of amounts to be disbursed in settling the liabilities determined at appropriate interest rates. Again, discounting is not generally required for short-term liabilities when the difference between the nominal and discounted amounts is not material.

3.7.4.E Investments in an associate or jointly controlled entity

Where one of the identified assets is an investment in an associate or a jointly controlled entity, the fair value must be determined for the investment in associate or jointly controlled entity as whole, rather than calculating a fair value based on the appropriate share of the fair values of the identifiable assets, liabilities and contingent liabilities of the associate or jointly controlled entity. See Chapter 10 at 4.10.1 for discussion on fair valuing large holdings of a financial instrument. By doing so, any goodwill relating to the associate or jointly controlled entity is subsumed within the carrying amount of the associate or jointly controlled entity rather than within the goodwill arising on the overall business combination. Nevertheless, although this fair value is effectively the 'cost' to the group to which equity accounting is applied, the underlying fair values of the identifiable assets, liabilities and contingent liabilities also need to be determined to apply equity accounting (see Chapter 17 at 3.2.2).

If the fair value exercise results in an excess of assets over the fair value of the consideration (commonly referred to as 'negative goodwill'), in accordance with the requirements discussed at 3.9.3 below, the acquirer is required to challenge the fair value placed on the associate or jointly controlled entity as it re-challenges the values placed on all of the assets, liabilities and contingent liabilities of the acquiree to ensure that the value has not been overstated. *[FRS 102.14.8(c), FRS 102.19.24(a)]*.

3.7.4.F Onerous contracts

A provision for an onerous contract, that would be recognised under Section 21 by the acquiree at the acquisition date, must be recognised and measured at its fair value on allocation of the cost of the business combination.

An onerous contract is one in which the "unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it." The unavoidable costs under a contract reflect the "least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it." The cost of fulfilling a contract is, "the incremental costs of fulfilling that contract and an allocation of other costs that relate directly to fulfilling contracts." *[FRS 102.21A.2]*. Therefore, an onerous contract is a contract that is directly loss-making, not

simply uneconomic by reference to current prices. However, in allocating the cost of a business combination, the acquirer must go further than considering only onerous contracts that are directly loss-making.

How we see it

We believe that contracts that are 'onerous' by reference to market conditions at the date of acquisition must be recognised as liabilities. This is consistent with the requirements for intangible assets.

How we see it

In addition to contracts which are onerous, in allocating the cost of a business combination to the assets acquired, liabilities and contingent liabilities assumed, we consider that favourable contracts must be recognised as intangible assets and unfavourable contracts recognised as liabilities.

An acquiree might hold an investment property subject to operating leases with a tenant on off-market terms for a fixed period. The fair value of a non-financial asset (such as investment property) would take into account the existence of these off-market leases. The fair value of the off-market leases would not be separately identified as an intangible asset or onerous contract. A similar issue is specifically addressed in IFRS 3. [IFRS 3.B42].

3.7.4.G Contingent liabilities

No specific guidance is included in FRS 102 in determining the fair value of a contingent liability. Its fair value would be based on the amount that a third party would charge to assume those contingent liabilities. This amount would reflect all expectations about possible cash flows and not the single most likely or the expected maximum or minimum cash flow. Many contingent liabilities are so defined because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation - even though the minimum cash flow may be zero, a third party would still charge a sum to assume the contingent liability.

3.7.5 Subsequent adjustments to fair values

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer must recognise provisional amounts for the items for which the accounting is incomplete. Within twelve months of the acquisition date, the acquirer must retrospectively adjust the provisional amounts recognised as assets and liabilities at the acquisition date to reflect new information obtained about any relevant facts and circumstances that existed at the acquisition date, i.e., the adjustments are accounted for as if they were made at the acquisition date. Any adjustments will impact the amount of goodwill (or negative goodwill) recognised. [FRS 102.19.19].

How we see it

Paragraph 19.19 of FRS 102 refers to the initial accounting being 'incomplete by the end of the reporting period' and the acquirer reporting 'provisional amounts for the items for which the accounting is incomplete'. This means that the initial accounting is incomplete at the date at which the financial statements for that period are authorised for issue. Thus, any items that are finalised up to the date the financial statements were authorised for issue must be reflected in the initial accounting, providing this is within the twelve-month period allowed.

Therefore, FRS 102 requires the allocation of the cost of the business combination to be completed within twelve months of the acquisition date. Where, as a result of completing the initial accounting, adjustments to the provisional values are identified, FRS 102 requires them to be recognised from the acquisition date. Although not explicitly stated in FRS 102, this means that:

- The carrying amount of the identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing the initial accounting is calculated as if its fair value at the acquisition date had been recognised from that date.
- And
- Comparative information presented for the periods before the initial accounting for the combination is complete is presented as if the initial accounting had been completed from the acquisition date. This includes any additional depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting.

These requirements are illustrated in the following example (note that the deferred tax implications have been ignored).

Illustration 3-15: Finalisation of provisional values upon completion of initial accounting

Entity A prepares financial statements for annual periods ending on 31 December 20X6. Entity A acquired Entity B on 30 September 20X6, in relation to which it sought an independent appraisal for an item of property, plant and equipment acquired in the combination. However, the appraisal was not finalised by the time Entity A completed its 20X6 annual financial statements in which it recognised a provisional fair value for the asset of £30,000, and a provisional value for acquired goodwill of £100,000. The item of property, plant and equipment had a remaining useful life at the acquisition date of five years. Goodwill is amortised over its useful life of 10 years.

Six months after the acquisition date, Entity A received the independent appraisal, which estimated the asset's fair value at the acquisition date at £40,000.

In preparing its 20X7 financial statements, Entity A is required to recognise any adjustments to provisional values as a result of completing the initial accounting from the acquisition date.

An adjustment is made to the carrying amount of the item of property, plant and equipment, measured as the fair value adjustment at the acquisition date of £10,000, less the additional depreciation that would have been recognised had the asset's fair value at the acquisition date been recognised from that date (£500 for three months' depreciation to 31 December 20X6), i.e., an increase of £9,500.

The carrying amount of goodwill is adjusted to reflect the increase in value of the asset at the acquisition date of £10,000. The decrease in goodwill will be net of £250 being the reduced amortisation charge for the three months to 31 December 20X6, i.e., a decrease of £9,750.

20X6 comparative information is to be restated to reflect these adjustments. Accordingly, the 20X6 balance sheet is restated by increasing the carrying amount of property, plant and equipment by £9,500, reducing goodwill by £9,750 and reducing retained earnings by £250. The 20X6 income statement is restated to include additional depreciation of £500 and a reduction in amortisation of goodwill of £250.

Per the disclosure requirements of paragraph 19.25B of FRS 102, Entity A would disclose in its 20X6 financial statements that the initial accounting for the business combination has been determined only provisionally and specify the line items for which provisional amounts have been recognised.

While FRS 102 does not specifically mandate disclosures in the subsequent financial statements, we consider it appropriate that in its 20X7 financial statements it would disclose the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period as it is required by paragraph 7 of Schedule 1 and paragraph 1(1) of Schedule 6 to the Regulations. Therefore, Entity A would disclose that:

- The fair value of the item of property, plant and equipment at the acquisition date has been increased by £10,000 with a corresponding decrease in goodwill.
- And
- The 20X6 comparative information is restated to reflect this adjustment, including additional depreciation of £500 and reduced amortisation of goodwill of £250 relating to the year ended 31 December 20X6.

The above Illustration shows a situation where a provisional value of an asset was finalised at a different amount as part of the completion of the initial accounting. By contrast, the following Illustration shows the identification of a new asset as a result of finalising the business combination accounting.

Illustration 3-16: Identification of an asset upon completion of initial accounting

Entity C prepares financial statements for annual periods ending on 31 December 20X6. Entity C acquired Entity D on 30 November 20X6. Entity C engaged an independent appraiser to assist with the identification and determination of fair values to be assigned to the acquiree's assets, liabilities and contingent liabilities and the cost of the business combination. However, the appraisal was not finalised by the time Entity C completed its 20X6 annual financial statements, and therefore the amounts recognised in its 20X6 annual financial statements were on a provisional basis.

As part of the work carried out in finalising the initial accounting, it was identified by the independent appraiser that Entity D had an intangible asset (meeting all of Section 18's recognition and identification criteria) with a fair value at the date of acquisition of £20,000. However, this had not been identified at the time when Entity C was preparing its 20X6 annual financial statements. Thus, no value had been included for this intangible asset.

In preparing its 20X7 financial statements, Entity C is required to recognise any adjustments to provisional values as a result of completing the initial accounting from the acquisition date. In this case, no value had been recognised, and indeed, the intangible asset had not been identified at the time of preparing its 20X6 financial statements. So, can an adjustment be made under the provisions of paragraph 19.19 of FRS 102?

The requirements are not limited to measurement adjustments. Adjustments to recognise subsequently identified assets or liabilities are permitted as a result of completing the initial accounting. The initial accounting involves the identification as well as the measurement of the acquiree's assets, liabilities and contingent liabilities. Therefore, in its financial statements for the year ended 31 December 20X7, Entity C retrospectively adjusts the prior year information to reflect the recognition of this intangible asset.

It is important that any adjustments to the provisional allocation reflect conditions as they existed at the date of the acquisition, rather than being affected by subsequent events; the objective is to determine the fair values of the items at the date of acquisition. There is a parallel to be drawn here with the accounting treatment of events subsequent to the balance sheet date. Only those events which provide further evidence of conditions as they existed at the acquisition date must be taken into account.

Beyond twelve months after the acquisition date, adjustments to reflect new information obtained about any relevant facts and circumstances that existed at the acquisition date must be accounted for prospectively, except that adjustments to the initial accounting for a business combination are to be recognised only to correct a material error in accordance with Section 10. [FRS 102.19.19].

Section 10 requires an entity, to the extent practicable, to correct a material error retrospectively and to restate the comparative information for the prior period(s) in which the error occurred. [FRS 102.10.21]. The accounting is similar to that outlined above for adjustments upon completion of initial accounting. The only difference being that there is no time limit as to when such adjustments may be required. Section 10 also has specific disclosure requirements in respect of material prior period errors (see Chapter 9 at 3.6.3). [FRS 102.10.23].

Adjustments to the initial accounting for a business combination after it is complete are not made for the effect of changes in estimates. In accordance with Section 10, the effect of a change in estimate is recognised in the current and future periods (see Chapter 9 at 3.4). [FRS 102.10.15, FRS 102.10.16, FRS 102.10.17].

3.8 Non-controlling interests

A non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent. [FRS 102 Appendix I, FRS 102.19.14A].

Extract from FRS 102

19.14A At the acquisition date, any non-controlling interest in the acquiree is stated at the non-controlling interest's share of the net amount of the identifiable assets, liabilities and provisions for contingent liabilities so recognised.

Consequently, where the acquirer obtains less than a 100% equity interest in the acquiree, a non-controlling interest in the acquiree is recognised reflecting the non-controlling interest's proportion of the net identifiable assets, liabilities and contingent liabilities of the acquiree at their attributed fair values at the date of acquisition; no amount is included for any goodwill relating to the non-controlling interests. There is no option under FRS 102 to measure non-controlling interests at fair value.

FRS 102 does not distinguish between non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation and other components of non-controlling interests (e.g., perpetual debt classified as equity under Section 22).

How we see it

The implication is that all non-controlling interests are measured in the same way based on present ownership interest. This means that any non-controlling interests, such as options, are valued at nil if they are not entitled to a present ownership interest.

The measurement of non-controlling interests in a business combination is illustrated in Illustration 3-17 below.

Illustration 3-17: Initial measurement of non-controlling interest in a business combination

Parent A acquires 80% of the ordinary shares of Target B for £95m in cash. The fair value of Target B's identifiable net assets is £85m. The impact of the business combination, and the measurement of non-controlling interest, is as follows:

	Dr	Cr
	£m	£m
Fair value of identifiable net assets	85	
Goodwill (£95m - (80% × £85m))	27	
Cash		95
Non-controlling interest (20% × £85m)		17

The ordinary shares are present ownership interests and entitle their holders to a proportionate share of the Target B's net assets in the event of liquidation. They are measured at the non-controlling interest's proportionate share of the identifiable net assets of Target B.

Further discussion on the accounting and presentation of non-controlling interests can be found in Chapter 8 at 3.7.

3.8.1 Call and put options over non-controlling interests

In some business combinations when less than 100% of the equity shares are acquired, the transaction might also involve options over some or all of the outstanding shares held by the non-controlling shareholders. The acquirer could hold a call option, i.e., a right to acquire the outstanding shares at a future date for cash at a particular price. Alternatively, it could have granted a put option to the other shareholders whereby they have the right to sell their shares to the acquirer at a future date for cash at a particular price. In some cases, there could be a combination of call and put options, the terms of which might be equivalent or might differ.

Those kinds of transactions raise many questions regarding the appropriate accounting treatment such as whether the parent has a present ownership interest in the shares subject to the call and/or put options, whether non-controlling interest is recognised, how put and/or call options are classified and whether the transactions are accounted for as a single arrangement. In some cases, put and/or call options are subject to employment conditions and could, in whole or in part, constitute an employee benefit (accounted under Section 28 - see Chapter 30) or a share-based payment arrangement (accounted under Section 26 - see Chapter 28). Section 19 gives no guidance as to how such options impact the accounting for a business combination. Those issues are discussed in Chapter 8 at 3.7.2.

3.9 Goodwill

FRS 102 defines 'goodwill' in terms of its nature, rather than in terms of its measurement. It is defined as: "Future economic benefits arising from assets that are not capable of being individually identified and separately recognised". [FRS 102 Appendix I].

Section 19 addresses accounting for goodwill both at the time of a business combination and subsequently. [FRS 102.19.14, FRS 102.19.22, FRS 102.19.23].

3.9.1 Initial recognition

Extract from FRS 102

- 19.22** The acquirer shall, at the acquisition date:
- (a) recognise goodwill acquired in a business combination as an asset; and
 - (b) initially measure that goodwill as its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with paragraphs 19.15 to 19.15C.

Section 19 requires that an acquirer, at the acquisition date, recognises goodwill acquired in a business combination as an asset. However, rather than attributing a fair value to the goodwill directly, the initial measurement of goodwill is required to be its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with Section 19's requirements. [FRS 102.19.14, FRS 102.19.22]. Thus, as discussed at 3.8 above, no amount is included for any goodwill relating to the non-controlling interests.

The cost of a business combination is the aggregate of the acquisition-date fair values of assets given, liabilities incurred or assumed, and any equity instruments issued by the acquirer, in exchange for control of the acquiree plus any directly attributable costs (see 3.6 above). [FRS 102.19.11].

Where the acquirer's interest in the net amount of the identifiable assets, liabilities and provisions for contingent liabilities exceeds the cost of the business combination, Section 19 regards this as giving rise to negative goodwill. [FRS 102.19.24]. Negative goodwill is discussed further in 3.9.3 below.

3.9.2 Subsequent measurement of goodwill

After initial recognition, an acquirer measures goodwill acquired in a business combination at cost less accumulated amortisation and accumulated impairment losses. [FRS 102.19.23]. Section 19 defers to Section 18 and Section 27 for the detailed requirements in relation to amortisation and impairment, respectively. Section 19 requires that goodwill is to be amortised on a systematic basis over a finite useful life following the principles of paragraphs 19 to 24 of Section 18, and that Section 27 is to be followed for recognising and measuring any impairment of goodwill. [FRS 102.19.23].

However, Section 19 states that: "If, in exceptional cases, an entity is unable to make a reliable estimate of the useful life of goodwill, the life shall not exceed 10 years". [FRS 102.19.23(a)]. This is consistent with UK company law. [1 Sch 22].

The useful life of goodwill is required to be disclosed. If the useful life of goodwill cannot be reliably estimated, disclosure must be made of the reasons supporting the period chosen (which cannot exceed 10 years). [FRS 102.19.25(g)].

See Chapter 21 at 3.3.3.A and Chapter 29 for further discussion of the requirements of Sections 18 and 27 regarding estimating the useful life, and impairment, respectively.

3.9.3 Excess over cost of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities (negative goodwill)

Extract from FRS 102

Excess over cost of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities

- 19.24** If the acquirer's interest in the net amount of the identifiable assets, liabilities and provisions for contingent liabilities recognised in accordance with paragraph 19.14 exceeds the cost of the business combination (also referred to as 'negative goodwill'), the acquirer shall:
- Reassess the identification and measurement of the acquiree's assets, liabilities and provisions for contingent liabilities and the measurement of the cost of the combination.
 - Recognise and separately disclose the resulting excess on the face of the statement of financial position on the acquisition date, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess.
 - Recognise subsequently the excess up to the fair value of non-monetary assets acquired in profit or loss in the periods in which the non-monetary assets are recovered. Any excess exceeding the fair value of non-monetary assets acquired shall be recognised in profit or loss in the periods expected to be benefited.

In some business combinations, the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities exceeds the cost of the combination. That excess is commonly referred to as 'negative goodwill'.

Where such an excess arises, Section 19 requires the acquirer to reassess the identification and measurement of the acquiree's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the combination. [FRS 102.19.24(a)].

Having undertaken that reassessment, any excess remaining after that reassessment is then required to be recognised and separately disclosed on the face of the statement of financial position, immediately below goodwill, and followed by a subtotal of the net amount of goodwill and the excess (i.e., negative goodwill). [FRS 102.19.24(b)].

Following initial recognition on the statement of financial position, negative goodwill up to the fair value of the non-monetary assets acquired is recognised in profit or loss in the periods in which the non-monetary assets are recovered. [FRS 102.19.24(c)].

How we see it

When the excess is less than the fair value of the non-monetary assets acquired, FRS 102 does not specify whether to allocate negative goodwill to non-monetary assets on a pro rata basis or to specific assets. This determination will lead to different profiles of amortisation.

For example, since inventories are usually turned over relatively quickly, any negative goodwill up to the fair value of the inventories (or allocated on the basis of the fair value of the inventories) may be released to the profit and loss account over a short period following the acquisition.

How we see it

Any negative goodwill in excess of the fair values of non-monetary assets acquired must be released in the periods expected to benefit. The exact meaning of this wording is not completely clear, but any reasonable interpretation is likely to be acceptable.

The periods in which the excess will be recognised in profit or loss must be disclosed. [FRS 102.19.25(h)].

3.10 Reverse acquisitions

In some business combinations, commonly referred to as reverse acquisitions, the acquirer is the entity whose equity interests have been acquired and the issuing entity is the acquiree (see 3.4.1 above). The legal subsidiary is the acquirer if it has control, i.e., the power to govern the financial and operating policies of the legal parent so as to obtain benefits from its activities [FRS 102.19.8, FRS 102.19.9, FRS 102 Appendix I]. See 3.4 above for further discussion on identifying the acquirer.

A reverse acquisition generally occurs when the owners of a company being 'acquired' (Company B) receive as consideration sufficient voting shares of the 'acquiring company' (Company A) so as to obtain control over the new combined entity. The acquisition is 'reverse' because, from an economic point of view, the acquirer (Company A) is being taken over by the acquiree (Company B).

Since the CA 2006 regards Company A as being the parent undertaking of Company B, it requires Company A to prepare consolidated financial statements. In preparing those consolidated financial statements, Company A is required to acquisition account for the acquisition of its subsidiary undertaking, Company B. [6 Sch 9].

In these circumstances, as Company B obtains control of Company A, and is therefore the acquirer under FRS 102, Company A is deemed to have been acquired by Company B and reverse acquisition accounting must be applied.

To adopt reverse acquisition accounting represents a departure from company law which does not envisage such occurrence. Such departure (a 'true and fair override') is required to the extent necessary for the financial statements to give a true and fair view. In such circumstances, there must be disclosure of the departure from the CA 2006, including the particulars, reasons and effect. [s404(5)].

In the absence of guidance within FRS 102, the discussion that follows is based on the guidance in IFRS 3. [IFRS 3.B19-IFRS 3.B27].

3.10.1 Measuring the cost of the business combination

In a reverse acquisition, the accounting acquirer usually issues no consideration for the accounting acquiree; equity shares are issued to the owners of the accounting acquirer (i.e., the legal subsidiary) by the accounting acquiree (i.e., the legal parent). In a reverse acquisition, the cost of the business combination is deemed to have been incurred by the legal subsidiary in the form of equity instruments issued to the owners of the legal parent. The cost of the combination is based on the number of equity instruments the legal subsidiary would have had to issue to provide the same percentage ownership interest of the combined entity to the owners of the legal parent as they have in the combined entity as a result of the reverse acquisition. The fair value of the number of equity instruments so calculated is used as the cost of the combination.

If the fair value of the equity instruments of the legal parent is used as the basis for determining the cost of the combination, it is the acquisition-date fair value of the acquiree's equity interests that is used, which is the total fair value of all the issued equity instruments of the legal parent before the business combination. This might be the case, for example, where the fair value of the legal parent's equity shares is more reliably measured.

Illustration 3-18: Reverse acquisition - calculating the cost of the business combination using the fair value of the equity shares of the legal subsidiary

Entity A, the entity issuing equity instruments and therefore the legal parent, is acquired in a reverse acquisition by Entity B, the legal subsidiary, on 30 September 20X6. The accounting for any income tax effects is ignored.

Balance sheets of Entity A and Entity B immediately before the business combination are:

	<i>Entity A</i>	<i>Entity B</i>
	£	£
Tangible fixed assets	1,300	3,000
Debtors	500	700
	<u>1,800</u>	<u>3,700</u>
Creditors: amounts falling due within one year	300	600
Creditors: amounts falling due after more than one year	400	1,100
	<u>700</u>	<u>1,700</u>
Net assets	<u>1,100</u>	<u>2,000</u>
Capital and reserves		
Called up share capital		
100 £1 ordinary shares	100	
60 £1 ordinary shares		60
Share premium account	200	540
Profit and loss account	800	1,400
	<u>1,100</u>	<u>2,000</u>

On 30 September 20X6, Entity A issues 2.5 shares in exchange for each ordinary share of Entity B. All of Entity B's shareholders exchange their shares in Entity B. Therefore, Entity A issues 150 ordinary shares in exchange for all 60 ordinary shares of Entity B and so has 250 issued shares in total.

The fair value of each ordinary share of Entity B at 30 September 20X6 is £40. The quoted market price of Entity A's ordinary shares at that date is £16.

The fair values of Entity A's identifiable assets and liabilities at 30 September 20X6 are the same as their carrying amounts, with the exception of tangible fixed assets. The fair value of Entity A's tangible fixed assets at 30 September 20X6 is £1,500. (For the purposes of illustration, deferred tax implications have been ignored.) Therefore, the fair value of Entity A's net assets is £1,300 (£1,100 plus £200).

As a result of the issue of 150 ordinary shares by Entity A, Entity B's shareholders own 60% of the issued shares of the combined entity (i.e., 150 shares out of 250 issued shares). The remaining 40% is owned by Entity A's shareholders. If the business combination had taken place in the form of Entity B issuing additional ordinary shares to Entity A's shareholders in exchange for their ordinary shares in Entity A, Entity B would have had to issue 40 shares for the ratio of ownership interest in the combined entity to be the same. Entity B's shareholders would then own 60 out of the 100 issued shares of Entity B and therefore 60% of the combined entity.

As a result, the cost of the business combination is £1,600 (i.e., 40 shares each with a fair value of £40). In this example, this is the same as calculated using the quoted market price of Entity A's shares (100 shares with a fair value per share of £16, i.e., £1,600).

In some circumstances, the combination may be effected whereby some of the consideration given by the legal acquirer to acquire the shares in the legal acquiree is cash. This is dealt with in more detail in the latest edition of the EY publication, International GAAP®.

3.10.2 Preparation and presentation of consolidated financial statements

Since the legal parent is the acquiree for accounting purposes, the consolidated financial statements prepared following a reverse acquisition reflect the fair values of the assets, liabilities and contingent liabilities of the legal parent, not those of the legal subsidiary. Therefore, the cost of the business combination is allocated by measuring the identifiable assets, liabilities and contingent liabilities of the legal parent that satisfy the recognition criteria at their fair values at the acquisition date. Any excess of the cost of the combination over the acquirer's interest in the net fair value of those items is then accounted for as goodwill.

In Illustration 3-18 above, goodwill of £300 would be calculated as the difference between the cost of the business combination of £1,600 and the fair value of the assets acquired of £1,300.

Although the accounting for a reverse acquisition reflects the legal subsidiary as being the acquirer, the consolidated financial statements prepared following a reverse acquisition are issued under the name of the legal parent (accounting acquiree). Consequently, they have to be described in the notes as a continuation of the financial statements of the legal subsidiary (accounting acquirer), with one adjustment, which is to adjust retrospectively the accounting acquirer's legal capital to reflect the legal capital of the accounting acquiree. Comparative information presented in those consolidated financial statements is therefore that of the legal subsidiary (accounting acquirer) - not that originally presented in the financial statements of the legal parent (accounting acquiree) - but is adjusted to reflect the legal capital of the legal parent (accounting acquiree).

Because the consolidated financial statements represent the continuation of the financial statements of the legal subsidiary except for its capital structure:

- The assets and liabilities of the legal subsidiary (accounting acquirer) are recognised and measured at their pre-combination carrying amounts, i.e., not at their acquisition-date fair values.
- The assets and liabilities of the legal parent (accounting acquiree) are recognised and measured in accordance with Section 19, i.e., generally at their acquisition-date fair values.
- The retained earnings and other equity balances reflect those of the legal subsidiary (accounting acquirer) before the business combination, i.e., not those of the legal parent (accounting acquiree).
- The amount recognised as issued equity interests in the consolidated financial statements is determined by adding the issued equity interest of the legal subsidiary (accounting acquirer) outstanding immediately before the business combination to the fair value of the consideration transferred by the accounting acquirer - see 3.10.1 above. However, the equity structure (i.e., the number and type of equity interests issued) reflects the equity structure of the legal parent (accounting acquiree), including the equity interests the legal parent issued to effect the combination. Accordingly, the equity structure of the legal subsidiary (accounting acquirer) is restated using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (accounting acquiree) issued in the reverse acquisition.
- The non-controlling interest reflects any non-controlling interest's proportionate share of the legal subsidiary's (accounting acquirer's) pre-combination carrying amounts of retained earnings and other equity interests (as discussed at 3.10.3 below).

And

- The income statement for the current period reflects that of the legal subsidiary (accounting acquirer) for the full period together with the post-acquisition results of the legal parent (accounting acquiree) based on the attributed fair values.

Illustration 3-19: Reverse acquisition - consolidated balance sheet at date of the business combination

If we consider the transaction in Illustration 3-18 above with the cost of consideration of £1,600, the consolidation at the date of the business combination would be as follows, using the guidance in IFRS 3. As discussed below and shown in Illustration 3-18, additional adjustments would be required to equity for a UK company.

	Entity A	Entity B	Consolidation adjustments	Consolidated
	£	£	£	£
Tangible fixed assets	1,300	3,000	200 ¹	4,500
Goodwill	-	-	300 ²	300
Debtors	500	700	-	1,200
	<u>1,800</u>	<u>3,700</u>	<u>500</u>	<u>6,000</u>
Creditors: amounts falling due within one year	300	600	-	900
Creditors: amounts falling due after more than one year	400	1,100	-	1,500
	<u>700</u>	<u>1,700</u>	<u>-</u>	<u>2,400</u>
Net assets	<u>1,100</u>	<u>2,000</u>	<u>500</u>	<u>3,600</u>
Capital and reserves				
Called up share capital				
100 £1 ordinary shares	100	-	(100) ³	-
60 £1 ordinary shares	-	60	1,600 ³	1,660
Share premium account	200	540	(200) ³	540
Issued equity	<u>300</u>	<u>600</u>	<u>1,300</u>	<u>2,200</u>
Profit and loss account	800	1,400	(800) ³	1,400
	<u>1,100</u>	<u>2,000</u>	<u>500</u>	<u>3,600</u>

¹ To recognise Entity A's tangible fixed assets at their fair value at the acquisition date.

² To recognise goodwill on consolidation, representing the difference between the cost of the combination, £1,600, and the fair value of Entity A's net assets acquired, £1,300.

³ To recognise the cost of the acquisition and to eliminate Entity A's share capital and reserves as at the date of the acquisition.

The equity as shown above would require further adjustment in a UK company. As stated above, the amount of share capital in the consolidated balance sheet does not equal the nominal value of either Entity B's share capital (£60) or that of Entity A following the acquisition (£250). Although the total share capital and share premium (issued equity) in the consolidated balance sheet of £2,200 is equivalent to the total as it would have been if Entity B had been the legal acquirer, the equity structure (i.e., the number and type of equity instruments issued) must reflect that of the legal parent and in a UK GAAP context, the amounts for share capital and related reserves, such as share premium, in the consolidated financial statements must also reflect the legal position. On this basis, a reserve, often called a 'reverse acquisition reserve' would be reflected as illustrated below.

For FRS 102 entities applying IAS 33 *Earnings per Share* there is further guidance in IFRS 3 on disclosure of earnings per share in reverse acquisitions. [IFRS 3.B25, IFRS 3.B26, IFRS 3.B27].

Illustration 3-20: Reverse acquisition - recognition of a reverse acquisition reserve

	Entity A	Entity B	Consolidation adjustments	Consolidated
	£	£	£	£
Tangible fixed assets	1,300	3,000	200 ¹	4,500
Goodwill			300 ²	300
Debtors	500	700	-	1,200
	1,800	3,700	500	6,000
Creditors: amounts falling due within one year	300	600	-	900
Creditors: amounts falling due after one year	400	1,100	-	1,500
	700	1,700	-	2,400
Net assets	1,100	2,000	500	3,600
Capital and reserves				
Called up share capital				
100 £1 ordinary shares	100	-	150 ³	250
60 £1 ordinary shares	-	60	(60) ⁴	-
Share premium account	200	540	(540) ⁴	200
Reverse acquisition reserve	-	-	1,750	1,750
Profit and loss account	800	1,400	(800) ⁵	1,400
	1,100	2,000	500	3,600

¹ To recognise Entity A's tangible fixed assets at their fair value at the acquisition date.

² To recognise goodwill on consolidation, representing the difference between the cost of the combination, £1,600, and the fair value of Entity A's net assets acquired, £1,300.

³ To recognise the nominal value of the shares issued by Entity A on the acquisition. Merger relief applies and so no share premium has been recognised on the transaction.

⁴ To eliminate the share capital and share premium of Entity B (as the capital reserves on this basis reflect those of the legal acquirer).

⁵ To eliminate the profit and loss reserves of Entity A.

3.10.3 Non-controlling interests

In some reverse acquisitions, some of the owners of the legal subsidiary (accounting acquirer) might not exchange their equity interests for equity interests of the legal parent (accounting acquiree) but retain their interest in the equity instruments of the legal subsidiary. Those owners are treated as a non-controlling interest in the consolidated financial statements after the reverse acquisition. That is because the owners of the legal subsidiary that do not exchange their equity interests for equity interests of the legal acquirer have an interest in only the results and net assets of the legal subsidiary - not in the results and net assets of the combined entity. Conversely, even though the legal parent is the acquiree for accounting purposes, the owners of the legal parent have an interest in the results and net assets of the combined entity.

The assets and liabilities of the legal subsidiary are measured and recognised in the consolidated financial statements at their pre-combination carrying amounts. Therefore, in a reverse acquisition, the non-controlling interest reflects the non-controlling shareholders' proportionate interest in the pre-combination carrying amounts of the legal subsidiary's net assets. These requirements are shown in the following Illustration.

Illustration 3-21: Reverse acquisition - non-controlling interests

This example uses the same facts in Illustration 3-18 above, except that in this case only 56 of Entity B's ordinary shares are tendered for exchange rather than all 60. Because Entity A issues 2.5 shares in exchange for each ordinary share of Entity B, Entity A issues only 140 (rather than 150) shares. As a result, Entity B's shareholders own 58.3% of the issued shares of the combined entity (i.e., 140 shares out of 240 issued shares).

As in Illustration 3-18 above, the cost of the business combination is calculated by assuming that the combination had taken place in the form of Entity B issuing additional ordinary shares to the shareholders of Entity A in exchange for their ordinary shares in Entity A. In calculating the number of shares that would have to be issued by Entity B, the non-controlling interest is ignored. The majority shareholders own 56 shares of Entity B. For this to represent a 58.3% ownership interest, Entity B would have had to issue an additional 40 shares. The majority shareholders would then own 56 out of the 96 issued shares of Entity B and therefore 58.3% of the combined entity.

As a result, the cost of the business combination is £1,600 (i.e., 40 shares each with a fair value of £40). This is the same amount as when all 60 of Entity B's ordinary shares are tendered for exchange (see Illustration 3-18 above). The cost of the business combination does not change simply because some of Entity B's shareholders do not participate in the exchange.

The non-controlling interest is represented by the 4 shares of the total 60 shares of Entity B that are not exchanged for shares of Entity A. Therefore, the non-controlling interest is 6.7%. The non-controlling interest reflects the non-controlling shareholders' proportionate interest in the pre-combination carrying amounts of the net assets of the legal subsidiary. Therefore, the consolidated balance sheet is adjusted to show a non-controlling interest of 6.7% of the pre-combination carrying amounts of Entity B's net assets (i.e., £134 or 6.7% of £2,000).

The consolidated balance sheet at 30 September 20X6 (the date of the business combination) reflecting the non-controlling interest is as follows (the intermediate columns for Entity B, non-controlling interest (NCI), Entity A and UK legal capital adjustments are included to show the workings):

	Entity B	NCI ¹	Entity A	UK legal capital adjustments ²	Consolidated
	Book values		Fair values		
	£	£	£	£	£
Tangible fixed assets	3,000		1,500	-	4,500
Debtors	700		500	-	1,200
Goodwill	-		300	-	300
	<u>3,700</u>		<u>2,300</u>	<u>-</u>	<u>6,000</u>
Creditors: amounts falling due within one year	600		300	-	900
Creditors: amounts falling due after one year	1,100		400	-	1,500
	<u>1,700</u>		<u>700</u>	<u>-</u>	<u>2,400</u>
Net assets	<u>2,000</u>		<u>1,600</u>	<u>-</u>	<u>3,600</u>
Capital and reserves					
Called up share capital					
240 £1 ordinary shares (Entity A)	60	(4)	1,600	(1,416)	240
Share premium account	540	(36)		(304)	200
Profit and loss account	1,400	(94)	-	-	1,306
Non-controlling interest	-	134	-	-	134
Reverse acquisition reserve	-	-	-	1,720	1,720
	<u>2,000</u>		<u>1,600</u>	<u>-</u>	<u>3,600</u>

¹ The non-controlling interest of £134 has two components. The first component is the reclassification of the non-controlling interest's share of the accounting acquirer's retained earnings immediately before the acquisition (£1,400 × 6.7% or £94). The second component represents the reclassification of the non-controlling interest's share of the accounting acquirer's issued equity (£600 × 6.7% or £40).

² A UK company makes adjustments to present the share capital structure of the legal parent, Entity A, with an equivalent entry to reverse acquisition reserve.

3.11 Business combinations achieved in stages (step acquisitions)

So far, this chapter has discussed business combinations which result from a single purchase transaction. However, in practice, some subsidiaries are acquired in a series of steps which take place over an extended period, during which the underlying value of the interest is likely to change, both because of the trading profits (or losses) which it retains and because of other movements in the fair value of its assets and liabilities. This raises questions regarding how to determine the cost of the business combination, allocating that cost to the assets acquired and liabilities and provisions for contingent liabilities assumed, and the resulting goodwill.

Extract from FRS 102

19.11A Where control is achieved following a series of transactions, the cost of the business combination is the aggregate of the fair values of the assets given, liabilities assumed and equity instruments issued by the acquirer at the date of each transaction in the series.

Where a parent acquires control of a subsidiary in stages, FRS 102 requires the transaction to be accounted for in accordance with paragraphs 19.11A and 19.14, applied at the date control is achieved. [FRS 102.9.19B]. Accordingly:

- The cost of the business combination is the aggregate of the fair values of the assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer at the date of each transaction in the series. [FRS 102.19.11A].
And
- The normal rules on allocation of the cost of the business combination under the purchase method apply whereby: "The acquirer shall, *at the acquisition date*, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and provisions for its contingent liabilities ... *at their fair values at that date*, except for the items specified in paragraphs 19.15A to 19.15C" [emphasis added]. [FRS 102.19.14].

This approach is consistent with the requirements of the CA 2006, whereby goodwill must be recognised as the difference between the fair values at the acquisition date of the identifiable assets and liabilities of the undertaking acquired and the acquisition cost of the interest in the shares of the undertaking. [6 Sch 9].

It is important to note that where the equity method of accounting has been discontinued, as it would be where a business combination is achieved in stages, any amounts recognised in other comprehensive income relating to the associate would not be reclassified to profit or loss in accounting for the business combination. [FRS 102.14.8(i)].

The following Illustration shows the application of these principles.

Illustration 3-22: Business combination achieved in stages (step acquisition) (1)

Company A acquires a 10% ownership interest in Company B on 1 January 20X6 for £5 million cash. Company A acquired a further 20% ownership interest in Company B for £10 million cash on 1 January 20X8 and obtained significant influence. At 1 January 20X9, Company A's equity-accounted interest in Company B was £18 million. Company A acquired a further 30% of Company B for £30 million cash on 1 January 20X9 and obtained control. The fair value of Company B's identifiable net assets at 1 January 20X9 was £60 million. In accordance with paragraph 19.11A of FRS 102, the cost of the business combination is £45 million, being the aggregate of the cash paid at each stage in exchange for control. Company A's share of the identifiable net assets of Company B is £36 million (being 60% of £60 million), resulting in goodwill of £9 million. Company A will record the following entries in its consolidated financial statements at the date of the business combination:

	<i>Dr</i>	<i>Cr</i>
	£m	£m
Identifiable net assets of Company B	60	
Goodwill (£45m - (60% of £60m))	9	
Non-controlling interest (40% of £60m)		24
Cash		30
Equity investment in Company B		18
Other comprehensive income ¹	3	

¹ This 'dangling entry' represents the difference between previous cash paid (£15m) and the share of the net assets at the date control is obtained (£18m). As this is not a profit or loss it must be taken to other comprehensive income.

FRS 102's approach to step acquisitions is a practical means of applying the purchase method because it does not require retrospective assessments of the fair value of the identifiable assets and liabilities of the subsidiary. However, the FRC notes that in certain circumstances not using the fair values at the dates of earlier purchases may result in accounting that is inconsistent with the way the investment has been treated previously and, for that reason, may fail to give a true and fair view. [FRS 102.A3.19].

For example, when an associate becomes a subsidiary, using the method required by the Regulations and paragraph 9.19B of FRS 102 to calculate goodwill has the effect that the group's share of profits or losses and reserve movements of its associate becomes reclassified as goodwill (usually negative goodwill). [FRS 102.A3.20].

A similar problem may arise where an entity has substantially restated its investment in an undertaking that subsequently becomes its subsidiary. For example, where such an investment has been impaired, the application of the purchase method as set out in the Regulations would increase reserves and create an asset (goodwill). [FRS 102.A3.20].

Consequently, the FRC acknowledges that, in the rare cases where the method for calculating goodwill set out in company law and paragraph 9.19B (as discussed above) would be misleading, the goodwill must be calculated as the sum of the goodwill arising from each purchase of an interest in the relevant undertaking, adjusted as necessary for any subsequent impairment. In such circumstances, goodwill arising on each purchase is calculated as the difference between the cost of that purchase and the fair values at the date of that purchase of the identifiable assets and liabilities attributable to the interest purchased. The difference between the goodwill calculated using this method and that calculated using the method provided by company law and FRS 102 is shown in reserves. Where the statutory requirement is not applied, section 404(5) of the CA 2006 requires disclosure of the particulars of the departure, the reasons for it and its effect. Paragraph 3 of section 5 of the standard sets out the disclosures when an entity departs from a requirement of FRS 102 or from a requirement of applicable legislation (see Chapter 6 at 8.2.2).

[FRS 102.A3.21]. This is shown in Illustration 3-23 below.

Illustration 3-23: Business combination achieved in stages (step acquisition) (2)

Company A acquires a 100% holding in Company B as a result of two separate transactions, several years apart, as set out in the table below.

<i>Transaction number</i>	<i>Holding acquired</i>	<i>Fair value of net assets</i>	<i>Total value of investee</i>	<i>Price paid</i>	<i>Cumulative price paid</i>
1	49%	£8m	£10m	£4.9m	£4.9m
2	51%	£30m	£40m	£20.4m	£25.3m

At the time of the first investment, Company A determined that it had significant influence of Company B and that it was neither a subsidiary nor an interest in a jointly controlled entity. In its consolidated financial statements, Company A accordingly accounted for its investment in Company B using the equity method, in accordance with Section 14 *Investments in Associates*, with the investment initially recognised at £4.9 million. Company A subsequently obtained control of Company B through a transaction with Company B's other shareholder, paying £20.4 million in return for acquiring its 51% interest in Company B. At that date, the carrying value of Company A's 49% investment in Company B, accounted for under the equity method, was £10.8 million, having reflected £5.9 million for its share of profits of £12 million.

Applying the purchase method as stipulated by FRS 102 would result in Company A determining the cost of the business combination at £25.3 million and recognising identifiable net assets of Company B at the acquisition date of £30 million - resulting in the recognition of negative goodwill of £4.7 million. This is despite the fact that Company A had paid more than its proportionate share of the fair value of the net assets at each transaction. There would also be a debit of £5.9 million taken to other comprehensive income, being the difference between the original price paid (£4.9 million) and the investment under the equity method (£10.8 million). This is effectively the reversal of the previously recognised equity-accounted share of profits. As discussed at 3.9.3 above, Company A would recognise this negative goodwill in profit or loss in the periods in which the non-monetary assets are recovered.

However, assuming that this accounting for goodwill is considered misleading, goodwill would be calculated as £6.1 million, being £1.0 million for the first transaction (£4.9 million - £3.9 million (49% × £8.0 million)) and £5.1 million for the second transaction (£20.4 million - £15.3 million (51% × £30.0 million)). The difference between this goodwill of £6.1 million and the negative goodwill of £4.7 million (calculated using the method provided by company law and FRS 102), i.e., £10.8 million, is to be taken to reserves (presumably through other comprehensive income). This difference of £10.8 million, together with the previously calculated debit to other comprehensive income of £5.9 million, means that a credit of £4.9 million is taken to other comprehensive income. This effectively represents 49% of the increase of £10 million in the fair value of the assets of Company B at the date of the business combination (i.e., £30 million - £20 million, being £8 million plus £12 million (Company B profits recognised between transaction 1 and 2)).

4 Disclosures relating to business combinations and goodwill

The disclosure requirements of FRS 102 in relation to business combinations and goodwill are discussed at 4.1 to 4.2 below. The CA 2006 contains a number of detailed disclosure requirements. Some of these duplicate those contained in FRS 102 but there are a few additional matters in the legislation, and these are considered at 4.3.3 below.

4.1 Business combinations during the reporting period

For each business combination, excluding any group reconstruction (see 5.6 below for disclosure requirements in respect of group reconstructions), that was effected during the period, the acquirer must disclose the following: [FRS 102.19.25, FRS 102.19.26B]

- (a) The names and descriptions of the combining entities or businesses
- (b) The primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree
- (c) The acquisition date
- (d) The percentage of voting equity instruments acquired
- (e) The amount of any non-controlling interest in the acquiree recognised at the acquisition date
- (f) The cost of the combination and a description of the components of that cost (such as cash, equity instruments and debt instruments)
- (g) For contingent consideration arrangements:
 - (i) The amount recognised as of the acquisition date
 - (ii) A description of the arrangement and the basis for determining the amount of the payment
 - And
 - (iii) An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer must disclose that fact
- (h) The amounts recognised at the acquisition date for each class of the acquiree's assets, liabilities and contingent liabilities, including goodwill
- (i) A qualitative description of the nature of intangible assets included in goodwill (see 3.7.3.A above)
- (j) The useful life of goodwill, and if this cannot be reliably estimated, supporting reasons for the period chosen (see 3.9.2 above). (Paragraph 19.26B of FRS 102 makes it clear that it is only in exceptional cases that an entity is unable to make a reliable estimate of the useful life of goodwill)
- (k) The periods in which any negative goodwill (see 3.9.3 above) will be recognised in profit or loss
- And
- (l) For each contingent liability that is not recognised in accordance with paragraph 19.15F of FRS 102 because its fair value cannot be measured reliably, for each class of contingent liability at the reporting date:
 - (i) A brief description of the nature of the contingent liability
 - (ii) An estimate of its financial effect, measured in accordance with paragraphs 21.7 to 21.11.
 - (iii) An indication of the uncertainties relating to the amount or timing of any outflow
 - And
 - (iv) The possibility of any reimbursement

The disclosures in (ii), (iii) and (iv) are required to be given, where practicable. If it is impracticable to make one or more of these disclosures, that fact must be stated [FRS 102.21.15]

Disclosure is required of the amounts of revenue and profit or loss of the acquiree since the acquisition date included in the consolidated statement of comprehensive income. Such disclosure must be provided separately for each material business combination or in aggregate for business combinations that are not individually material. [FRS 102.19.25A].

As discussed at 3.7.5 above, the accounting for a business combination might be based on provisional amounts which are later retrospectively adjusted to reflect their finalisation within twelve months after the acquisition date. [FRS 102.19.19]. In this circumstance, disclosure is required of that fact and the line items for which provisional amounts have been recognised. [FRS 102.19.25B]. FRS 102 is silent as to whether any disclosures are required on the subsequent finalisation of provisional amounts. As any subsequent adjustments will be accounted for retrospectively by restating comparatives, we would expect disclosure that such adjustments have been made, and the reasons. [1 Sch 7, 6 Sch 1].

4.2 Goodwill reconciliations

In addition to disclosures for business combinations effected during the period, an acquirer must disclose a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, showing separately: *[FRS 102.19.26]*

- Additional goodwill recognised during the reporting period arising from new business combinations
 - Amortisation
 - Impairment losses recognised during the reporting period in accordance with Section 27
 - Goodwill derecognised during the reporting period in relation to previously acquired businesses.
- And
- Other changes

A similar reconciliation is also required in respect of any negative goodwill - albeit with no impairment, and with 'amortisation' replaced by 'amounts recognised in profit or loss in accordance with paragraph 19.24(c) of FRS 102'. *[FRS 102.19.26A]*.

The above reconciliations need not be presented for prior periods. *[FRS 102.19.26. FRS 102.19.26A]*.

Section 27 requires further disclosures be made in respect of the amount of the impairment losses and reversals on goodwill (including the line items in which included), together with a description of the events and circumstances leading to the recognition or reversal of the impairment loss (see Chapter 29 at 9).

[FRS 102.27.32, FRS 102.27.33(a), FRS 102.27.33A].

4.3 Other disclosures

4.3.1 Step acquisitions

As discussed at 3.11 above, in rare cases where the method for calculating goodwill set out in company law and paragraph 9.19B would be misleading, the goodwill must be calculated as the sum of goodwill arising from each purchase of an interest in the relevant undertaking adjusted as necessary for any subsequent impairment. Where the FRS 102 or statutory requirement is not applied, paragraph 3.5 and section 404(5) of the CA 2006 sets out the necessary disclosures when applying a 'true and fair override' (see Chapter 6 at 8.2.2). *[FRS 102.3.5, s404(5)]*.

4.3.2 Reverse acquisitions

As discussed at 3.10 above, to adopt reverse acquisition accounting represents a departure from company law which does not envisage such occurrence. Such departure is required where it is necessary to give a true and fair view. In such circumstances, there must be disclosure of a true and fair view override departure from the CA 2006, and disclosure of the particulars, reasons and effect. *[FRS 102.3.5, s404(5)]*.

4.3.3 Company law disclosures

The CA 2006 contains a number of detailed disclosure requirements that are relevant for business combinations to be shown in the notes to the financial statements. *[6 Sch 13]*. Some of these duplicate those contained in FRS 102 but there are a few additional matters in the legislation that need to be considered.

The CA 2006 requires disclosure of the names of subsidiaries acquired, (or where a group was acquired, the name of the parent undertaking of that group) and whether they have been accounted for by the acquisition or the merger method of accounting, even if they do not significantly affect the figures shown in the consolidated financial statements. *[6 Sch 13(2)]*.

In relation to an acquisition which significantly affects the figures shown in the consolidated financial statements, the CA 2006 requires disclosures of: *[6 Sch 13(3), 6 Sch 13(4)]*

- (a) The composition and the fair value of the consideration for the acquisition given by the parent company and its subsidiary undertakings
- And
- (b) Where the acquisition method of accounting has been adopted:
 - (i) The book values immediately prior to the acquisition of each class of assets and liabilities of the undertaking or group acquired (to be stated in tabular form)
 - (ii) The fair values at the date of acquisition, of each class of assets and liabilities of the undertaking or group acquired (to be stated in tabular form)

- (iii) A statement of the amount of any goodwill or negative consolidation difference arising on the acquisition

And

- (iv) An explanation of any significant adjustments made

There must also be stated the cumulative amount of goodwill resulting from acquisitions in that and earlier years which has been written off otherwise than in the consolidated profit and loss account. That figure must be shown net of any goodwill attributable to subsidiary undertakings or businesses disposed of prior to the balance sheet date. [6 Sch 14]. This disclosure requirement would apply in limited circumstances only, for example when the entity has legacy amounts of goodwill written off directly to reserves, which was a policy permitted under previous UK GAAP prior to the introduction of FRS 10 *Goodwill and intangible assets*. Under FRS 102, such amounts are never reclassified to profit or loss.

UK company law provides an exemption from disclosing the above information in certain circumstances. It need not be disclosed with respect to an undertaking which:

- Is established under the law of a country outside the United Kingdom.

Or

- Carries on business outside the United Kingdom.

if in the opinion of the directors of the parent company the disclosure would be seriously prejudicial to the business of that undertaking or to the business of the parent company or any of its subsidiary undertakings and the Secretary of State agrees that the information must not be disclosed. [6 Sch 16].

5 Group reconstructions

Section 19 requires all business combinations (apart from certain public entity combinations) to be accounted for by applying the purchase method, except for group reconstructions which may be accounted for using the merger accounting method [emphasis added]. [FRS 102.19.6].

Under FRS 102, the use of the merger accounting method for group reconstructions is optional. In most cases where the criteria to apply the merger accounting method are met, the acquirer will wish to use the merger accounting method, thereby avoiding the need to determine fair values of the identifiable assets, liabilities and contingent liabilities of the acquiree as well as the fair value of the consideration given.

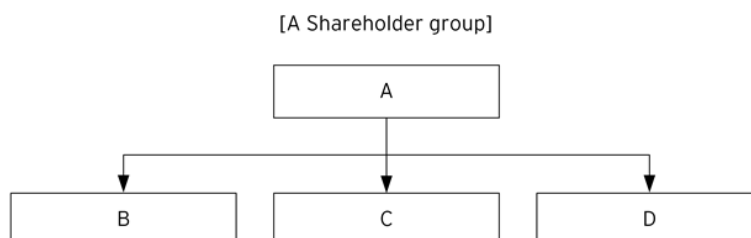
Where the option of using the merger accounting method is not taken, the purchase method (acquisition accounting) needs to be used. Historically, FRS 6 *Acquisitions and Mergers* stated: "Acquisition accounting would require the restatement at fair value of the assets and liabilities of the company transferred, and the recognising of goodwill, which is likely to be inappropriate in the case of a transaction that does not alter the relative rights of the ultimate shareholders", [FRS 6.78], and this sentence in FRS 6 was used as support for the argument that application of acquisition accounting was unlikely to give a true and fair view. While FRS 102 contains no such health warning, the position is likely to remain the same that, in certain circumstances, notwithstanding that it is permitted (or required, where the strict criteria for use of the merger accounting method are not met) by company law and FRS 102, the application of the purchase method and all that it entails would not be appropriate, and that a 'true and fair override' to apply the merger accounting method may be necessary.

In addition, as discussed at 3.4 above, when applying the purchase method, it is necessary to identify the accounting acquirer in the business combination. In certain group reconstructions, particularly those effected using a newly incorporated entity, the accounting acquirer is not necessarily the legal acquirer (or there might not be an accounting acquirer). Therefore, it could be that use of the merger accounting method is appropriate in these scenarios (see Illustration 5-1 below).

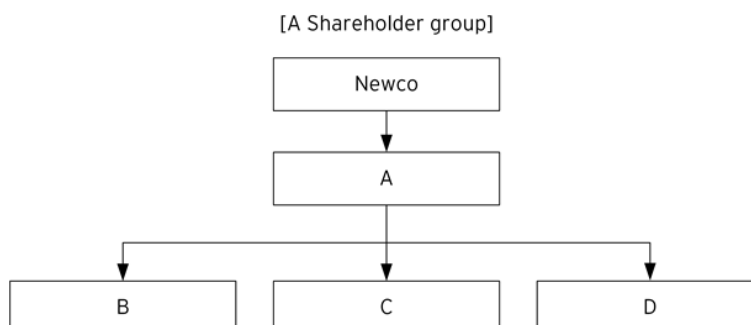
Illustration 5-1: Newco inserted at the top of an existing group

A Newco is incorporated and inserted at the top of an existing group, which is a business as defined in Section 19. Newco issues shares to the existing shareholders of Entity A in exchange for the shares already held in that entity. There are no changes to the shareholder group. The group structure before and after this transaction is as follows:

Before



After



How would this reorganisation be accounted for in Newco's consolidated financial statements?

How we see it

The transaction in this specific fact pattern is a group reconstruction because it is the addition of a new parent entity to the group. In our view, Newco cannot elect to apply the purchase method. Rather, its consolidated financial statements are a continuation of the existing group.

Neither Newco nor Entity A is identified as the acquirer. Newco is not identified as the acquirer as it issues shares to effect the combination. [FRS 102.19A.5]. FRS 102 notes that the result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses. Since Newco is not a business, Entity A is also not identified as the acquirer. [FRS 102.19.3]. Accordingly, it is appropriate to use merger accounting rather than the purchase method (which requires identification of an acquirer). As explained at 5.2.1.A below, this accounting might sometimes require use of a 'true and fair override', with its related disclosures.

Furthermore, the transaction does not result in any change of economic substance (e.g., in terms of any real alteration to the composition or ownership of the group). Accordingly, Newco's consolidated financial statements reflect that the arrangement is in substance a continuation of Entity A's group (combined with a capital reorganisation to reflect Newco's capital structure) and will reflect pre-combination carrying amounts for Entity A's group under merger accounting.

The determination of whether a group applies the purchase method or the merger accounting method is further discussed at 5.4.1.A below.

5.1 Scope and applicability to various structures

Extract from FRS 102

Appendix I

Glossary

group reconstruction

Any one of the following arrangements:

- (a) the transfer of an equity holding in a subsidiary from one group entity to another;
- (b) the addition of a new parent entity to a group;
- (c) the transfer of equity holdings in one or more subsidiaries of a group to a new entity that is not a group entity but whose equity holders are the same as those of the group's parent;
- (d) the combination into a group of two or more entities that before the combination had the same equity holders;
- (e) the transfer of the business of one group entity to another; or
- (f) the transfer of the business of one group entity to a new entity that is not a group entity but those equity holders are the same as those of the group's parent.

FRS 102 identifies that while its explanation of the merger accounting method (see 5.3 below) is drafted in terms of an acquirer or issuing entity issuing shares as consideration for the transfer to it of shares in the other parties to the combination, the provisions also apply to other arrangements that achieve similar results. [FRS 102.19.28].

5.2 Qualifying conditions

Extract from FRS 102

Group reconstructions

19.27 Group reconstructions may be accounted for by using the merger accounting method provided:

- (a) the use of the merger accounting method is not prohibited by company law or other relevant legislation;
- (b) the ultimate equity holders remain the same, and the rights of each equity holder, relative to the others, are unchanged; and
- (c) no non-controlling interest in the net assets of the group is altered by the transfer.

The first condition is discussed further in 5.2.1 below.

The following Illustration shows one issue that could arise when analysing the second condition.

Illustration 5-2: Application of the true and fair override to apply merger accounting where the rights of each equity holder relative to the others before and after the transaction are changed

Company A owns 100% of each of Companies B and C. Company A is owned by two individuals, X owns 85% and is the controlling party, while Y owns 15%.

Y wishes to exit the business. To facilitate this, Newco is incorporated to become the new parent company of the group. Newco issues shares to X in exchange for all X's shares in Company A. Y sells their shares to Newco in return for loan notes of £2m. These are settled immediately following the transaction by Company A declaring and paying a dividend of £2m to Newco, and Newco using the resulting cash to settle the liability.

In the consolidated financial statements of Newco, can it apply the merger accounting method?

The definition of a group reconstruction in FRS 102 includes the addition of a new parent entity to a group (see 5.1 above). However, viewed as a whole, the transaction results in X and Y having different ownership interests in the group after the transaction, since Y exits. This contravenes the requirements in paragraph 19.27 of FRS 102 that the relative rights of the equity holders remain unchanged (see 5.2 above).

How we see it

In our view, the substance of the transaction has two separate elements: the insertion of Newco (a group reconstruction) and the exit of Y. Therefore, in our view, merger accounting may be applied in Newco's consolidated financial statements, and a true and fair override is required in respect of the requirements in paragraph 19.27 of FRS 102 that the relative rights of the equity holders remain unchanged.

The third condition must be considered, for example, when the group reconstruction involves transfers in or out of a sub-group with a non-controlling interest. In such a case, the non-controlling interest is likely to be affected by the transfer and the transaction might not qualify for merger accounting as a result.

5.2.1 UK company law and GAAP considerations

UK company law sets out requirements that must be met in consolidated financial statements before merger accounting can be applied. The conditions laid down in the Regulations for accounting for an acquisition of a subsidiary undertaking as a merger are that: [6 Sch 10]

- (a) The undertaking whose shares are acquired is ultimately controlled by the same party both before and after the acquisition (see 5.2.1.A).
 - (b) The control referred to in (a) above is not intended to be transitory (see 5.2.1.B).
- And
- (c) The adoption of the merger method of accounting accords with generally accepted accounting principles or practice (see 5.2.1.C).

The conditions set out in the Regulations apply only to consolidated financial statements and where an undertaking becomes a subsidiary undertaking of the parent company. [6 Sch 7(1)]. They do not apply to group reconstructions involving a business which is not a subsidiary undertaking.

For LLPs, only criteria (c) above needs to be met. [3 Sch 10 (LLP)]. Again, the conditions set out in the LLP Regulations apply only to consolidated financial statements and where an undertaking becomes a subsidiary undertaking of the parent LLP. [3 Sch 7(1) (LLP)]. They do not apply to group reconstructions involving a business which is not a subsidiary undertaking.

5.2.1.A The same controlling party before and after the acquisition

The undertaking must be controlled by the same party both before and after the transaction. Accordingly, for example, the transfer of a 75% subsidiary from one group entity to another would qualify for the merger accounting method (assuming the other conditions under the Regulations and FRS 102 are met).

A transaction in which a new parent is inserted above an existing group might not meet the requirements for use of the merger accounting method. While the undertaking whose shares are acquired (e.g., the previous ultimate parent of a group) would have the same ultimate equity holders as before, it could be that there is no single controlling party either before or after the transaction. The Basis of Conclusions to FRS 102 observes that paragraph 10 of Schedule 6 to the Regulations is generally consistent with paragraph 19.27 of FRS 102 (see the extract at 5.2 above). However, if an entity considers that, for the overriding purpose of giving a true and fair view, merger accounting needs to be applied in circumstances other than those set out in paragraph 10 of Schedule 6 to the Regulations, it may do so providing the relevant disclosures are made in the notes to the financial statements. [FRS 102.BC.A3.30]. See Chapter 6 at 8.2.2 for a discussion of the true and fair override and the disclosures required.

Other arrangements meeting the definition of a group reconstruction under FRS 102 involving equity holders that are the same, but with no single controlling party, may also need to invoke 'a true and fair override' in order to apply the merger method of accounting.

In some cases, a newly incorporated company (Newco) might be involved in a transaction and in certain circumstances it might be identified as an acquirer, meaning that the purchase method is appropriate (see Illustration 3-6 at 3.4.2 above). There is further discussion of whether Newcos can be an acquirer in 3.4.2 above and 5.2.1.B below.

5.2.1.B Control is not intended to be transitory

The note on legal requirements in Appendix III to FRS 102 provides no additional guidance on this criterion. IFRS 3 contains a similar requirement within its scope exemption for business combinations under common control. [IFRS 3.B1]. This criterion addresses concerns that business combinations between parties acting at arm's length - that would otherwise be accounted using the purchase method - could be structured through the use of 'grooming' transactions so that, for a brief period immediately before and after the combination, the combining entities or businesses are under common control.

Judgement will be required when assessing whether control is transitory in certain scenarios; for example, when a transaction that qualifies as a group reconstruction under FRS 102 is completed at the same time as other transactions that result in a change of control.

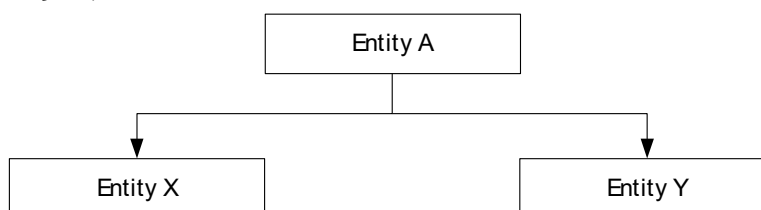
Often a reorganisation involves the formation of a new entity (Newco) to facilitate the sale of part of an organisation.

How we see it

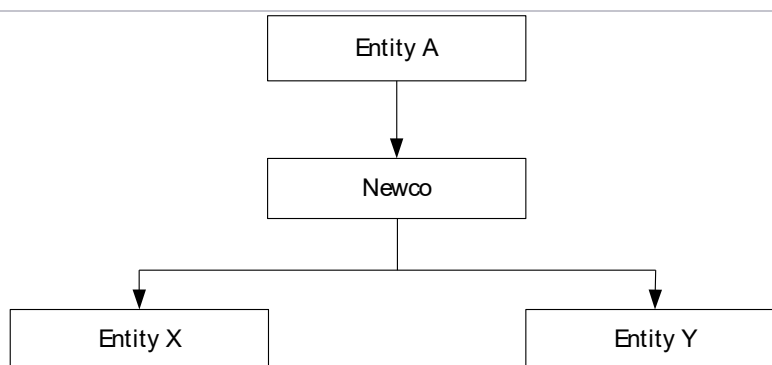
In our view, common control is not considered to be 'transitory' just because a reorganisation is undertaken to facilitate the disposal of businesses (e.g., by sale or IPO). Whether common control is transitory or not is assessed by looking at the duration of control over each of the combining businesses in the period before and after the reorganisation. It is not limited to an assessment of the duration of control only after the reorganisation.

Illustration 5-3: Transitory control

Entity A currently has two businesses operated through Entity X and Entity Y. The group structure (ignoring other entities within the group) is as follows:



Entity A proposes to combine the two businesses (currently housed in two separate entities, Entity X and Entity Y) into the one entity and then spin-off the combined entity as part of an IPO. Both of the businesses have been owned by Entity A for several years. The internal reconstruction will be structured such that Entity A will establish a new entity (Newco) and transfer its interests in Entity X and Entity Y to Newco, resulting in the following group structure:



After the IPO, Newco will no longer be under the control of Entity A.

In the consolidated financial statements of Newco, is it entitled to use the merger accounting method?

The question of whether the entities or businesses are under common control applies to the combining entities that existed before the combination, excluding Newco, i.e., Entity X and Entity Y. These entities have clearly been under the common control of Entity A and remain so after the transfer.

If Newco were preparing consolidated financial statements without there being an intended IPO, it would be entitled to use the merger accounting method (assuming that all other conditions for merger accounting in the CA 2006 and paragraph 19.27 of FRS 102 are met). However, as the purpose of the transaction was to facilitate the disposal of the businesses by way of the IPO, such that Entity A no longer has control over Entity X and Entity Y, does this mean that common control is 'transitory' and the merger accounting method cannot be applied?

In our view, the answer is 'no'. Common control is not considered to be transitory and therefore the reorganisation does not breach the transitory control condition for use of merger accounting in the CA 2006. This is consistent with the ordinary meaning of 'transitory', something which is fleeting, brief or temporary. The common control of Entity X and Entity Y was not fleeting in the fact pattern as both entities had been controlled by Entity A for several years. Assuming all other legal conditions and those in paragraph 19.27 of FRS 102 are met, Newco may apply the merger accounting method in its consolidated financial statements.

Although this Illustration involves a new entity, the same considerations apply regardless of the manner in which the internal reconstruction has been structured. For example, Entity X might have acquired Entity Y, with Entity X then being the subject of an IPO. In such a situation, Entity X would be entitled to use the merger accounting method with respect to the group reconstruction (assuming all other legal conditions and those in paragraph 19.27 of FRS 102 had been met). By contrast, if Entity Y had only recently come into the group, this could indicate that control is transitory.

However, if such a restructuring was an integral part of another transaction such as a sale or disposal via an IPO, the circumstances might be such that Newco could be regarded as the acquirer if it is considered to effectively be an extension of the new owners, and therefore use of the purchase method might be appropriate. An example is in Illustration 3-6 at 3.4.2 above. A Newco incorporated by the existing parent of the subsidiaries concerned would not generally be identified as the acquirer, but in this particular situation the critical distinguishing factor is that the acquisition of the subsidiaries is conditional on an IPO of Newco. This means that there has been a substantial change in ownership of the subsidiaries by virtue of the IPO. Whether a Newco formed to facilitate an IPO is capable of being identified as an acquirer depends on the facts and circumstances and ultimately requires judgement.

5.2.1.C Adoption of the merger accounting method accords with GAAP

This criterion is met for group reconstructions meeting the qualifying conditions set out in Section 19 for use of the merger accounting method under FRS 102 (see 5.2 above). [FRS 102.19.27].

5.3 Merger accounting method

FRS 102 explains that where the merger accounting method is applied:

- The carrying values of the assets and liabilities of the parties to the combination are not required to be adjusted to fair value, although appropriate adjustments must be made to achieve uniformity of accounting policies in the combining entities. [FRS 102.19.29].
- The results and cash flows of all the combining entities must be brought into the financial statements of the combined entity from the beginning of the financial year in which the combination occurred, adjusted so as to achieve uniformity of accounting policies.

- (c) The comparative information must be restated by including, for all the combining entities, the total comprehensive income for the previous reporting period and their statement of financial position for the previous reporting date, adjusted as necessary to achieve uniformity of accounting policies. [FRS 102.19.30].
- (d) The difference, if any, between the nominal value of the shares issued plus the fair value of any other consideration given, and the nominal value of the shares received in exchange must be shown as a movement on other reserves in the consolidated financial statements. Any existing balances on the share premium account or capital redemption reserve of the new subsidiary must be brought in by being shown as a movement on other reserves. These movements must be shown in the statement of changes in equity. [FRS 102.19.31].

And

- (e) Merger expenses are not to be included as part of this adjustment, but must be charged to the statement of comprehensive income as part of profit or loss of the combined entity at the effective date of the group reconstruction. [FRS 102.19.32].

These requirements in FRS 102 are similar to those contained in the Regulations when accounting for the acquisition of a subsidiary under the merger method of accounting in Companies Act group accounts.

[6 Sch 11].

FRS 102 requires a subsidiary to be excluded from consolidation where (1) the exercise of the rights of the parent over the assets or management of the subsidiary are substantially hindered by severe long-term restrictions or (2) the interest on the subsidiary is held exclusively with a view to subsequent resale and the subsidiary has not previously been consolidated. [FRS 102.9.9]. The standard also permits a subsidiary to be excluded from consolidation when its inclusion is not material (in aggregate, if there is more than one subsidiary excluded) for the purpose of giving a true and fair view. [FRS 102.9.9A]. If a subsidiary is excluded from consolidation for the aforementioned reasons, then the excluded subsidiary would not be one of the combining entities referred to in point (b) and point (c) above.

The above wording explaining the merger accounting method is drafted in terms of an acquirer or issuing entity issuing shares as consideration for the transfer of shares in the other parties to the combination, [FRS 102.19.28], and refers to consolidated financial statements. The application of the above requirements in the context of consolidated financial statements are discussed further at 5.3.1 to 5.3.5 below.

However, FRS 102 indicates that the provisions also apply to other arrangements that achieve similar results. [FRS 102.19.28]. In particular, the definition of a group reconstruction also includes arrangements such as the acquisition by an individual entity of the trade and net assets of another entity within the same group. Particular issues relating to the application of the above requirements in the context of individual financial statements are discussed at 5.4 below and Illustrations 5-10 to 5-16 demonstrate the application of the merger accounting method in the individual financial statements.

5.3.1 Carrying values of assets and liabilities

For group reconstructions involving the transfer of an equity holding in a subsidiary from one group entity to another, no adjustments would be expected to be required to conform accounting policies. This is because in the preparation of the consolidated financial statements of the ultimate parent entity, uniform accounting policies would have been expected to be adopted by all members of the group. [FRS 102.9.17]. However, it would be necessary to make adjustments where the combining entities have used different accounting policies when preparing their own financial statements, and the carrying values of the assets and liabilities being used are based on the financial statements of the transferred entity. This is more likely to be the case for a group reconstruction involving the combination into a group of two or more entities that before the combination had the same equity holders.

The main issue relating to the use of carrying values is whether the amounts for the transferred entity (or entities) are based on the carrying values reported at the level of:

- (a) The financial statements of the transferred entity
- Or
- (b) The consolidated financial statements of the parent

The carrying values with respect to the reporting entity are the same as those in its existing financial statements prior to the transfer of the other entity.

How we see it

In our view, either basis (a) or (b) above for determining the carrying values of the transferred business could be acceptable provided that the resulting information is relevant and reliable in the particular circumstances. This may require an entity to exercise judgement.

Where the transferred entity had been previously acquired by the parent, using the carrying values (including any fair value adjustments and goodwill arising on that acquisition) reported in the consolidated financial statements of the parent might be more appropriate as those carrying amounts might be more recent (and therefore relevant) and reflect the perspective of the party that effectively directs the transaction. This results in the assets and liabilities being reported on the same basis as if the transferred entity had been acquired by the reporting entity at the time the transferred entity was acquired by the parent.

Using the carrying values reported in the financial statements of the transferred entity is more straightforward. Rather than the assets and liabilities being reported in two previous sets of financial statements, they are now reported in a single set of financial statements. Indeed, the Regulations state that “the assets and liabilities of the undertaking acquired must be brought into the group accounts at the figures at which they stand in the undertaking’s accounts, subject to any adjustment authorised or required by this Schedule”. [6 Sch 11(2)].

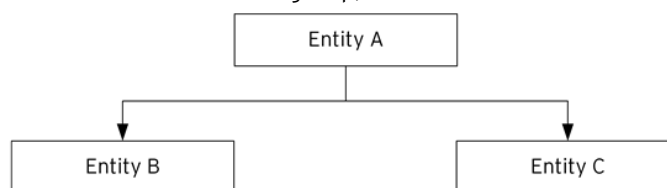
When evaluating which basis to use, the following factors can be helpful:

- The timing of the group reconstruction in comparison to when the transferred business was previously acquired by the controlling party, if applicable. Generally, the carrying amounts in the consolidated financial statements might be more relevant as they were reassessed more recently. However, the longer the period since the previous acquisition by the controlling party, the less relevant this factor might be.
- Whether the transaction is a ‘grooming’ transaction in preparation for a spin-off, sale or similar external transaction. Generally, the carrying amounts in the consolidated financial statements might be more relevant in such a situation (for the reasons explained above).
- The identity and nature of the users of the financial statements. If a broad group of users of the financial statements of the receiving entity after the transaction are parties that previously relied upon the financial statements of, or including, the transferred business before the transaction (e.g., if there are significant non-controlling interests and/or creditors), using the amounts in the financial statements of the transferred entity might provide more relevant information.
- Whether consistent accounting policies are used within the group for similar and related common control transactions.
- Difficulties in identifying reliable book values under UK GAAP for the transferred business. It will be more difficult and costly to use the carrying amounts in the consolidated financial statements if the controlling party has not previously prepared UK GAAP consolidated financial statements. In addition, it might be that allocations of goodwill and intangible assets which are reported in the UK GAAP consolidated financial statements need to be made when determining the consolidated book values relating to the transferred business. In such circumstances, it might be more straightforward to determine the carrying amounts in accordance with UK GAAP for the transferred business particularly if these already exist.

The considerations on use of different bases for the carrying values of the transferred business are further discussed at Illustration 5-4 below, and in relation to different hive transactions at Illustration 5-10 at 5.4.2.A below, Illustration 5-11 at 5.4.2.C below, Illustration 5-13 at 5.4.2.E below and Illustration 5-14 at 5.4.3.A below.

Illustration 5-4: Merger accounting method - carrying amounts of assets acquired and liabilities assumed

Entity A currently has two businesses operated through wholly owned subsidiaries Entity B and Entity C. The group structure (ignoring other entities within the group) is as follows:



Both entities have been owned by Entity A for several years.

On 1 October 20X6, Entity A restructures the group by transferring its investment in Entity C to Entity B, such that Entity C becomes a subsidiary of Entity B.

In Entity B's consolidated financial statements for the year ending 31 December 20X6, which carrying amounts would be reflected in respect of the assets and liabilities of Entity C?

How we see it

The rationale for using the carrying amounts reported in Entity A's consolidated financial statements in the consolidated financial statements of Entity B is that from a group perspective of Entity B's shareholder, Entity A, nothing has changed except the location of those assets and liabilities. Entity B has effectively taken on the group's ownership. Therefore, the carrying amounts used in the consolidated financial statements of Entity A are appropriate and relevant values to apply to the assets and liabilities of Entity C consolidated by Entity B, as they represent the carrying amounts to the Entity A group.

The carrying amounts of Entity C on this basis will be based on their fair values as at the date Entity C became part of the Entity A group and adjusted for subsequently in accordance with FRS 102. Any goodwill relating to Entity C that was recognised in Entity A's consolidated financial statements, will also be recognised in Entity B's consolidated financial statements. The carrying amounts of the net assets of Entity B will remain as before.

5.3.2 Restatement of financial information prior to the date of the combination

The description of the merger accounting method explicitly requires the results (and cash flows) of all combining entities to be included from the beginning of the financial year and for comparatives to be restated, subject to the exclusion from consolidation of certain subsidiaries dealt with in paragraphs 9.9 and 9.9A of FRS 102 (see 5.3 above). [FRS 102.19.30].

This will be appropriate where the entity applying the merger accounting method in its consolidated financial statements and the entity (or entities) transferred to it under the group reconstruction have been under the control of the ultimate parent or common controlling party for at least that period of time. Indeed, this is consistent with the equivalent requirements in the Regulations which are as follows:

[6 Sch 11(3), 6 Sch (4)]

- The income and expenditure of the undertaking acquired must be included in the group accounts for the entire financial year, including the period before the acquisition.

And

- The group accounts must show corresponding amounts relating to the financial year as if the undertaking acquired had been included in the consolidation throughout that year.

Effectively, the use of the merger accounting method results in the consolidated financial statements reflecting information as if the new sub-group had existed for the entire duration of the period covered by the financial statements. However, where the entities have come under the common control of the ultimate parent or common controlling party at a date after the beginning of the comparative period, this will not have been the case.

How we see it

In our view, in this situation, the results (and cash flows) of the transferred entity (or entities) must be included only from the date that it, and the entity applying the merger method of accounting, came under the control of the parent or the controlling party. This is the earliest date that the sub-group could have been created, and the results (and cash flows) must reflect that position.

5.3.3 Equity eliminations

As well as combining the assets and liabilities of the companies concerned, it will be necessary to eliminate the share capital of the new subsidiary against the cost of the investment as stated in the balance sheet of the new holding company. This is in principle a straightforward exercise, but when the two amounts do not equate to each other, the question arises of what to do with the difference, positive or negative.

The description of the merger accounting method at 5.3 above appears to presume that the cost of the investment will normally be carried at the nominal value of the shares of the new holding company which have been issued to effect the combination, together with the fair value of any other consideration given. (The ability to record these shares at nominal rather than fair value on issue depends on qualifying for merger relief under section 612 of the CA 2006, which is discussed at 5.5.1 below.) This will not be the case in a group reconstruction falling within the scope of group reconstruction relief under section 611 of the CA 2006 where, as a result of recognising a minimum premium value in share premium, the cost of investment reflects an amount in excess of the nominal value of the shares issued (see 5.5.2 below).

How we see it

Where a group reconstruction falls within the remit of group reconstruction relief under section 611 of the Companies Act 2006 and the cost of investment reflects an amount in excess of the nominal value of shares issued in exchange for the investment in subsidiary, we believe that this cost must be used in determining the difference to be accounted for under FRS 102, consistent with the requirements of the CA 2006.

FRS 102 requires the difference to be shown as a movement on other reserves in the consolidated financial statements and also to be shown in the statement of changes in equity. [FRS 102.19.31]. The CA 2006 also requires such difference to be shown as a movement in consolidated reserves. [6 Sch 11(6)]. However, neither FRS 102 nor the legislation specifies any particular reserve.

Where the cost of the investment is less than the nominal value of the share capital of the subsidiary, the elimination of these two amounts will leave a residual credit in shareholders' funds in the consolidated balance sheet; this is generally classified as some form of capital reserve (or merger reserve).

Where the reverse situation applies, the net debit has to be eliminated against consolidated reserves. There are no particular rules on the matter, but common practice is to eliminate against a merger or similar reserve, or retained earnings, although some companies create a separate debit reserve. To the extent that the subsidiary has reserves that could be reclassified to profit or loss in the future under FRS 102, e.g., a cash flow hedge reserve, a fair value available-for-sale reserve (where IAS 39 is applied) or a reserve arising from debt assets at fair value through other comprehensive income under IFRS 9, it would not be appropriate to eliminate any debit adjustment against such reserves.

Apart from the effects of dealing with any imbalance as discussed above, there is no other elimination of the reserves of the subsidiary, which are combined with those of the holding company, in contrast to the treatment under the purchase method. However, some of the subsidiary's other reserves may need to be reclassified in order to make sense in the context of the group financial statements.

FRS 102 requires that any existing balance on the share premium account or capital redemption reserve of the new subsidiary undertaking is brought in by being shown as a movement on other reserves in the statement of changes in equity. [FRS 102.19.31]. This is because these statutory reserves do not relate to the share capital of the reporting entity. Such a difference would generally be taken to the same reserve as that on the elimination of the share capital of the subsidiary, because in reality the distinction between share capital and share premium can be considered arbitrary in this context.

Although the discussion above deals with the equity eliminations required, the application of the merger method of accounting also requires comparative information in the consolidated financial statements to be restated (see 5.3.2 above). [FRS 102.19.30]. Assuming the new subsidiary is being included from the beginning of the comparative period, this will generally mean that where share capital has been issued by the reporting entity to effect the group reconstruction, in applying the merger method of accounting, it is treated as if it had been in issue at the beginning of that period. However, if the subsidiary had issued any

share capital between the beginning of the comparative period and the date of the group reconstruction, then this will need to be shown as a movement in the year and not at the beginning of the comparative period. The movement will be the equivalent amount of shares issued by the reporting entity (parent entity) to acquire those newly issued subsidiary shares. Where the reporting entity has given any other form of consideration to effect the group reconstruction, e.g., cash or incurred an intra-group financial liability, arguably this might also be accounted for as if the liability for such consideration arose at the beginning of the comparative period, but this then raises an issue as to whether the liability is discounted to its present value at that date, with any unwinding of the discount reflected in the consolidated profit or loss.

How we see it

We believe it would be acceptable to account for the liability for such consideration at the date of the reorganisation, with the corresponding debit being reflected in the consolidated statement of equity at that time.

5.3.4 Expenses of the merger

One other question which sometimes arises in this context is how to account for the expenses of the merger. FRS 102 requires that all merger expenses are charged to the statement of comprehensive income as part of profit or loss of the combined entity at the effective date of the group reconstruction.

[FRS 102.19.32].

However, some of these costs may be regarded as share issue expenses and therefore qualify to be written off against any share premium account recognised by the holding company in respect of the shares issued to effect the group reconstruction. FRS 102 does not prohibit the subsequent charging of such costs to the share premium account by means of a transfer between reserves.

Similarly, if a debt instrument such as a loan was utilised to finance the merger, some of these costs may be regarded as debt transaction costs and therefore qualify to be capitalised against the liability recognised by the holding company in respect of the debt instrument issued to effect the group reconstruction.

[FRS 102.11.13]

5.3.5 Non-coterminous accounting periods

Particular practical problems in applying the merger method of accounting can arise when the accounting periods of the combining companies do not match each other. For many group reconstructions involving existing companies within a group, this might not be an issue as the ultimate controlling parent is likely to have taken steps to ensure that its subsidiaries had coterminous accounting periods (or prepared interim financial statements as at the ultimate controlling parent's reporting date). However, for some forms of group reconstructions that might not be the case and the requirement (in applying merger accounting) to restate the consolidated financial statements retrospectively can cause difficulties.

The CA 2006 requires that directors of a company, as well as preparing individual accounts for a company's financial year (based on its accounting reference period), also prepare group accounts for the same year. [s399(2)]. The Companies Act group accounts so prepared must give a true and fair view in respect of the accounting period of the parent company, [s404(2)], so this will require the period used by the subsidiary to be made to conform to that of its parent rather than the other way round. Naturally, the parent could change its own accounting reference date, but this can be amended only for the future, not retrospectively. It will therefore be necessary to try to draw up financial statements for the subsidiary at each of the relevant balance sheet dates of its new parent company.

Another treatment which might be appropriate is to use non-coterminous years for the comparative figures, with the result that there will be the need to deal with the effects of either a 'gap' or an overlapping period as an adjustment to reserves. However, the use of such non-coterminous financial statements would be appropriate only if the consolidated financial statements present materially the same picture as if coterminous years had been used. As indicated in Chapter 8 at 3.5.2, the Regulations and Section 9 require that, in preparing consolidated financial statements, a subsidiary's reporting date can be used only if it is no more than three months before that of the parent, and that adjustments are made for the effects of significant transactions or events that occur between the subsidiary's reporting date and those of the consolidated financial statements.

Another instance where problems can arise is when a company is incorporated for the purpose of acting as the new parent company in a group reconstruction. The accounting reference period of the group must by law be that of the parent company, so this may result in the inadvertent creation of an accounting period which is not the one the group would have preferred. Moreover, unless the company has been in existence for two years, arguably its statutory accounts are not able to deal with the results of the group for the current and comparative periods, because strictly they will go back only as far as the date of incorporation of the parent company.

However, in practice, particularly in situations where a new top holding company is set up as part of a group reconstruction, many companies simply produce consolidated financial statements for the more relevant period(s), as if the company had always been in existence. Only the individual financial statements of the new top holding company are prepared for the period from the date of incorporation. The justification for this approach is based on the more specific provisions of the Regulations relating to group accounts:

- The consolidated balance sheet and profit and loss account must incorporate in full the information contained in the individual accounts of the undertakings included in the consolidation. [6 Sch 2(1)].
And
- The principles of the merger accounting method require information for the undertaking acquired to be included for the entire financial year, with comparatives for the previous financial year. [6 Sch 11(3), 6 Sch 11(4)].

Consider the following Illustration:

Illustration 5-5 Merger accounting by a newly incorporated parent company

Company A is incorporated on 1 April 20X6 to effect a group reorganisation on 1 July 20X6 whereby it will become the new parent entity of an existing group, headed by Company B. Company B has a financial year ending on 31 December and has prepared consolidated financial statements for the year ended 31 December 20X5. Company A gives notice to have an accounting reference date of 31 December and will prepare consolidated financial statements made up to 31 December 20X6. In doing so, Company A has determined that it is appropriate to account for the acquisition of the existing group under the merger method (invoking a true and fair override, if necessary - see 5.2.1.A above).

As indicated above, arguably the statutory consolidated financial statements will include the existing Company B group for only the 9-month period from the date of incorporation of Company A. However, this does not really provide relevant information to the shareholders of the group who have continued to have an interest in the Company B group. Common practice would be for Company A to present the year ended 31 December 20X6 (with comparatives for the year ended 31 December 20X5). The notes to the financial statements will need to explain the basis on which the consolidated financial statements have been drawn up.

If Company A had instead been incorporated on 1 October 20X5, a similar problem arises, but again, a pragmatic approach is to prepare accounts for the same period as described above. However, this may be appropriate only because Company A is a Newco and therefore is assumed to have no trade in the period from 1 October to 31 December 20X5.

5.4 Application of merger accounting in individual financial statements

5.4.1 Hive transactions

A common transaction in the individual financial statements of entities within a group is the transfer of trade and assets from one entity to another. These result in different accounting issues, which are discussed at 5.4.1.A to 5.4.4.B below. This guidance focuses on three variations of a transfer of trade and assets from:

- (a) A subsidiary to a parent, ('hive up')
- (b) One subsidiary to a fellow subsidiary, ('hive across')
- And
- (c) A parent to a subsidiary, ('hive down')

In all of the following discussions and examples in 5.4.1.A to 5.4.4.B below, it is assumed that the conditions for the use of merger accounting in FRS 102 are met (see 5.2 above), i.e.,:

- The ultimate equity holders remain the same, and the rights of each equity holder, relative to the others, are unchanged.
And
- No non-controlling interest in the net assets of the group is altered by the transfer.

Section 19 requires that the use of the merger accounting method is not prohibited by company law or other relevant legislation. [FRS 102.19.27]. All of the following examples relate to individual accounts. Therefore, the conditions for use of the merger accounting method included in the Regulations and LLP Regulations do not apply; these conditions apply only in group accounts. [6 Sch 10, 6 Sch 10 (LLP)].

In addition, it is assumed that the trade and assets transferred meet the definition of a 'business' in the Glossary to FRS 102 (see 3.2.1 above). [FRS 102 Appendix I].

5.4.1.A Use of the merger accounting method or the purchase method?

Group reconstructions meeting the specified conditions may be accounted for by using the merger accounting method. [FRS 102.19.27]. This suggests that use of the purchase method is also available for such group reconstructions.

How we see it

We believe that a receiving entity accounting for a group reconstruction can only apply the purchase method if the transaction has substance for the combining parties. If there is no substance to the transaction, the merger accounting method is the only method that can be applied to that transaction. If there is substance to the transaction, whichever accounting policy is adopted must be applied consistently to similar categories of transactions as required by Section 10 of FRS 102 (see Chapter 9 at 3.1 and 3.2). An entity needs to exercise judgement in developing and consistently applying an accounting policy that results in information that is relevant and reliable in the particular circumstances.

In our view, where the purchase method is selected, the transaction must have substance from the perspective of the reporting entity. This is because the purchase method results in the reassessment of the value of the net assets of one or more of the entities involved and/or the recognition of goodwill. As discussed at 5 above, FRS 6 noted these as reasons why the purchase method may be inappropriate for some group reconstructions. Careful consideration is required of all of the facts and circumstances from the perspective of each entity, before it is concluded that a transaction has substance.

How we see it

Evaluating whether a group reconstruction (including a hive transaction) has substance will involve consideration of multiple factors, including (but not necessarily limited to):

- (a) Whether or not the transaction is a business combination
- (b) The purpose of the transaction
- (c) The involvement of outside parties in the transaction, such as non-controlling interest or other third parties
- (d) Whether or not the transaction is conducted at fair value
- (e) The existing activities of the entities involved in the transaction
- And
- (f) Whether or not it is bringing entities together into a reporting entity that did not exist before

Further discussion of the points is as follows:

- Whether or not the transaction is a business combination (see 3.2.1 above for a full discussion of the definition of a business and of a business combination). Importantly, Section 19 states that, "The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other businesses, the acquiree." [FRS 102.19.3]. Therefore, if the transaction is not a business combination, use of the purchase method is generally not appropriate.
- The purpose of the transaction. It is important to understand the economics and objectives of a transaction in relation to all of the parties to it. These will often inform management's judgements as to the appropriate accounting.
- Whether or not the transaction is conducted at fair value. If the transaction is equivalent to an arm's length transaction between third parties, then it might be appropriate to apply the purchase method. An example of this is a business combination for which the consideration paid is cash or loan (with formally documented interest and/or repayment terms), of an amount commensurate to the fair value of the trade and assets acquired (i.e., of the business, including goodwill). It might often be difficult to obtain a reliable estimate of the fair value of shares issued by an entity as consideration for the transfer of the trade and assets in a group reconstruction. In addition, the economic substance of the transaction might be the same irrespective of the number of shares issued, for example, in a hive down to a wholly owned subsidiary.

- The existing activities of the entities involved in the transaction. It is relevant to consider the existing activities of the entities involved in the transaction and whether the transaction is bringing businesses together into a 'reporting entity' that did not exist before. Some transfers of businesses may be more in the nature of a continuation of an existing business (or part of a business) than a business combination. One example where this is relevant is in the case of a hive up (see 5.4.2 below). It may be difficult to categorise a hive up transaction as a business combination because there is no acquirer that obtains control of a business; the parent already controlled the business that has been transferred to it.
- Whether or not it is bringing entities together into a reporting entity that did not exist before. As discussed at 3.4.2 above, it is difficult to identify Newco as the acquirer in a business combination and so merger accounting is likely to be more appropriate where a business has been transferred to a Newco. However, a group reconstruction involving a Newco could be undertaken in connection with an IPO or spin off or other change in control and significant change in ownership and, in some circumstances, it might be possible to identify the Newco as the acquirer (see the discussion at 3.4.2 and 5.2.1.B above). The accounting will depend on a careful analysis of the facts and circumstances and ultimately requires judgement.

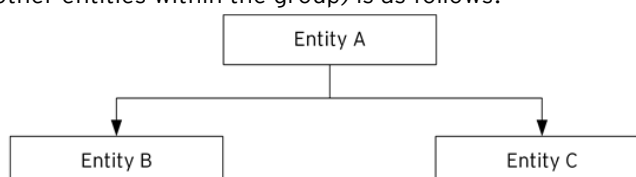
How we see it

In our view, the merger accounting method is often more appropriate for transactions involving share consideration.

If an entity concludes that use of the purchase method is appropriate for a particular transaction, then Section 19's requirements regarding the application of the purchase method apply. [FRS 102.19.6]. In particular, it is important to determine which party is the accounting acquirer (see 3.4 above).

Illustration 5-6: Determining if a group reconstruction has substance for applicability of the purchase method (1)

Entity A currently has two businesses operated through wholly owned subsidiaries Entity B and Entity C. The group structure (ignoring other entities within the group) is as follows:



Entity A proposes to combine the two complementary businesses (currently housed in two separate entities, Entity B and Entity C) into one entity, in anticipation of spinning off the combined entity by way of an IPO. Both businesses have been owned by Entity A for several years. The reorganisation will be structured such that Entity C will acquire the shares of Entity B from Entity A for cash at their fair value of £1,000. The carrying amount of the net assets of Entity B is £200 (both in the individual financial statements of Entity B and in the consolidated financial statements of Entity A). The net of the acquisition-date fair values of the identifiable assets acquired and liabilities assumed of Entity B (measured in accordance with Section 2A) is £600.

How would this transaction (to facilitate a subsequent spin-off) be accounted for in the consolidated financial statements of both Entity C and Entity A?

As far as Entity C is concerned, there is a business combination that needs to be accounted for. In this fact pattern, there is substance to the transaction. There is a business purpose to the transaction; it has been conducted at fair value; both Entity B and Entity C have existing activities; and they have been brought together into a reporting entity that did not exist before. Accordingly, Entity C can choose to apply either the purchase method or the merger accounting method in its consolidated financial statements. The selected accounting policy must be applied consistently to similar transactions.

If Entity C selects the purchase method, it will need to identify whether Entity C or Entity B is the acquirer (see 3.4 above). Assuming that Entity C is identified as the acquirer, in summary, this will mean that the net identifiable assets of Entity B will be initially reflected at their acquisition-date fair values (£600), together with goodwill of £400 (£1,000 less £600), in the consolidated statement of financial position.

As far as Entity A is concerned (i.e., from the perspective of the controlling party), there has been no change in the reporting entity - all that has happened is that Entity B, rather than being directly held and controlled by Entity A, is now indirectly held and controlled through Entity C (i.e., no change in control). Accordingly, there is no business combination and the effects resulting from the intragroup transaction are eliminated in full. Thus, the carrying amounts for Entity B's net assets included in the consolidated financial statements of Entity A do not change. There are also no non-controlling interests affected. The transaction therefore has no impact on the consolidated financial statements of Entity A (except for any potential tax consequences).

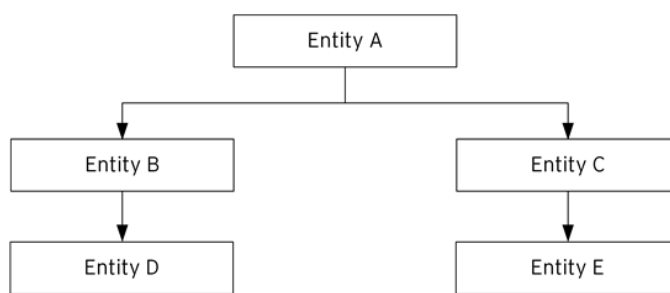
In Illustration 5-6 above, Entity C had to account for its business combination with Entity B, as it was preparing consolidated financial statements. In some situations, Entity C would not need to account for the business combination at all, as it might be exempt as an intermediate parent company from preparing consolidated financial statements (see Chapter 8 at 3.1.1). If in Illustration 5-6 above, Entity C had acquired the business of Entity B, rather than the shares, then the same accounting policy choice would have to be made for the business combination in Entity C's financial statements, even if they are not consolidated financial statements.

However, in other types of reorganisations, careful consideration of the factors above might indicate that there is no substance to the transaction. This is shown in Illustration 5-7 below.

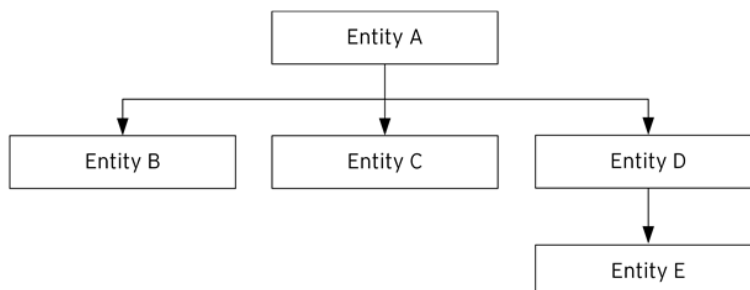
Illustration 5-7: Determining if a group reconstruction has substance for applicability of the purchase method (2)

Entity A engages in different business activities in two geographical areas through four wholly owned subsidiaries (all owned for several years). Each subsidiary individually meets the definition of a business in FRS 102. Traditionally, the legal structure followed the geographical areas of operations. To align with its management structure, which is organised by business segment, Entity A proposes to reorganise its legal structure. This two-step process involves (i) Entity B distributing its shares in Entity D to Entity A, and (ii) Entity D acquiring the shares in Entity E. The transaction price for (ii) reflects the carrying amount of Entity E's net assets as included in the consolidated financial statements of Entity A. The group structure before and after this reorganisation is as follows:

Before



After



How would this transaction (to align the group's legal and management structure) be accounted for in the consolidated financial statements of both Entity A and Entity D?

As far as Entity A is concerned, neither its own acquisition of the shares in Entity D (by way of distribution from Entity B) nor the transfer of shares in Entity E from Entity C to Entity D represents a business combination. As described in Illustration 5-6 above, from the perspective of the controlling party, there is no change of control. Because there are also no non-controlling interests affected, the reorganisation has no impact on the consolidated financial statements of Entity A (except for any potential tax consequences).

In contrast, in the consolidated financial statements of Entity D, there is a business combination that needs to be accounted for. In this fact pattern, the transaction is bringing entities together into a reporting entity that did not exist before and both Entity D and Entity E have existing activities. Nevertheless, there is no substance to the transaction. There is no clear business purpose to the transaction; the restructuring is purely internal, with no external parties being involved; and the transaction is not conducted at fair value. Consequently, Entity D cannot apply the purchase method in its consolidated financial statements. This reorganisation will be accounted for using the merger accounting method.

5.4.1.B Transactions at undervalue and section 845 of the CA 2006

When an entity sells an asset (or a group of assets and liabilities, for example, a business) for an amount that is less than its fair value (including for nil consideration), the entity is making a transfer at undervalue because it is not receiving an arm's length consideration. Therefore, the entity must consider whether it is making a distribution under Part 23 of the CA 2006 and whether it has sufficient distributable reserves to do so. In the context of hive transactions, this is particularly relevant when the transaction involves a transfer of value from a group entity to its direct or indirect parent/owner or to a fellow subsidiary. An example of a transfer of value by the transferor (the selling entity) is a hive up or hive across in which the consideration received by the entity is less than the fair value of the trade and assets sold. An example of a transfer of value by the transferee (the purchasing entity) is a hive down or hive across in which the consideration paid by the entity exceeds the fair value of the trade and assets purchased.

It is not the intention of this publication to discuss all the requirements relating to the lawfulness of undervalue transactions, which is an area where an entity might need to obtain appropriate legal advice on the specific transaction. However, sections 845 and 846 of the CA 2006 are often relevant to such transactions and are briefly discussed below.

Section 845 of the CA 2006 applies to a company in determining the 'amount of a distribution' in relation to the sale, transfer or other disposition of a non-cash asset, providing that:

- The company has 'profits available for distribution' at the time of the distribution.
- And
- If the amount of the distribution were to be determined in accordance with section 845, the company could make the distribution without contravening Part 23 of the CA 2006.

For the purposes of section 845, the profits available for distribution are treated as increased by the amount (if any) by which the amount or value of the consideration for the disposition exceeds the book value of the asset. The book value of the asset is the amount at which the asset is stated in the relevant accounts of the transferor used to support the distribution (or if not stated in those accounts, nil). [s845]. Where any part of the amount at which the asset is stated in the relevant accounts represents an unrealised profit (for example, where an item of property, plant and equipment has been revalued), that profit is treated as a realised profit for the purpose of determining the lawfulness of the distribution. [s846].

If section 845 applies, the amount of the distribution is the amount by which the book value of the asset exceeds any consideration received. If the consideration exceeds the book value, the amount of the distribution is nil. [s845].

Illustration 5-8: Application of section 845

Entity A has a property, measured at cost less impairment, with a book value of £750,000. Entity A has distributable reserves of £600,000. Entity A sells the property to its parent, Entity P.

In the following scenarios, what is the amount of any distribution in law?

Entity A receives cash of the following amounts, from Entity P, in consideration for the property:

1. £750,000: Distribution is measured as (£750,000 - £750,000 = £nil).
2. £150,000: Distribution is measured as (£750,000 - £150,000 = £600,000).
3. £nil: Distribution would be measured as (£750,000 - £nil = £750,000). Entity A does not have sufficient distributable reserves for this transaction, so it cannot be conducted as planned (see discussion following Illustration 5-9 below).

Illustration 5-9: Application of sections 845 and 846

Entity B has a property, measured at revaluation under Section 17, with a carrying value of £900,000. Entity B purchased the property for £600,000 and the related revaluation reserve is £300,000. Entity B has distributable reserves of £150,000. Entity B sells the property to its parent, Entity P for £475,000.

The carrying value of the property exceeds the consideration received by £425,000 (£900,000 less £475,000), which is the amount at which the distribution is measured under section 845. Entity B has only £150,000 of reserves available for distribution. However, by virtue of section 846, the revaluation reserve of £300,000 is considered realised for the purpose of distributing the property to which the revaluation reserve relates. Therefore, total profits available for distribution are £450,000 which are sufficient to cover the amount of the distribution.

Detailed worked examples demonstrating the application of sections 845 and 846 are provided in the ICAEW/ICAS Technical Release TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006*. [TECH 02/17BL Appendix 1].

It is important that the transferor company has positive profits available for distribution (as defined) sufficient to cover the amount of the distribution (as defined). In a transaction to sell an asset at book value, the amount of the distribution is nil but if the transferor has nil or negative profits available for distribution, it would not be able to enter into the transaction as planned. However, alternative structures for the transaction could be considered. For example, the buyer could pay an amount equal to fair value (in the case of a sale of trade and assets, the fair value of the business) for the transaction. The asset could also be sold at book value plus an amount exceeding the deficit on distributable reserves. (This is because, for the purposes of section 845, the profits available for distribution are treated as increased by the amount of any excess of the consideration for the transfer over the book value of the asset. While the amount of the distribution is nil, in order to effect the transaction, there must be a positive (not a nil) balance on profits available for distribution after such adjustment for that excess.) Another possibility is that the seller might be in a position to effect a capital reduction in order to create positive profits available for distribution prior to the transaction. An entity might often need to obtain legal advice in order to structure the transaction appropriately.

Undervalue transactions in group reconstructions are often undertaken in such a way that intermediate holding companies are affected. For example, one subsidiary sells its trade and assets to another, and there is an intermediate holding company between the selling subsidiary and the common parent of both the selling and buying subsidiaries. That intermediate holding company must also consider the adequacy of its distributable reserves (including the effects of any impairment in its investment in the subsidiary) when its subsidiary conducts a transaction at undervalue. [TECH 02/17BL.9.71]. See 5.4.3.B below.

5.4.1.C Balances arising from merger accounting and realised profits

As discussed at 5.4.6 below, application of merger accounting often results in balances within equity, which could be a debit or a credit. TECH 02/17BL contains guidance on debits within equity arising on group reconstructions. While this guidance is written in the context of IFRS 3, TECH 02/17BL explains that it is equally applicable to a group reconstruction accounted for under FRS 102. [TECH 02/17BL.9.41].

The guidance within TECH 02/17BL is as follows:

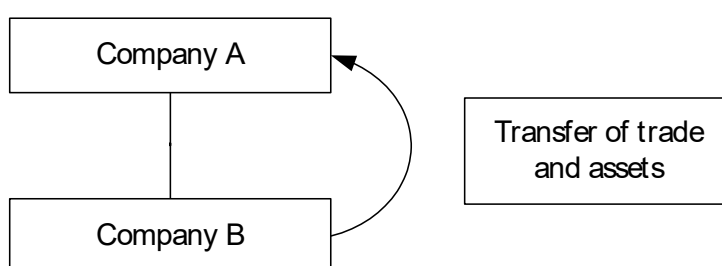
- Where the accounting is to recognise the net assets acquired at the transferor's book amounts (rather than at their fair values), the consideration payable may exceed the book amount of the net assets acquired. This will leave a debit difference to be recognised. It is not goodwill. The debit is sometimes referred to as a 'merger difference' and is recorded in equity. [TECH 02/17BL.9.36].
- A business combination involving members of the same group is completed under the direction of the controlling party, the common parent. Consequently, any excess paid by the acquirer over the book amount of the selling shareholder's net assets is accounted for in a similar manner to a distribution or return of capital to the common parent. Distributions and returns of capital are dealt with through equity, and therefore it is logical also to recognise the debit in equity. [TECH 02/17BL.9.37].
- Such a debit directly to equity is not necessarily, however, a distribution as a matter of law. This is because the debit described above is determined on a book basis, whereas the question as to whether there would be an actual distribution is determined by whether the company gives consideration other than an issue of its shares, to its parent or a fellow subsidiary, with a fair value in excess of the fair value of the net assets and business acquired. Accordingly, the debit might form part of an actual distribution or might not. [TECH 02/17BL.9.38].
- In a case where the debit in equity does not form part of an actual distribution, then at the date of acquisition the debit does not represent a loss; the acquiring company has purchased net assets worth at least the book value of the consideration given but, under the appropriate accounting, has recognised these at a lower amount. The difference between the two is the amount of the debit. As the debit is not a loss at all, it is neither realised nor unrealised. However, it can subsequently become a realised loss. [TECH 02/17BL.9.39].
- To the extent that the assets, if they had been recognised at the higher amount, together with any goodwill that would have been recognised, would have been written down, say, by depreciation or impairment, an equivalent amount of the debit becomes a realised loss. It is a realised, rather than unrealised, loss because, had the debit been carried as an asset, any write down for depreciation or impairment would be required, by section 841 and the principles of realisation, to be regarded as realised. [TECH 02/17BL.9.40].

A debit adjustment to reserves in a public company would result in a restriction to the reserves available for distribution via the 'net assets test' in section 831 of the CA 2006. [s831, TECH 02/17BL.9.42].

The guidance in TECH 02/17BL discussed above deals with the situation where there is a net debit to be taken to equity as a result of merger accounting. However, for some group reconstructions, the net amount to be recognised is a credit (see 5.4.6 below). In determining whether this credit represents realised profits or not, reference must be made to the guidance in TECH 02/17BL. Paragraph 3.18 of TECH 02/17BL recommends a 'top slicing' approach in determining realised profits for exchanges of assets where the consideration received is partly 'qualifying' consideration and partly other consideration. This means that where an asset is sold partly for qualifying consideration and partly for other consideration (for example, a mixed consideration of cash and a freehold property), any profit arising is a realised profit to the extent that the fair value of the consideration received is in the form of qualifying consideration.

[TECH 02/17BL.3.18]. Paragraph 3.18A expands on the application of 'top slicing' when the consideration received comprises a combination of assets and liabilities. For example, this will often be the case on a transfer of trade and assets for no consideration. The guidance states that any liabilities are first deducted from the amount of qualifying consideration received; therefore, the profit will be realised only to the extent of any net balance (i.e., cash less liabilities) of qualifying consideration received. [TECH 02/17BL.3.18-+18A].

5.4.2 Hive up transactions



5.4.2.A Hive up immediately after acquisition

Illustration 5-10: Hive up immediately after acquisition

Fact pattern

1. Company A acquires Company B on 31 December 20X6 in a business combination for £5,000 cash. Company B has net assets with a book value in its individual financial statements of £2,800 and a fair value of £3,500 (including deferred tax adjustments arising on the business combination). Goodwill of £1,500 arises in the consolidated financial statements of Company A, also prepared under FRS 102.
2. On 1 January 20X7, Company B sells its trade and assets to Company A in consideration for an intercompany receivable of £2,800 equal to the book value of net assets in Company B's individual financial statements.
3. Company B has positive distributable reserves (see 5.4.1.B above).
4. Company A prepares consolidated and individual financial statements under FRS 102. Company A and Company B use consistent accounting policies.
5. Company A uses the merger accounting method for the hive up (see 5.4.1.A above). However, in this particular case of a hive up immediately after acquisition, using the merger accounting method achieves the same result as applying the purchase method.

Analysis

In using the merger accounting method, Company A must determine which are the appropriate book values of net assets of Company B to use, those from its consolidated financial statements or from Company B's individual financial statements.

How we see it

In our view, it is generally appropriate for Company A to use the consolidated book values of net assets (including goodwill) relating to Company B's trade and assets. This reflects the substance of the transaction, which is equivalent to Company A purchasing the trade and assets directly from the third party, combined with the acquisition of a cash shell, Company B. Using the consolidated book values has the effect that the same assets (including goodwill) and liabilities are presented in relation to the trade and assets acquired in both the consolidated and individual financial statements of Company A.

Company B is selling its trade and assets for a consideration equal to the book value of the net assets in its individual financial statements, which is less than fair value of the trade and assets (i.e., the business). Since it

has positive distributable reserves, section 845 applies (see 5.4.1.B above) and, in this case, because Company B receives an intercompany receivable equal to the book value of its net assets, the amount of the distribution is measured at nil.

The hive up results in the following entries in Company A's separate financial statements and Company B's individual financial statements:

<i>Company A</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Investment in Company B	5,000	
Cash		5,000
To record the initial purchase of Company B		
Goodwill	1,500	
Net assets (at acquisition date fair value)	3,500	
Intercompany payable		2,800
Investment in Company B		2,200
To record the hive up transaction		

The credit to investment is in substance part of the consideration for the hive up. The remaining investment balance of £2,800 is supported by the intercompany receivable in Company B (see below). For a discussion of impairment following a hive up, see 5.4.2.E below.

<i>Company B</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Intercompany receivable	2,800	
Net assets		2,800
To record the hive up transaction		

5.4.2.B Other forms of consideration

It is unlikely that a hive up would be effected by shares since this would result in the subsidiary holding shares in its parent, which is generally prohibited by section 136 of the CA 2006. [s136].

If Company B gifted its business to its parent Company A i.e., for nil consideration, it would need sufficient profits available for distribution to cover the book value of the net assets distributed. In this example, this would have the effect that, instead of the intercompany receivable recorded above, a distribution in equity would be recorded for the same amount. An entity would never have quite sufficient reserves to distribute the entirety of its net assets because some of those net assets will be represented by share capital and premium. An entity might need to obtain legal advice in order to structure the transaction appropriately. For example, Company B might conduct a capital reduction in advance of the hive up (although one share, that is not a redeemable share, must always be left outstanding) and a nominal consideration could be paid for any share capital remaining. [s641].

Company A would record the same goodwill and net assets for the hive up of Company B's trade and assets as shown in the example above, together with a credit to the carrying amount of its investment in Company B of £5,000 (less any amount supported by nominal consideration paid to Company B).

5.4.2.C Hive up sometime after acquisition

Illustration 5-11: Hive up sometime after acquisition

Fact pattern

1. Assume the facts are the same as Illustration 5-10, at 5.4.2.A above, but Company B was acquired on 31 December 20X3 by Company A. Since acquisition, Company B has recorded profits of £600 per year in its individual financial statements. Goodwill is amortised over 10 years, and the property is depreciated over 30 years from the acquisition date.
2. On original acquisition, in Company A's consolidated financial statements, property that was recorded in Company B's individual financial statements at historical cost of £125 was ascribed a fair value of £1,000. A deferred tax liability of £219 (at a substantively enacted tax rate of 25%) arose on the fair value adjustment ($25\% \times (£1000 - £125)$), giving a net of tax adjustment to the fair values of the identifiable net assets acquired of £656.
3. On 1 January 20X7, Company B sells its trade and assets to Company A, in consideration for an intercompany receivable of £4,600 (£2,800 plus £1,800 cumulative profits for three years) equal to the book value of net assets in Company B's individual financial statements.
4. Company B has positive distributable reserves (see 5.4.1.B above).
5. Company A prepares consolidated and individual financial statements under FRS 102. Company A and Company B use consistent accounting policies.
6. Company A uses the merger accounting method to account for the transaction in its individual financial statements.

Analysis

As in Illustration 5-10 at 5.4.2.A above, Company A must determine which are the appropriate book values of net assets of Company B to use, those from its consolidated financial statements or from Company B's individual financial statements.

How we see it

In our view, it would generally be most appropriate to use the consolidated book values of the net assets (including goodwill) relating to Company B's trade and assets.

If, as seems likely, the fair value of the trade and assets transferred exceeds the consideration received (based on the book value of the related net assets in its individual financial statements), Company B would be making an undervalue transfer (see 5.4.1.B above). However, since Company B has positive distributable reserves and is paid book value for its net assets, the amount of the distribution is zero in accordance with section 845 and there is also no accounting effect of the distribution to reflect in Company B's equity.

The hive up results in the following entries in Company A's separate financial statements and Company B's individual financial statements:

Company A	Dr	Cr
	£	£
Goodwill ¹	1,050	
Net assets ²	5,234	
Intercompany payable		4,600
Investment ³		400
Merger reserve ⁴		1,284

To record the hive up transaction

¹Goodwill of £1,500 arising on original acquisition has been amortised for three years at £150 per year. Note that goodwill is not remeasured at the date of hive up.

²Net assets of Company B in Company A's consolidated financial statements are £3,500 at the date of acquisition and Company B has made £1,800 cumulative profits in the three years post-acquisition. There was a fair value adjustment on property of £656 (net of deferred tax), depreciated for three years of its 30-year useful economic life, giving accumulated depreciation net of unwind of deferred tax of £66. Therefore, the net assets of Company B in A's consolidated financial statements at the date of hive up are £5,234 (£3,500 plus £1,800 less £66).

³Company A's investment has been written down to the amount that can be supported by the intercompany receivable in Company B of £4,600: i.e., £5,000 (from original acquisition) less £4,600. For a discussion of impairment following a hive up, see 5.4.2.E below.

⁴An adjustment in equity, sometimes to a separate reserve (in this example, the merger reserve), is recorded for the merger accounting difference arising. [FRS 102.19.31]. The merger reserve represents the cumulative profits made by Company B as shown in Company A's consolidated financial statements, i.e., cumulative profit of £1,800 less £66 net depreciation/deferred tax unwind on the property fair value adjustment less goodwill amortisation of £450. The reserve would be assessed to determine whether any amount of it represents a realised profit using the guidance in TECH 02/17BL (see 5.4.1.C above).

<i>Company B</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Intercompany receivable	4,600	
Net assets		4,600
To record the hive up transaction		

For other forms of consideration, there are similar considerations to those discussed in at 5.4.2.B above.

5.4.2.D Hive up of a business not previously acquired

Illustration 5-12: Hive up of a business not previously acquired

Fact pattern

1. Company B has been owned by Company A since incorporation. Company A has an investment in Company B of £1,000.
2. On 1 January 20X7, Company B sells its business (trade and assets) to Company A, in consideration for an intercompany receivable equal to the book value of net assets (relating to that business) of £4,600 in Company B's individual financial statements.
3. Company B has positive distributable reserves before and after the transaction (see 5.4.1.B above).
4. Company A prepares consolidated and individual financial statements. Company A and Company B use consistent accounting policies.
5. As in Illustration 5-10 (at 5.4.2.A above) and illustration 5-11 (at 5.4.2.C above), Company A uses the merger accounting method for the hive up in its individual financial statements.

Analysis

This may be an undervalue transfer if the fair value of the trade and assets exceeds the book value of the related net assets in Company B's individual financial statements. Since Company B has positive distributable reserves and is paid book value for the net assets, the amount of the distribution is nil in accordance with Section 845 and there is also no accounting effect of the distribution to reflect in Company B's equity.

In this case, the book values of the net assets of the business hived up are the same in the individual financial statements of Company B and the consolidated financial statements of Company A and, therefore, are the only book values that can be used to account for the hive up in Company A's individual financial statements. More generally, the book values of net assets from a selling subsidiary's individual financial statements could be subject to accounting policy alignment.

Therefore, the accounting in both companies is straightforward, since both companies recognise/derecognise net assets at the book value of £4,600 and an equivalent intercompany balance. In this example, the carrying amount of the investment in Company B remains supported by the intercompany receivable of £4,600 held by Company B. In situations where the investment carrying amount would not be supported as a consequence of the hive up, a credit to the investment would be recorded with an adjustment to equity for any difference between the net assets recorded in Company A's books and the credit to the cost of investment.

For a discussion of impairment following a hive up, see 5.4.2.E below.

5.4.2.E Assessing the parent's carrying value of investment for impairment

After a hive up, the parent company may need to assess whether the carrying value of its investment in the subsidiary transferring its trade and assets remains recoverable.

In Illustration 5-12 at 5.4.2.D above, it is clear that there is no impairment since the intercompany receivable of £4,600 held by Company B following the hive up is in excess of the investment of £1,000. However, in other cases, there might be an apparent 'impairment' in value, if the carrying value of the parent's investment exceeds the consideration given for the hive up.

Illustration 5-13: Debit merger difference ('impairment') arises on hive up*Fact pattern*

1. Company A acquired Company B on 31 December 20X3, for a fair value of £10,000, when Company B's net assets were stated in its individual financial statements at £6,000.
2. On 1 January 20X7, Company B sells its trade and assets to Company A in consideration for an intercompany receivable of £7,500 equal to the book value of net assets in Company B's individual financial statements.
3. On 1 January 20X7, the carrying value of Company B's net assets (including goodwill) from Company A's consolidated financial statements is £11,500.
4. Company B has positive distributable reserves (see 5.4.1.B above).
5. The value in use/fair value of Company B supported the carrying value of Company A's cost of investment of £10,000 prior to the hive up. There is no remaining trade in Company B after the hive up.
6. Company A applies merger accounting and recognises the net assets of Company B at their book values from Company B's individual financial statements, i.e., £7,500, and an intercompany payable for the same amount.

Analysis

Subsequent to the hive up, Company A assesses its investment in Company B and identifies that the intercompany receivable of £7,500 held by Company B does not support the investment carrying value of £10,000. There is an apparent 'impairment' of £2,500. However, Company A has suffered no loss and so it would not be appropriate for it to recognise an impairment loss in profit or loss as a result of the hive up. This is because there is no change to the net assets that it controls; they have simply moved between the legal entities. Company A must recognise the reduction in the cost of investment, which is in substance part of the consideration paid by Company A for the hive up. Therefore, it is appropriate to consider the debit of £2,500 as a merger accounting difference to be recognised in equity in Company A. It is not goodwill, since the application of the merger accounting method does not result in the recognition of new goodwill. [FRS 102.19.31]. See 5.4.1.C above for a discussion of whether such merger accounting differences result in realised profits and losses.

How we see it

In our view, accounting for the hive up using the book values of the net assets (including goodwill) of the subsidiary in the consolidated financial statements generally avoids or mitigates an overall debit arising on the transaction. This is because the investment is essentially exchanged for the net assets (including goodwill) relating to the hive up as included in the consolidated financial statements.

If this were the appropriate accounting in Company A, the amounts it would record are:

Company A	Dr	Cr
	£	£
Net assets	11,500	
Intercompany payable		7,500
Investment ¹		2,500
Merger reserve ²		1,500

To record the hive up transaction

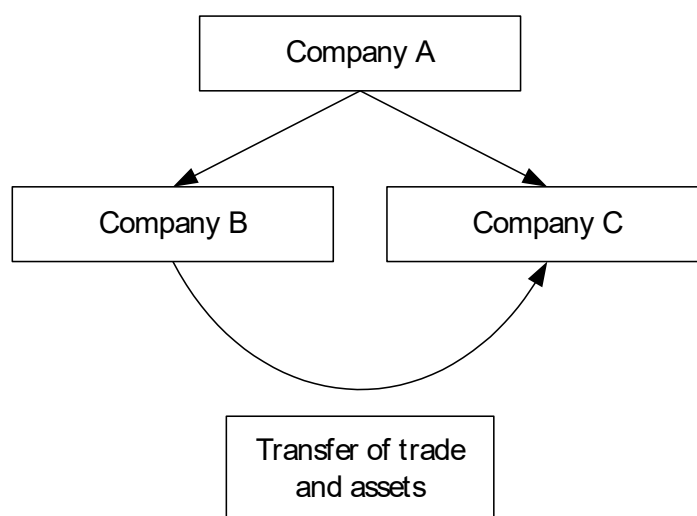
¹To write down the investment to the amount receivable in Company B.

²An adjustment in equity, sometimes to a separate reserve (in this example, the merger reserve), is recorded for the merger accounting difference arising. [FRS 102.19.31]. The reserve would be assessed to determine whether any amount of it represents a realised profit using the guidance in TECH 02/17BL (see 5.4.1.C above).

Although the investment is written down to the same amount (£7,500) using the book values of Company B from either Company B's individual financial statements or Company A's consolidated financial statements, when the latter amounts are used to account for the hive up, no overall debit arises on the transaction. Instead, a credit balance arises of £1,500, essentially representing the increase in the consolidated net assets (including goodwill) of Company B since its original acquisition, which is reflected in the net assets recorded on the hive up, but not in the consideration that was agreed between the two parties.

Care must be taken that any genuine impairment in the parent's investment in its subsidiary, i.e., one resulting from factors other than the hive up, is identified and recognised appropriately in the parent's profit or loss. This is because otherwise a debit merger accounting difference recorded in equity may inappropriately include a true impairment loss.

5.4.3 Hive across transactions



Similar issues arise when considering a hive across transaction, as when considering a hive up (see 5.4.2 above): the seller must consider whether it is making a sale at undervalue (see 5.4.1.B above), and the buyer must consider the appropriate basis on which to recognise the net assets acquired in its individual financial statements (see 5.4.1.A above).

5.4.3.A Hive across for intercompany consideration

Illustration 5-14: Hive across for intercompany consideration

Fact pattern

1. On 1 January 20X7, Company B transfers its trade and assets to its fellow subsidiary Company C, for an intercompany receivable of £6,000 equal to the book value of Company B's net assets in its individual financial statements.
2. The fair value of Company B's trade and assets (i.e., the business) is £12,500 at the date of transfer.
3. Company B has positive distributable reserves (see 5.4.1.B above).
4. Company A prepares consolidated and individual financial statements under FRS 102. Company A, Company B and Company C use consistent accounting policies.
5. Company A has a cost of investment in Company B of £7,000 and in Company C of £1,000.
6. Company A's consolidated financial statements at 31 December 20X6 show amortised goodwill of £1,500 and net assets of £8,500 in respect of Company B's trade and assets, as Company A had acquired Company B in a previous transaction.

Analysis

As discussed at 5.4.1.A above, Company C must determine whether to apply the merger accounting method or the purchase method to the hive across.

How we see it

If Company C applies the merger accounting method to the hive across, it must consider which book values of net assets to use, those from Company B's individual financial statements or from Company A's consolidated financial statements. Which is most appropriate will depend on specific facts and circumstances. Since Company B has been previously acquired, using the book values of net assets (including goodwill) from the consolidated financial statements could be more appropriate. There could be other circumstances in which the book values from Company B's individual financial statements would be considered most appropriate, for example, if the substance of the transaction were a continuation of the trade and assets hived across, as would be the case if Company C were newly incorporated for the purpose of the transaction.

If Company C uses the consolidated book values of net assets (including goodwill), the accounting is similar to that shown in Illustration 5-11 at 5.4.2.C above, except that a credit to equity (for example, to a separate merger reserve) will arise for all of the difference between the book values recognised and the consideration given of £6,000, and there is no investment to be credited.

If, in different circumstances, Company C were to use the individual book values of net assets, the accounting is similar to that shown in Illustration 5-13 at 5.4.2.E above, with net assets and an intercompany payable recognised of £6,000.

Where Company C uses the consolidated book values of net assets (including goodwill), the accounting in each of Companies B and C is as follows:

<i>Company C</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Goodwill	1,500	
Net assets	8,500	
Intercompany payable		6,000
Merger reserve ¹		4,000

To record the hive across transaction

¹See 5.4.1.C above for a discussion of whether such merger accounting differences result in realised profits and losses.

<i>Company B</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Intercompany receivable	6,000	
Net assets		6,000

To record the hive across transaction

The common parent, Company A, must also consider the effect of the hive across on its financial statements. In the consolidated financial statements, the transaction has no effect. In Company A's individual financial statements, there is a cost of investment in Company B of £7,000 but Company B contains only a receivable of £6,000. On the face of it, there is an apparent 'impairment' in the cost of investment in Company B, but Company A has suffered no loss because it has simply transferred assets from one subsidiary to another. Therefore, it would be inappropriate to recognise an impairment loss in Company A's profit or loss.

How we see it

In our view, it is appropriate for Company A to reallocate an appropriate amount of its investment in Company B to its investment in Company C. Company A's total investment in its subsidiaries B and C remains the same.

5.4.3.B Intermediate parent companies in a hive across transaction

When there is an intermediate parent above the seller in a hive across (for example, between Companies A and B in Illustration 5-14 at 5.4.3.A above), there are further legal and accounting considerations for the intermediate parent.

This situation is addressed by TECH 02/17BL which highlights that such transactions have potential to be unlawful, even if the intermediate parent suffers no accounting impairment loss. TECH 02/17BL states that when the seller transacts at an undervalue (see 5.4.1.B above) the actual value of the intermediate parent's investment in its subsidiary is diminished by the transfer, and so it is possible that knowledge of the proposed transaction and passive acquiescence in it may result in its being, in law, a distribution by the intermediate parent. If so, and if the intermediate parent has insufficient profits available for distribution, then it will be unlawful. [TECH 02/17BL.9.71].

Another issue for intermediate parents to consider is whether an impairment of the cost of investment in the selling subsidiary (or in any intermediate parent companies in the group structure above the selling subsidiary) arises as a result of the hive across transaction. If the business remaining in the selling subsidiary after a hive across does not support the carrying value of the investment in the selling subsidiary, its immediate parent company may need to recognise an impairment loss. This could also affect subsequent intermediate parent companies up the chain in the group structure. This does not affect the common parent company of the buying and selling subsidiaries but may affect intermediate parents above the selling subsidiary as far as the common parent. See Illustration 5-14 at 5.4.3.A above for considerations of the common parent in a hive across.

5.4.3.C Other forms of consideration

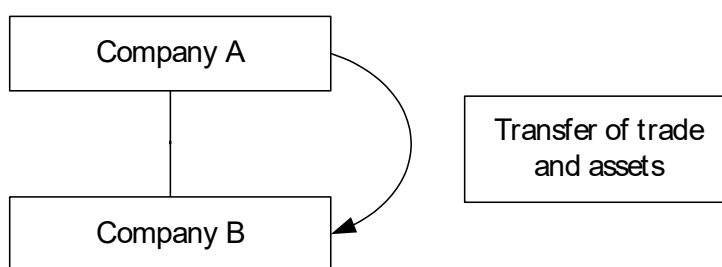
Similarly to a hive up transaction, it is unlikely that a hive across would be effected by shares since this would result in cross-holdings within the group, which may add complexity to a group structure.

If Company B gifted its business to Company C i.e., for nil consideration, the considerations and accounting for Company B would be similar to those described in 5.4.2.B above.

Company C would record a credit to equity, representing the capital contribution of a gifted business. Capital contributions are assessed to determine whether any portion represents a realised profit in accordance with section 3 of TECH 02/17BL.

As discussed in Illustration 5-14 at 5.4.3.A above, Company A must consider whether the carrying amount of its investment in Company B remains recoverable, and may need to reallocate an appropriate amount of its investment in Company B to its investment in Company C.

5.4.4 Hive down transactions



5.4.4.A Hive down for share consideration

Illustration 5-15: Hive down for share consideration

Fact pattern

- On 1 January 20X7, Company A transfers its trade and assets to Company B, its wholly owned subsidiary, in exchange for the issue of shares from Company B, with nominal value of £300.
- The book value of net assets in Company A's financial statements immediately before transfer is £2,500 and comprise property of £1,100, inventory of £1,200, trade receivables of £700, £500 of cash, and payables of £1,000.
- Company A is not part of a wider group. Therefore, the book values of its net assets are the same in the individual and consolidated financial statements that contain Company A.
- Company A has a policy of revaluation of property, which is stated in its financial statements at 31 December 20X6 at £1,100. Its original cost was £700.
- Company A and Company B prepare financial statements. Company A and Company B use consistent accounting policies.

Analysis

As discussed at 5.4.1.A above, Company B must determine whether to apply the merger accounting method or the purchase method to the hive down.

Company B applies the merger accounting method to the hive down and so recognises the net assets of £2,500. Group reconstruction relief is relevant to this transaction since Company B, a wholly owned subsidiary, is issuing shares to its parent Company A for consideration that is (at least in part) non-cash assets. [s611]. While group reconstruction relief is optional (see Chapter 8 at 4.2.1), Company B chooses to make use of this relief.

Group reconstruction relief establishes the 'minimum premium value' to be recognised in the share premium account. For further discussion and examples of the operation of group reconstruction relief, see 5.5.2 below and Chapter 8 at 4.2.1. In this example, Company B is required to recognise a minimum premium value, which is the amount (if any) by which the 'base value' of the consideration for the shares allotted (being the base value of the assets transferred less the base value of any liabilities of the transferor company assumed by the issuing company) exceeds the aggregate nominal value of the shares. [s611].

The base value of the assets transferred is taken as:

- The cost of those assets to the transferor company
- Or
- If less, the amount at which those assets are stated in the transferor company's accounting records immediately before the transfer

The base value of the liabilities assumed is taken as the amount at which they are stated in the transferor company's accounting records immediately before the transfer. [s611].

Broadly speaking, the base value is often equal to the book value of the assets and liabilities in the transferring entity's records immediately before transfer, although this would not be true of assets carried at fair value or valuation, if the resulting carrying amount is higher than the original cost to the transferor.

In this example, the base value of the property is its original cost of £700. The base value of the remaining assets and liabilities is the book value of £1,400.

Therefore, Company B recognises the following accounting entries:

<i>Company B</i>	<i>Dr</i>	<i>Cr</i>
	£	£
Net assets	2,500	
Share capital ¹		300
Share premium (minimum premium value) ²		1,800
Merger reserve ³		400
To record the hive down transaction		

¹ Recognised at the nominal value of shares issued.

² Base value of net assets is £2,100 (£700 property plus £1,400 other net assets). Minimum premium value is the base value less the nominal value of shares issued of £300.

³ The difference above of £400, between the book value of net assets recognised and the required entries to share capital and premium, arises as a result of the revaluation of property of £400. This difference can be credited to an unrealised reserve where group reconstruction relief is taken.

Company A must derecognise its net assets and recognise the investment in Company B arising from the issue of shares.

How we see it

If it is determined that the transaction lacks substance for Company A, since it has simply swapped a direct investment in trade and assets for an indirect investment in the same trade and assets, via Company B, then Company A recognises the additional cost of investment in Company B at the carrying amount of the net assets given up. This accounting would usually be appropriate if Company B were a newly incorporated company or when Company B is wholly owned.

If a hive down transaction is considered to have substance to Company A (for example, this might be the case if Company B is not a wholly owned subsidiary), it could choose to recognise its additional investment in Company B at the fair value of the consideration given, i.e., the fair value of the trade and assets given up, as long as the fair value can be reliably measured. Any gain recognised as a result of this accounting would be unrealised and recognised in other comprehensive income, since the additional investment received in Company B, an unquoted subsidiary, would not be regarded as qualifying consideration.

If the fair value of the trade and assets given up cannot be reliably measured, then Company A recognises the additional cost of investment in Company B at the carrying amount of the net assets given up.

5.4.4.B Other forms of consideration

If the consideration paid is cash or other monetary assets such as a receivable, under merger accounting, any difference between the book values of net assets recognised and the consideration paid would be recognised in equity.

If Company B overpays for the trade and assets of its parent (including goodwill), in comparison to their fair value, this could be a distribution of value to its parent. See 5.4.1.B above.

In Company A, any excess of consideration received over the carrying amount of the net assets sold would be recognised as a gain. If realised, the gain will be recognised in profit or loss; if unrealised, the gain will be recognised in other comprehensive income. The gain will be realised only if the consideration represents qualifying consideration (see section 3 of TECH 02/17BL). Care must be taken in determining whether an intercompany receivable represents qualifying consideration.

If the consideration is less than the net assets sold or there is no consideration (a gift), Company A is making a capital contribution to its wholly owned subsidiary. The difference would be debited to its investment in Company B, which is then assessed for impairment. In Company B, the gift of Company A's business would result in a credit to equity, for example, to a merger or capital contribution reserve. Whether this reserve is realised or not is assessed using the guidance in TECH 02/17BL, discussed at 5.4.1.C above.

5.4.5 Financial information prior to the date of the combination

The description of the merger accounting method explicitly requires the results (and cash flows) of all combining entities (excluding those subsidiaries that are not consolidated under paragraphs 9.9 and 9.9A of FRS 102) to be included from the beginning of the financial year and for comparatives to be restated. [FRS 102.19.30]. While these paragraphs are framed in the context of a parent combining with a new subsidiary and will apply to consolidated financial statements prepared by the parent, the definition of a group reconstruction includes, for example, the hive transactions discussed at 5.4.1 to 5.4.4 above.

Application of the requirement to restate comparative information for such transactions, [FRS 102.19.30], would mean that the entity accounting for the acquired business under the merger method of accounting would include the results of that business from the beginning of the financial year and in the comparative year in its individual financial statements. However, in the context of individual financial statements, consideration needs to be given to paragraph 13(a) of Schedule 1 to the Regulations which requires that only profits realised at the reporting date are included in profit or loss. [FRS 102.A3.25]. This results in two possible approaches, of which the former is most common practice (note that legal mergers can create complexities and are not addressed in this guidance):

- Since the pre-transaction profits of the acquired business are not profits (and consequently cannot be realised profits) of the acquiring entity, they must not be included in the acquiring entity's profit and loss account. For UK companies, the Regulations require that only realised profits (with limited exceptions relating to the fair value accounting rules) are included in the profit and loss account. [1 Sch 13, 1 Sch 40]. The acquiring entity 'merger accounts' in its individual financial statements on a prospective basis only from the date of transfer, rather than reflecting the acquired business from the beginning of the financial year and for comparative periods.
- Or
- If the profits of the acquired business represented realised profits of that business, the acquiring entity could reflect the transfer from the beginning of the financial year and comparatives could be restated. The fact that the cumulative pre-transaction profits of the acquired business are not realised profits of the acquiring entity could be dealt with by disclosure or by transferring those profits to a 'non-distributable' reserve.

How we see it

FRS 102 does not explicitly deal with restatement of comparative information in standalone accounts subject to hive transactions. In our view, in the statutory accounts of a UK company, the pre-transaction profits of the acquired business are not profits of the acquiring entity and, therefore, must not be included in the acquiring entity's profit and loss account.

This does not preclude presentation of the pre-transaction and comparative profits using the second approach on a pro forma basis. Such information may be particularly relevant where a group reconstruction represents the continuation of an existing business, for example, where a business is transferred to a newly incorporated group entity. However, such pro forma figures are not required to be given. In this context, it is notable that the Statement of Recommended Practice *Accounting by Limited Liability Partnerships* ('LLP SORP') issued by CCAB effective for LLPs adopting FRS 102 recommends use of the first approach in relation to the application of merger accounting on initial transition of an existing entity to a single-entity LLP for the same reasons as explained above. However, the LLP SORP also considers that the second approach gives relevant information and recommends presentation of pro forma numbers on that basis. [LLP SORP Appendix 4].

Where the company applying the merger method of accounting to a hive transaction is a newly incorporated company, the company law requirements relating to a company's first accounting period will also need to be considered (see 5.4.7 below). This will further restrict the capability of including the pre-transaction results of the acquired business and is another reason for using a prospective approach.

5.4.6 Equity eliminations

As discussed at 5.3.3 above, the merger method of accounting under FRS 102 involves an equity elimination relating to the difference between the share capital of the new subsidiary (and any share premium or capital redemption reserve) and the cost of the investment as stated in the balance sheet of the new holding company.

However, in the context of applying the merger method in a hive transaction, there is no share capital (or share premium or capital redemption reserve) of the business transferred requiring elimination. Therefore, the difference to be shown as a movement on other reserves relates to the nominal value of any shares issued plus any share premium recognised plus the fair value of any other consideration given by the acquiring entity. This difference will generally be a debit to reserves (i.e., debit reserves, credit consideration transferred).

As indicated at 5.3.3 above, there are no particular requirements governing where to eliminate any debit adjustments in reserves arising on the application of the merger method of accounting in consolidated financial statements. The same is true for any debit adjustment for individual financial statements.

For some group reconstructions, the nominal value of the shares issued plus any share premium recognised plus the fair value of any other consideration given will be less than the book amount of the net assets acquired in the group reconstruction. In that situation, there will be a net credit to be taken to equity.

We recommend that the net credit is taken to a separate merger reserve.

Whether any net debit or credit arising from applying the merger accounting method represents a realised loss or profit is discussed at 5.4.1.C above.

5.4.7 Newly incorporated companies (Newcos)

It may be that in certain hive transactions involving the acquisition of the trade and net assets within the same group, the company acquiring the business is a newly incorporated company (Newco).

As discussed at 5.3.5 above, when a company is incorporated for the purpose of acting as the new parent company in a group reconstruction (Newco), it might not have been in existence for the entirety of the current and comparative period that would have been presented in respect of the transferred business if no reorganisation had occurred. In contrast to common practice in consolidated financial statements, individual financial statements cannot be prepared for a period prior to incorporation. In addition, as discussed at 5.4.5 above, hive transactions in individual financial statements of UK companies are accounted for prospectively from the date of the reorganisation. Therefore, Newco must present financial statements for its actual period since incorporation, recognising the hive transaction from the date that it takes place. However, if considered relevant, the pre-reorganisation period(s) could be given as supplementary pro forma information, as explained in Illustration 5-16 below.

Illustration 5-16: Hive transaction by a newly incorporated company

Parent A sets up a newly incorporated subsidiary, Subsidiary B, on 1 April 20X6 to effect a group reorganisation on 1 July 20X6 whereby Subsidiary B will acquire the trade and assets of an existing subsidiary of Parent A, Subsidiary C. All companies within Parent A's group have financial years ending on 31 December. Subsidiary B gives notice to have an accounting reference date of 31 December and will prepare its first individual financial statements made up to 31 December 20X6. In doing so, Subsidiary B will account for the acquisition of the former business of Subsidiary C under the merger method of accounting.

The CA 2006 requires that directors of a company prepare individual accounts for each financial year, [s394], and that a company's first financial year is required to begin with the date of its incorporation and end with its accounting reference date. [s391(5)]. In addition, Companies Act individual accounts must, in the case of the profit and loss account, give a true and fair view of the profit or loss of the company for the financial year. [s396(2)(b)].

Accordingly, the statutory individual financial statements of Subsidiary B can only be for the 9-month period from the date of its incorporation. Also, Subsidiary B includes the results of the business acquired from 1 July 20X6 in its individual financial statements. However, if it wished to present information about its underlying business for what it might consider to be for a more relevant period, i.e., for the year ended 31 December 20X6 (with comparatives for the year ended 31 December 20X5), it could do so in supplementary pro-forma form.

This approach is recommended in the LLP SORP in relation to the application of merger accounting on initial transition of an existing entity to a single-entity LLP for the same reasons as explained at 5.4.5 above. [LLP SORP Appendix 4].

5.5 Implications for the share premium account

Under the CA 2006, a company issuing shares at a premium must transfer “a sum equal to the aggregate amount or value of premiums on those shares” to an account called “the share premium account”. [s610(1)].

UK company law includes certain reliefs - ‘merger relief’ and ‘group reconstruction relief’ - from recognising share premium at all, or in full, where certain conditions are met. These reliefs, which are discussed further below, impact the accounting considerations for capital and reserves of the issuing entity only, but are not relevant for the purposes of measuring the cost of the combination in connection with application of the purchase method.

The implications of these reliefs in measuring the cost of investments in subsidiaries in separate financial statements are discussed further in Chapter 8 at 4.2.1.

5.5.1 Merger relief

The rules on merger relief and those on merger accounting are frequently confused with each other. However, not only are they based on the satisfaction of different criteria but they, in fact, have quite distinct purposes. As discussed at 5.3 above, merger accounting is a form of financial reporting which applies to a group reconstruction meeting certain qualifying conditions, but although the merger relief provisions were originally brought in to facilitate merger accounting, merger relief is purely a legal matter to do with the maintenance of capital for the protection of creditors and has very little to do with accounting *per se*. Moreover, merger relief may be available under transactions which are accounted for as acquisitions, rather than mergers, and the two are not interdependent in that sense.

Section 612 of the CA 2006 relieves the issuing company from the requirement in section 610 of the CA 2006 of establishing share premium on shares issued meeting certain conditions. This is known as ‘merger relief’. This usually arises in transactions involving a share for share exchange in which the issuing company has secured at least a 90% equity holding in the other company (as explained further below).

However, if the transaction falls within section 611 of the CA 2006 (‘group reconstruction relief’), section 612 does not apply to the transaction. [s612(4)]. Section 611 is discussed at 5.5.2 below and requires a ‘minimum premium value’ to be recognised in the share premium account in certain circumstances.

Merger relief applies where the issuing company has secured at least a 90% equity holding in another company in pursuance of an arrangement providing for the allotment of equity shares in the issuing company on terms that the consideration for the shares allotted is provided by:

- The issue or transfer of the issuing company of equity shares in the other company
- Or
- The cancellation of any such shares not held by the issuing company

A company secures at least a 90% equity holding in another company if, in consequence of an acquisition or cancellation of equity shares in another company (in pursuance of that arrangement), it holds equity shares of an aggregate amount equal to 90% or more of the nominal value of that other company’s equity share capital (or of each class of that other company’s equity share capital, where divided into different classes).

For this purpose, shares held by the issuing company, its holding company or subsidiary (or its or their nominees) contribute to the equity holding achieved, and any shares held by the other company as treasury shares, are excluded in determining the nominal value of the other company’s equity shares.

It does not matter whether any of the other company’s shares were acquired in pursuance of the arrangement. Consequently, the relief could apply both to equity shares issued in exchange for equity shares in another company which lead to the issuing company having at least a 90% equity holding and to equity shares issued in exchange for equity shares in another company after a 90% equity holding has already been achieved.

Where the conditions are met, section 612 relieves the issuing company from the requirement in section 610 to establish share premium on those shares.

Moreover, if the arrangement also provides for allotment of any shares in the issuing company on terms that the consideration for the shares is to be provided by (a) the issue or transfer to the issuing company of non-equity shares in the other company or (b) by the cancellation of any such shares in that company not held by the issuing company, the relief from establishing share premium extends to any shares in the issuing company allotted on those terms in pursuance of the arrangement.

The precise wording of section 612 (and related sections 613, 615 and 616) need to be considered carefully in order to ensure that any particular transaction falls within its terms. [s612, s613, s615, s616]. In particular, the references to 'equity shares' mean shares comprised in a company's equity share capital, and 'non-equity shares' to shares of any class that are not equity shares. [s548, s616]. See Chapter 8 at 4.2.1.

Over the years there have been some differences of legal opinion as to whether merger relief is in fact compulsory when the conditions of section 612 are met, or whether it is optional. The CA 2006 says that where the conditions are met, then section 610 "does not apply to the premiums on those shares" issued. Therefore, some people argue that the effect of this relief is simply to make section 610 optional rather than mandatory, but the more prevalent view is it makes it illegal to set up a share premium account. Therefore, if a company wishes to set up a share premium account where merger relief is available, the directors might wish to take legal advice.

Where merger relief is taken, and the purchase method is applied, as the cost of the business combination is based on the fair value, any amount that would have been taken to share premium account needs to be reflected in another reserve, generally a 'merger reserve' in the consolidated financial statements. Where merger accounting is applied, such an amount is not reflected in any 'merger reserve' as the mechanics of merger accounting uses the nominal value of shares issued. Whether such a reserve arises in the separate financial statements is discussed in Chapter 8 at 4.2.1.

5.5.2 Group reconstruction relief

Section 611 of the CA 2006 provides a partial relief from the basic requirement to Section 610 as regards transfers to the share premium account where the issuing company is a wholly-owned subsidiary of another company ('the holding company') and allots shares to that other company or another wholly-owned subsidiary of the holding company in consideration for the transfer to the issuing company of non-cash assets of a company ('the transferor company') that is a member of the group of companies that comprises the holding company and all its wholly-owned subsidiaries. [s611(1)].

Application of the relief in this instance means that just a 'minimum premium value' is required to be transferred to the share premium account - that amount being the amount (if any) by which the base value (see Chapter 8 at 4.2.1) of the consideration for the shares allotted exceeds the aggregate nominal value of the shares. [s611(2)-(5)].

Where group reconstruction relief is taken, and the purchase method is applied, as the cost of the business combination is based on the fair value, any amount that would otherwise have been taken to share premium account needs to be reflected in another reserve, generally a 'merger reserve' in the consolidated financial statements. Where merger accounting is applied, such an amount is not reflected in any 'merger reserve' as the mechanics of merger accounting uses the nominal value of shares issued (or the base value of the consideration).

Chapter 8 at 4.2.1 provides further detail and examples of the application of merger relief and group reconstruction relief in separate financial statements and Illustration 5-15 at 5.4.4.A above demonstrates an application of group reconstruction relief to a hive down.

5.6 Disclosure requirements

As discussed at 4 above, group reconstructions are scoped out of the 'normal' business combination disclosures required by FRS 102. Instead, FRS 102 provides that, for each group reconstruction that was effected during the period, the combined entity must disclose: [FRS 102.19.33, 6 Sch 13(1), 6 Sch 13(2)]

- (a) The names of the combining entities (other than the reporting entity)
 - (b) Whether the combination has been accounted for as an acquisition or a merger
- And

- (c) The date of combination

Additional disclosures required by the CA 2006 for a group reconstruction accounted for as a merger are:

- (a) If the transaction significantly affects the figures shown in the group accounts, the composition and fair value of the consideration given by the parent company and its subsidiary undertakings (subject to the exemption in paragraph 16 of Schedule 6 to the Regulations, as noted below). [6 Sch 13(3)].

- (b) Any adjustment to consolidated reserves as a result of setting off the nominal value of the issued share capital of the undertaking acquired held by the parent company and its subsidiary undertakings against the aggregate of:
- (i) The appropriate amount in respect of qualifying shares issued by the parent or its subsidiary undertakings (i.e., the nominal value of any shares subject to either merger or group reconstruction relief, together with the minimum premium value for shares subject to group reconstruction relief) in consideration for the acquisition of shares in the undertaking acquired.
And
 - (ii) The fair value of any other consideration given, determined as at the date of the acquisition.
[6 Sch 11(6), 6 Sch 16A(d)]
- (c) The address of the registered office of the undertaking acquired (whether in or outside the United Kingdom). [6 Sch 16A(a)]
And
- (d) The name of the ultimate controlling party that controls the undertaking whose shares are acquired and its registered office (whether in or outside the United Kingdom). [6 Sch 16A(b), 6 Sch 16A(c)].

Additional disclosures required by the CA 2006 for a group reconstruction accounted for as an acquisition are discussed at 4.3.3 above.

The requirement above regarding the fair value and composition of consideration need not be given with respect to an undertaking which:

- Is established under the law of a country outside the United Kingdom.
Or
- Carries on business outside the United Kingdom

if in the opinion of the directors of the parent company the disclosure would be seriously prejudicial to the business of that undertaking or to the business of the parent company or any of its subsidiary undertakings and the Secretary of State agrees that the information must not be disclosed. [6 Sch 16].

6 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for business combinations are set out below.

	FRS 102	IFRS
Method of accounting for business combinations	Purchase method used for all business combinations except certain group reconstructions and public benefit entity combinations.	Purchase method used for all business combinations. IFRS 3 excludes business combinations under common control. IFRS 3 makes no special provisions for business combinations involving public benefit entities.
Common control transactions	Merger accounting permitted for certain group reconstructions (and certain public benefit entity combinations). Merger method of accounting explained. Group reconstructions are not defined in the same way as business combinations under common control in IFRS 3 and can include some transactions that are not business combinations.	Out of scope. IFRS 3 does not specify the accounting for business combinations under common control. Such transactions can be accounted using the purchase method in IFRS 3 (if the transaction has substance) or accounted for by pooling of interests or merger accounting, if applying the GAAP hierarchy. In our view, a policy choice to apply merger accounting or the purchase method to transactions with substance must be consistently applied to similar categories of transactions.
Definitions of a business and business combination	A 'business' is an integrated set of activities and assets conducted and managed for providing a return to investors or lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally contains inputs, processes and outputs that are or will be used to generate revenues. If goodwill is present, there is a presumption that the transferred set is a business. A 'business combination' is the bringing together of separate entities or businesses into one reporting entity.	A 'business' is an integrated set of activities and assets capable of being conducted and managed (by a market participant) for providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities. A business consists of inputs and processes applied to those inputs that have the ability to contribute to the creation of outputs. A 'business combination' is a transaction or other event in which an acquirer obtains control of one or more businesses. IFRS 3 allows use of an optional test to identify concentration of fair value as a simplified assessment of whether an acquired set of activities and assets is a business. This can be elected separately for each transaction. If the concentration test is not applied or not met, a full assessment of whether there is a business is undertaken. To meet the definition of a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The criteria used in the assessment differ depending on whether the acquired set has outputs or not.
Identifying the acquirer	There must be an acquirer for all business combinations using purchase method. The application guidance states, <i>inter alia</i> , that if a new entity is formed to issue equity instruments to effect a	There must be an acquirer for all business combinations within scope of IFRS 3. Paragraph B18 of IFRS 3 states, <i>inter alia</i> , that if a new entity is formed to issue equity instruments to effect a business combination, one of the pre-existing combining entities "shall be identified" as

FRS 102		IFRS
	business combination, it is likely that the acquirer is one of the pre-existing combining entities.	the acquirer by applying the guidance in paragraphs B13 to B17 of IFRS 3.
Acquisition date	Date on which the acquirer obtains control of the acquiree. Control is the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.	Date on which the acquirer obtains control of the acquiree. IFRS 3 refers to IFRS 10 for the meaning of 'control'. An investor controls an investee when it (1) has power over the investee, (2) is exposed, or has rights, to variable returns from its involvement with the investee and (3) has the ability to affect those returns through its power over the investee. IFRS 10 has extensive guidance on the determination of control.
Acquisition expenses	Capitalise as part of the cost of combination, so included within goodwill.	Expense.
Contingent consideration	Recognised at the amount that is probable and can be reliably measured. Subsequent adjustments (other than the unwinding of any discounting) are recognised in goodwill. No specific guidance relating to contingent consideration that may be classified as equity.	Recognised at fair value, regardless of whether payment is probable or can be measured reliably. Subsequent adjustments to profit or loss for contingent consideration classified as a financial liability. No subsequent adjustment for contingent consideration classified as equity.
Contingent payments to employees or selling shareholders and separation of transactions from the business combination	Specific requirement on separating other transactions from the exchange transaction that is the business combination (similar to IFRS 3 but with less application guidance). The cost of a transaction that remunerates employees or former owners of the acquiree for future services is not part of the cost of a business combination. However, unlike IFRS 3, new FRS 102 does not contain a requirement that contingent consideration is automatically forfeited if employment terminates is post-combination remuneration	More extensive Application Guidance. Contingent consideration forfeited if employment terminates is post-employment remuneration.
Measurement period	Provisional amounts to be finalised within twelve months after the acquisition date.	Provisional amounts to be finalised at the sooner of (i) one year from the acquisition date and (ii) when the acquirer receives the information it was seeking.

FRS 102		IFRS
Initial measurement of acquiree's assets, liabilities and contingent liabilities	Fair value (except deferred tax, employee benefits, share-based payments and leases in which the acquiree is the lessee - where FRS 102 sets out specific requirements).	Fair values (except deferred tax, employee benefits, share-based payments, assets held for sale, reacquired rights, indemnification assets, leases in which the acquiree is the lessee, and insurance contracts - where IFRS 3 sets out specific requirements). IFRS 3 also addresses the subsequent measurement of reacquired rights and indemnification assets.
Recognition of the identifiable assets and liabilities	Identifiable assets acquired and liabilities assumed are recognised only if they meet the definitions of assets and liabilities in Section 2 at the acquisition date, their fair value can be measured reliably, and they are part of the business combination rather than the result of a separate transaction. There are certain recognition exceptions. Note that Section 2 has been updated to align with the IASB's Conceptual Framework.	Identifiable assets acquired and liabilities assumed are recognised only if they meet the definitions of assets and liabilities in the <i>Conceptual Framework for Financial Reporting</i> at the acquisition date. There are certain recognition exceptions. IFRS 3 does not refer to reliable fair value measurement as a recognition criterion (except for contingent liabilities). In effect, this is assumed to be the case in a business combination.
Recognition of intangible assets separate from goodwill	Recognise at fair value if (a) meet recognition criteria (i.e., probable cash flows and fair value can be measured reliably), (b) are separable and (c) arise from contractual or legal rights. Option to recognise if meet (a) and only one of (b) or (c). This policy choice must be applied consistently to a class of intangible assets and to all business combinations.	Recognise at fair value if meet either separability or contractual - legal criterion (regardless of being separable). Probability and reliable measurement criteria always considered to be satisfied for intangible assets acquired in a business combination.
Step acquisitions	Cost of the business combination is the aggregate of the fair values of assets given, liabilities incurred or assumed and equity instruments issued at each stage of transaction plus any directly attributable costs. True and fair override may be used in certain circumstances to compute goodwill as the sum of the goodwill arising on each step. Cumulative amounts recognised in other comprehensive income are not reclassified to profit or loss.	Existing interest held immediately before control is achieved is remeasured at fair value with gain or loss recognised in profit or loss. Fair value of the existing equity interest is used in computing the cost of the combination/goodwill. Changes in value in other comprehensive income reclassified to profit or loss on the same basis as if the acquirer had disposed directly of the previously held equity interest.

FRS 102		IFRS
Non-controlling interests	Measure at proportionate share of net assets consolidated. No specific guidance for any non-controlling interests that are not entitled to a present ownership interest, the implication being they are valued at nil.	Policy choice for each business combination to use fair value or share of net assets for interests entitled to proportionate net assets share. Otherwise, fair value.
Positive goodwill	Amortised on a systematic basis over its finite useful life (cannot be indefinite). If, in exceptional circumstances, no reliable estimate of useful life can be made, the maximum life is 10 years. Test for impairment if impairment indicators.	Not amortised. Measured at cost less impairment. Mandatory annual impairment test (in addition to when there are impairment indicators).
Negative goodwill	Amount up to the fair value of non-monetary assets is recognised in periods in which non-monetary assets are recovered. Excess is amortised over periods expected to benefit.	Immediate gain in profit or loss.
Disclosures	Less onerous disclosure requirements.	Extensive disclosure requirements.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

acquisition date	The date on which the acquirer obtains control of the acquiree.
business	An integrated set of activities and assets conducted and managed for the purpose of providing: (a) a return to investors; or (b) lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.
business combination	The bringing together of separate entities or businesses into one reporting entity.
combination that is in substance a gift	A combination carried out at nil or nominal consideration that is not a fair value exchange but in substance the gift of one entity to another.
goodwill	Future economic benefits arising from assets that are not capable of being individually identified and separately recognised.
group reconstruction	Any one of the following arrangements: (a) the transfer of an equity holding in a subsidiary from one group entity to another; (b) the addition of a new parent entity to a group; (c) the transfer of equity holdings in one or more subsidiaries of a group to a new entity that is not a group entity but whose equity holders are the same as those of the group's parent; (d) the combination into a group of two or more entities that before the combination had the same equity holders; (e) the transfer of the business of one group entity to another; or (f) the transfer of the business of one group entity to a new entity that is not a group entity but those equity holders are the same as those of the group's parent.
merger	An entity combination that results in the creation of a new reporting entity formed from the combining parties, in which the controlling parties of the combining entities come together in a partnership for the mutual sharing of risks and benefits of the newly formed entity and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant. All of the following criteria must be met for an entity combination to meet the definition of a merger: (a) no party to the combination is portrayed as either acquirer or acquiree, either by its own board or management or by that of another party to the combination; (b) there is no significant change to the classes of beneficiaries of the combining entities or the purpose of the benefits provided as a result of the combination; and (c) all parties to the combination, as represented by the members of the board, participate in establishing the management structure of the combined entity and in selecting the management personnel, and such decisions are made on the basis of a consensus between the parties to the combination rather than purely by exercise of voting rights.

Public benefit entity

An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.¹⁰⁶

¹⁰⁶ The term 'public benefit entity' does not necessarily imply that the purpose of the entity is for the benefit of the public as a whole. For example, many PBEs exist for the direct benefit of a particular group of people, although it is possible that society as a whole also benefits indirectly. The important factor is what the primary purpose of such an entity is, and that it does not exist primarily to provide economic benefit to its investors. Organisations such as mutual insurance companies, other mutual co-operative entities and clubs that provide dividends or other economic benefits directly and proportionately to their owners, members or participants are not PBEs.

Some PBEs undertake certain activities that are intended to make a surplus in order to fund their primary activities. Consideration should be given to the primary purpose of an entity's (or group's) activities in assessing whether it meets the definition of a PBE.

PBEs may have received contributions in the form of equity, even though the entity does not have a primary profit motive. However, because of the fundamental nature of public benefit entities, any such contributions are made by the equity holders of the entity primarily to enable the provision of goods or services to beneficiaries rather than with a view to a financial return for themselves. This is different from the position of lenders; loans do not fall into the category of equity.

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Chapter 23

Leases

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Overview

This chapter discusses the requirements of Section 20 *Leases* and how the section is to be applied. Section 20 prescribes the accounting requirements for the recognition, measurement, presentation and disclosure of leases and applies to both lessees and lessors. It has a single lessee accounting model and requires lessees to recognise assets and liabilities for most leases on their statements of financial position. Lessors, however, classify leases as operating or finance leases depending on whether the risks and rewards incidental to ownership of the underlying asset are transferred to the customer and account for the lease accordingly.

Under Section 20, leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the date when it makes the underlying asset available for use by the lessee.

What you need to know

- Section 20 requires lessees to recognise most leases on their statements of financial position.
- Lessees apply a single accounting model for all leases, with certain exemptions.
- Lessors classify leases as operating or finance leases depending on whether the risks and rewards incidental to ownership of the underlying asset are transferred to the lessee and account for the lease accordingly.
- Entities need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting. Although we believe that the assessment of whether a contract contains a lease is straightforward in most arrangements, judgement may be required in applying the definition of a lease to certain arrangements, particularly those that include significant services.

1 Introduction

The requirements of Section 20 set out in this chapter reflect changes arising from the Periodic Review 2024 amendments to FRS 102 and are applicable for reporting periods beginning on or after 1 January 2026. Prior to these amendments, Section 20 followed the precedent of previous UK and international accounting standards such as SSAP 21 *Accounting for Leases and Hire Purchase Contracts* and IAS 17 *Leases*. The amendments introduce significant changes to lease accounting under UK GAAP, aligning the requirements more closely to those set out under IFRS 16 *Leases*, which replaced IAS 17 for IFRS reporting entities for financial periods beginning on or after 1 January 2019.

Due to the similarities between Section 20 and IFRS 16, which contains extensive guidance, we draw on that guidance as part of the explanation in this chapter, applying the hierarchy on selecting accounting policies as set out in Section 10 *Accounting Policies, Estimates and Errors* (refer to Chapter 9 at 3.1).

2 Comparison between Section 20 and IFRS

As set out at 1 above, following the Periodic Review 2024, Section 20 has been aligned closely to IFRS 16. However, Section 20 contains less extensive guidance than IFRS 16 and also includes certain simplifications. The key differences between Section 20 and IFRS 16 are discussed at 2.1 to 2.8 below. The table at 12 below contains a more extensive summary of the GAAP differences.

2.1 Scope - Leases with non-typical contractual terms

The scope of Section 20 is similar to the scope of IFRS 16 with one exception.

Certain leases are excluded from the scope of Section 20 and instead classified as financial instruments within scope of Section 12 *Other Financial Instruments Issues* if the lease could, as a result of non-typical contractual terms, result in a loss to the lessor or the lessee. [FRS 102.20.1(f)]. No similar scope exclusion exists in IFRS 16, and therefore certain leases with non-typical contractual terms may be accounted for as leases under IFRS 16, but financial instruments under FRS 102. However, the Basis for Conclusions to FRS 102 notes that in practice not many leases are expected to fall within the scope of Section 12. [FRS 102.B20.2]. Refer to 3.1.1 below.

2.2 Lessee accounting - Discount rate on initial recognition

Under IFRS 16, for lessees, lease payments are discounted using the interest rate implicit in the lease if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses the incremental borrowing rate. [IFRS 16.26].

Under FRS 102, for lessees, consistent with IFRS 16, lease payments are discounted using the interest rate implicit in the lease if that rate can be readily determined. However, if that rate cannot be readily determined, Section 20 offers lessees a choice (which can be made on a lease-by-lease basis), to use either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate. [FRS 102.20.49]. The term 'lessee's obtainable borrowing rate' is unique to FRS 102. The concept is similar to that of the incremental borrowing rate but is expected to be simpler to determine, and therefore it was introduced into FRS 102 by the Financial Reporting Council ('FRC') as a proportionate simplification. [FRS 102.B20.12(a)]. See 5.6 below.

FRS 102 also offers a further simplification for public benefit entities. A public benefit entity that is unable readily to determine any of the three rates (interest rate implicit in the lease, incremental borrowing rate or obtainable borrowing rate), instead uses the rate of interest it can otherwise obtain on deposits held with financial institutions. [FRS 102.PBE20.50]. Refer to 5.6 below.

2.3 Lessee accounting - Leases that provide a lessee with incoming resources arising from a government grant or non-exchange transaction

A lessor may provide a lessee with incoming resources from a government grant or, for a public benefit entity, a non-exchange transaction. This may be the case if, for example, a lease is provided by a government body, and the lease payments are significantly below market rents.

IFRS 16 does not contain any specific guidance on the accounting for such transactions.

FRS 102 states that at the commencement date, or in the event of a modification that is not accounted for as a separate lease, a lessee uses the information readily available to it to determine whether it is in receipt of such incoming resources. If so, the lessee recognises those incoming resources as part of the cost of the right-of-use asset. The incoming resources must be recognised and measured in accordance with, as applicable, Section 24 *Government Grants* or (for a public benefit entity only) paragraphs PBE34.64 to PBE34.74 *Incoming Resources from Non-Exchange Transactions* of Section 34 *Specialised Activities*. FRS 102 goes on to state that if the contractual payments are so low that they are not substantive (e.g., peppercorn or nominal consideration), the arrangement may not meet the definition of a lease.

[FRS 102.20.35]. In such cases, the requirements of Section 34 regarding incoming resources from non-exchange transactions applies to the public benefit entity as for other donations. [FRS 102.B20.B14].

Refer to 6.2.1 below.

2.4 Lessee accounting – Discount rate on modifications

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions. [FRS 102 Appendix I, IFRS 16 Appendix A]. Examples include adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term. Section 20 and IFRS 16 contain broadly similar requirements on the accounting for lease modifications, but Section 20 includes a simplification with regards to the discount rate to apply in certain circumstances.

IFRS 16 requires lessees to use a revised discount rate for all lease modifications which are not accounted for as separate leases. [IFRS 16.45(c)].

In general, when applying Section 20 to a lease modification that is not accounted for as a separate lease, the lessee is required to remeasure the lease liability using a revised discount rate. However, Section 20 allows the use of an unchanged discount rate when any of the following conditions are met:

- The additional consideration from the lease modification is insignificant to the total consideration of the original lease.
- The lease modification decreases the scope of the lease by removing the right to use one or more underlying assets, and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope.

Or

- The lease modification decreases the consideration payable for the remaining term of the lease, but does not decrease the scope of the lease by removing the right to use one or more underlying assets. [FRS 102.20.72].

Refer to 6.5.2 below.

2.5 Lessee accounting – Leases of low value assets

Both Section 20 and IFRS 16 provide a recognition exemption accounting policy choice for lessees in respect of leases for which the underlying asset is of 'low value'. A lessee that makes this election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit. [FRS 102.20.6, IFRS 16.6]. This election can be made on a lease-by-lease basis. [FRS 102.20.7, IFRS 16.7].

Under both Section 20 and IFRS 16, the assessment of whether an underlying asset is of low value is performed on an absolute basis (meaning the assessment is not affected by the size, nature or circumstances of the lessee). However, there are differences between Section 20 and IFRS 16 on how low value assets are identified. Neither provides a quantitative threshold for defining low value assets, but IFRS 16 provides examples of low value assets, stating that examples "...can include tablet and personal computers, small items of office furniture and telephones". [IFRS 16.B8]. The Basis for Conclusions to IFRS 16 also explains that the IASB had in mind leases of underlying assets with a value, when new, "...in the order of magnitude of \$5,000 or less". [IFRS 16.BC100]. In contrast, Section 20 highlights examples of assets which are not of low value, such as vehicles, land and buildings and production line equipment. No list of examples of low-value assets is provided. The Basis for Conclusions to FRS 102 indicates that the FRC intended this to offer FRS 102 reporters greater flexibility in defining low-value assets. As a result, FRS 102 preparers may be able to apply the on-balance sheet lease accounting model to a smaller proportion of their leases when compared with entities applying IFRS 16. [FRS 102.B20.10, FRS 102.B20.11].

Refer to 6.1.2 below.

2.6 Lessor accounting – Straight-line basis for lease payments

IFRS 16 requires all operating lease payments to be recognised as income on a straight-line basis, unless another systematic basis is more representative of the pattern in which benefit from use of the underlying asset is diminished. [IFRS 16.81].

FRS 102 contains this same requirement with one exception: if lease payments increase annually by fixed increments intended to compensate for expected annual inflation over the lease period, the fixed minimum increment that reflects expected general inflation will be recognised as an income as incurred.

[FRS 102.20.106 (b)].

Refer to 7.4 below.

2.7 Sale and leaseback

Under IFRS 16, when an entity enters into a sale and leaseback transaction and the transfer of the asset from the seller-lessee to the buyer-lessor qualifies as a sale in accordance with the requirements of IFRS 15 *Revenue from Contracts with Customers*, the seller-lessee is required to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. [IFRS 16.100(a)].

Under Section 20, where an entity enters into a sale and leaseback transaction and the transfer of the asset qualifies as a sale in accordance with Section 23 *Revenue from Contracts with Customers*, entities have an accounting policy choice in respect of the measurement of the right-of-use asset and the treatment of any gain. The policy choice available (to be applied consistently) is to either:

- Measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor (a policy aligned to the required approach under IFRS 16).
- Or
- Measure the right-of-use asset arising from the leaseback in accordance with the requirements for initial measurement of the right-of-use asset on lease commencement explained in paragraph 20.46, with any excess of the sale proceeds over the previous carrying amount of the asset deferred, and amortised over the lease term, and any shortfall of the sales proceeds under the carrying amount recognised immediately in profit or loss. [FRS 102.20.123(a)]. This option is not available in IFRS 16.

Refer to 9.2 below.

2.8 Disclosure

Section 20 contains similar detailed disclosure requirements to IFRS 16, with some differences for both lessees and lessors.

For lessees:

- IFRS 16 requires a lessee to disclose information about its leases in a single note or separate section in its financial statements, although information can be incorporated by cross-reference. [IFRS 16.52]. In addition, IFRS 16 requires certain disclosures to be provided in a tabular format (unless another format is more appropriate). [IFRS 16.54]. Section 20 does not include equivalent requirements.
- IFRS 16 requires lease commitment disclosures for short-term leases accounted for using the recognition exemption in paragraph 6 of IFRS 16 to be disclosed, if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense for the year disclosed in accordance with paragraph 53(c) of IFRS 16 relates. [IFRS 16.55]. Section 20 requires a lessee to disclose separately lease commitments for short-term leases and leases of low-value assets at the end of the reporting period, for each of (a) periods not later than one year; (b) periods later than one year and not later than five years; and (c) periods later than five years. [FRS 102.20.82].
- IFRS 16 requires lessees to disclose a maturity analysis of lease liabilities applying paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures* separately from the maturity analysis of other financial liabilities. [IFRS 16.58]. Section 20 does not require lessees to disclose a maturity analysis of lease liabilities. However, the Regulations require some disclosures for the aggregate of all items shown under 'creditors' in an entity's balance sheet.

Disclosure requirements for lessees are discussed at 6.8 below.

For lessors:

- IFRS 16 requires certain disclosures by lessors to be provided in a tabular format (unless another format is more appropriate). [IFRS 16.91]. Section 20 does not include an equivalent requirement.
- IFRS 16 requires a lessor to disclose how it manages the risk associated with any rights it retains in underlying assets. In particular, a lessor discloses its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. [IFRS 16.92(b)]. Section 20 requires entities (lessees and lessors) to disclose additional qualitative information where necessary to understand the entity's significant leasing arrangements, [FRS 102.20.115], but contains no specific requirement for a lessor to disclose how it manages the risk associated with any rights it retains in underlying assets.

Disclosure requirements for lessors are discussed at 7.8 below.

In addition to the disclosure differences for lessees and lessors set out above, disclosure differences will also arise where an entity makes use of optional simplifications that are permitted by Section 20, or as a result of other differences between FRS 102 and IFRS. For example:

- An entity that has applied either or both of the practical expedients in paragraph 13 of Section 20 (relating to portfolio application – refer to 6.6.3 and 7.6.2 below) or paragraph 33 of Section 20 (relating to non-lease components – refer to 4.2.2.B below), must disclose that fact. *[FRS 102.20.78]*.
- In a sale and leaseback transaction where the transfer of the asset is a sale, a seller-lessee that has elected to measure the right-of-use asset arising from the leaseback in accordance with paragraph 46 of Section 20 is required to disclose that fact. *[FRS 102.20.77(v)]*. (Refer to 9.2 below).
- A lessee that has used an unchanged discount rate in accordance with paragraph 72 of Section 20 to remeasure a lease liability on lease modification (refer to 6.5.2 below) must disclose that fact, and the carrying amount at the end of the reporting period of lease liabilities which have been remeasured in that manner. *[FRS 102.20.79]*.
- For right-of-use assets meeting the definition of heritage assets (refer to Chapter 36 at 5.2.4), a lessee must apply the disclosure requirements in paragraphs 55 to 56 of Section 34 and is not required to provide the disclosures required by paragraphs 20.80(e) and 20.81 for those right-of-use assets. *[FRS 102.20.84]*.

3 Requirements of Section 20 for leases: Objective and scope of Section 20

3.1 Objective and scope of Section 20

Section 20 sets out the principles for the recognition, measurement, presentation, and disclosure of leases. Section 20 paragraph 1 applies to all leases, including leases of right-of-use assets in a sublease, except for the following:

- (a) Leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources
- (b) Leases of biological assets within the scope of Section 34 held by a lessee (refer to Chapter 36 at 2.4)
- (c) Service concession arrangements within the scope of Section 34 (refer to Chapter 36 at 4). Entities should evaluate the applicability of Section 34 before evaluating whether an arrangement contains a lease
- (d) Licences of intellectual property granted by a lessor within the scope of Section 23 (refer to Chapter 25 at 9)
- (e) Rights held by a lessee under licensing agreements within the scope of Section 18 *Intangible Assets other than Goodwill* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights (refer to Chapter 21)
- (f) Leases that could lead to a loss to the lessor or the lessee as a result of non-typical contractual terms (refer to 3.1.1 below) [FRS 102.20.1]

A lessee may, but is not required to, apply Section 20 to leases of intangible assets not covered by the exception in (e) above. [FRS 102.20.2]. Therefore, a lessee could choose to account for leases of such intangible assets under Section 20 (refer to Chapter 21).

IFRS 16 contains a scope exclusion similar to (e) above, and for IFRS reporting entities there are differing views about whether other intangible assets (for example, a licence of software), not specifically referred to in IFRS 16.3(e), are excluded from the scope of IFRS 16 based on interpretations of that paragraph. Given the consistency between IFRS 16.3(e) and FRS 102.20.1(e), similar diversity of views may arise for entities applying FRS 102. If an entity determines that an intangible asset is not excluded from the scope of Section 20, paragraph 2 of Section 20 permits, but does not require, an entity to account for the intangible asset as a lease. [FRS 102.20.2].

If a cloud computing arrangement contains a lease of an asset other than a licence of software (or the entity has determined that a licence of software is not excluded from the scope of Section 20 and has elected to account for leases of intangible assets under Section 20), an entity should apply the provisions of Section 20 to the cloud computing arrangement. This includes identifying and separating lease and non-lease components and allocating contract consideration, which is discussed in section 4.2 below.

Entities are required to apply paragraphs 34.49 to 34.56 of FRS 102 to account for heritage asset held under a lease. [FRS 102.20.3]. (Refer to Chapter 36 at 5).

3.1.1 Leases with non-typical contractual terms classified as financial instruments

Certain leases are not accounted for as leases in accordance with Section 20 but instead classified as financial instruments within scope of Section 12 if the lease could, as a result of non-typical contractual terms, result in a loss to the lessor or the lessee. The Basis for Conclusions to FRS 102 states that this could include contractual terms that are unrelated to changes in the price of the leased asset, changes in foreign exchange rates, or a default by one of the counterparties. [FRS 102.BC.B20.1]. The Basis for Conclusions also notes that "...the reference to 'changes in the price of the leased asset' is framed widely and in practice not many leases are expected to fall within the scope of Section 12." Section 12 is addressed in Chapters 11 to 15 [FRS 102.BC.B20.2].

Although it is not clear precisely what contractual terms are referred to, it is likely that this does not refer to rents that vary according to:

- Non-financial variables specific to the parties to the contract, e.g., rents that vary with future sales or amount of future use.
- Or
- Future price indices and future market rates of interest that are relevant to the parties to the contract.

Accounting for these variable lease payments is addressed by Section 20 (refer to 5.5.3 and 5.5.8 below). In summary variable lease payments that depend on an index or rate are included in the measurement of the lease liability (refer to 5.5.3 below) and variable lease payments that do not depend on an index or rate (e.g., percentage of revenue) are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs (refer to 5.5.8 below).

3.2 Recognition exemptions

Section 20 allows a lessee to elect not to apply the recognition requirements to:

- Short-term leases.
And
- Leases for which the underlying asset is of low value. [*FRS 102.20.5*].

These recognition exemptions are discussed further in 6.1.1 and 6.1.2 below.

4 Requirements of Section 20 for leases: What is a lease?

Section 20 defines a lease as a contract, or part of a contract, which conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. [FRS 102 Appendix I]. The determination of whether an arrangement contains a lease is performed at the inception of the contract. [FRS 102.20.15].

The assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, determining whether the contract conveys the right to direct the use of an identified asset may be challenging. We discuss this further below.

4.1 Determining whether an arrangement contains a lease

Extract from FRS 102

Appendix I

Glossary

Lease	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
contract	An agreement between two or more parties that creates enforceable rights and obligations.

At inception of a contract, an entity assesses whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [FRS 102.20.15]. Refer to 4.1.2 and 4.1.3 below for additional discussion on identified assets.

A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce). [FRS 102.20.26].

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity assesses whether, throughout the period of use, the customer has both of the following:

- The right to direct the use of the identified asset (refer to 4.1.5 below).
- And
- The right to obtain substantially all of the economic benefits from use of the identified asset (refer to 4.1.4 below). [FRS 102.20.16].

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term. [FRS 102.20.16].

An entity assesses whether a contract contains a lease for each potential separate lease component. [FRS 102.20.17]. Refer to 4.2.1 below.

4.1.1 Joint ventures

Entities often enter into joint ventures with other entities for certain activities (e.g., exploration of oil and gas fields, development of pharmaceutical products). Lease contracts may be entered into for the use of an asset by a joint venture, and where this is the case, it is necessary for the parties to the joint venture to consider whether those arrangements meet the definition of the lease, and if so, how each party should account for their interest in the lease.

Under Section 15 *Investments in Joint Ventures*, joint ventures can take one of three forms: jointly controlled operations ('JCO'); jointly controlled assets ('JCA'); and jointly controlled entities ('JCE'). Section 15 defines a jointly controlled entity as a joint venture "...that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest." [FRS 102.15.8]. Jointly controlled operations arise when a joint venture is established that does not involve the formation of a separate corporation, partnership or other entity or financial structure that exists separately from the venturers. 'Venturers' is the term used under Section 15 to mean "A party to a joint venture that has joint control over that joint venture". [FRS 102 Appendix I]. In some cases, there may be a lead venturer and other venturers. In addition to 'venturers', there may well be other investors in the joint venture.

A contract to receive goods or services may be entered into by a joint venture or on behalf of a joint venture. Unlike IFRS 16, Section 20 does not explicitly state that in such a case the joint venture is considered to be the customer in the contract, but assuming this reflects the substance of the arrangement, we would expect a similar conclusion to be reached under FRS 102. Accordingly, in determining whether such a contract contains a lease, an assessment needs to be made as to which party (e.g., the joint venture or the lead venturer) has the right to control the use of an identified asset throughout the period of use.

If the parties to a joint venture collectively have the right to control the use of an identified asset throughout the period of use as a result of their collective control of the operation, the joint venture is the customer to the contract that may contain a lease. It would be inappropriate to conclude that the contract does not contain a lease on the grounds that each of the parties to the joint venture either has rights to a non-physically distinct portion of an underlying asset and, therefore, does not have the right to substantially all of the economic benefits from the use of that underlying asset or does not unilaterally direct its use. Determining if the parties to the joint venture collectively have the right to control the use of an identified asset throughout the period of use would require a careful analysis of the rights and obligations of each party.

A contract for the use of an asset in a joint venture might be entered into in a number of different ways, including:

- Directly by the joint venture, if the joint venture has its own legal identity.
- By each of the parties to the joint venture individually signing the same arrangement.
- By one or more of the parties to the joint venture on behalf of the joint venture. Generally, this would be evidenced in the contract and the parties to the joint venture would have similar rights and obligations as they would if they individually signed the arrangement. In these situations, the facts and circumstances, as well as the legal position of each entity, need to be evaluated carefully.
- By the lead venturer of the joint venture in its own name, i.e., as principal. This may occur when the lead venturer leases equipment which it then uses in fulfilling its obligations as the lead venturer of the joint venture and/or across a range of unrelated activities, including other joint ventures with unrelated activities, such as with other joint operating parties.

4.1.1.A Jointly controlled entity enters into the contract

Based on the definitions in Section 15, the joint venture in the first scenario at 4.1.1 above would typically be a jointly controlled entity, as it has its own legal identity. Where a jointly controlled entity enters into a contract directly on its own behalf, the venturers would not account for the contract (or their share of the contract) in their own financial statements. Instead, the accounting for that contract would be included in the financial statements of jointly controlled entity itself, with the venturers then accounting for their interest in the jointly controlled entity in accordance with Section 15.

4.1.1.B Parties to jointly controlled operation collectively enter into the contract

In some instances, the venturers who are party to a jointly controlled operation may enter into a contract for the use of an identified asset on behalf of the joint operation. The second and third scenarios at 4.1.1 above may be examples of this. In such cases, if it has been determined that a contract is, or contains, a lease, each of the venturers will account for their respective interests in the joint venture (including any leases) under paragraphs 15.4 to 15.7 of FRS 102. Therefore, they will account for their individual share of any right-of-use assets and lease liabilities, and associated depreciation and interest.

As discussed at 4.1.1.C below, in some cases a contract may be entered into by the lead venturer in its own name, and the lead venturer may determine that it is the lessee in that contract. However, the lead venturer may then enter into an arrangement with one of its joint ventures, whereby it yields control of the right to use the asset to the joint venture for a period of time. In such cases, the lead venturer needs to evaluate whether it has entered into a sublease with the joint venture. The conclusion as to whether the joint venture is a customer, i.e., the lessee in a contract with a lead venturer would depend on the individual facts and circumstances.

If it is determined that the lead venturer has subleased an asset to a jointly controlled operation, Section 15 requires the other venturers to recognise their respective share of the joint arrangement's right-of-use asset and lease liability, and the lead venturer accounts for its sublease to the joint arrangement separately. However, if there is no sublease, the other venturers recognise expenses when incurred for their share of the costs incurred by the lead venturer in respect of the leased asset.

4.1.1.C Lead venturer enters into the contract

In the fourth scenario at 4.1.1 above (i.e., where the lead venturer enters the arrangement in its own name), the lead venturer will need to assess whether the arrangement is, or contains, a lease. If the lead venturer controls the use of the identified asset, it would recognise the entire right-of-use asset and lease liability on its statement of financial position. This is on the basis that in respect of its interests in jointly controlled operations, a venturer recognises the assets that it controls and the liabilities that it incurs in its financial statements. Identifying the liabilities that a venturer incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual arrangements that relate to the jointly controlled operation, and would include consideration of the laws pertaining to those agreements. As the sole signatory to the lease agreement, we would therefore expect the lead operator to recognise 100% of the lease liability. This would be the case even if it is entitled to invoice the other parties their proportionate share of the costs under the joint operating agreement (JOA).

If the lead venturer determines that it is the lessee, it would also evaluate whether it has entered into a sublease with the joint venture.

4.1.2 Identified asset

An arrangement only contains a lease if there is an identified asset.

An asset is typically identified by being explicitly specified in a contract. For example, the contract may specify a building by its address or a car by its registration number. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

[FRS 102.20.19].

Illustration 4-1: Implicitly specified asset

Customer X enters into a five-year contract with Supplier Y for the use of rolling stock specifically designed for Customer X. The rolling stock is designed to transport materials used in Customer X's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract, but Supplier Y owns only one rolling stock that is suitable for Customer X's use. If the rolling stock does not operate properly, the contract requires Supplier Y to repair or replace the rolling stock. Assume that Supplier Y does not have a substantive substitution right. Refer to 4.1.3 below.

Analysis: The rolling stock is an identified asset. While the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfil the contract.

Illustration 4-2: Identified asset - implicitly specified at the time the asset is made available for use by the customer

Customer X enters into a five-year contract with Supplier Y for the use of a car. The specification of the car is specified in the contract (brand, type, colour, options etc.). At inception of the contract the car is not yet built.

Analysis: The car is an identified asset. Although the car cannot be identified at inception of the contract, it is apparent that it will be identifiable at the commencement of the lease. The car is identified by being implicitly specified at the time that it is made available for use by the customer (i.e., at the commencement date).

A capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). A capacity or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fibre optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset. [FRS 102.20.22].

Some contracts allow the use of an identified asset for specified, non-consecutive periods. This is discussed further at 5.4.1.A below.

Illustration 4-3: Identified asset - physically distinct portion of a larger asset

Customer X enters into a 12-year contract with Supplier Y for the right to use three fibres within a fibre optic cable between New York and London. The contract identifies three of the cable's 20 fibres for use by Customer X. The three fibres are dedicated solely to Customer X's data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right (refer to 4.1.3 below).

Analysis: The three fibres are identified assets because they are physically distinct and explicitly specified in the contract.

Illustration 4-4: Identified asset - capacity portion of an asset**Scenario A**

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

Analysis: The capacity portion of the pipeline is an identified asset. While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.

Scenario B

Assume the same facts as in Scenario A, except that Customer X has the right to use 60% of the pipeline's capacity throughout the term of the arrangement.

Analysis: The capacity portion of the pipeline is not an identified asset because 60% of the pipeline's capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Land easements or rights of way are rights to use, access or cross another entity's land for a specified purpose. For example, a land easement might be obtained for the right to construct and operate a pipeline or other assets (e.g., railway line, utility pipes or telecommunication lines) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement. A land easement may be perpetual or for a specified term. It may provide for exclusive or non-exclusive use of the land and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of Section 20, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual but are term-based include:

- Very long-term contracts, e.g., very long-term leases of land (e.g., 999 years) are expected to be in the scope of Section 20. This is not stated in Section 20 or IFRS 16, but the view is consistent with a point explicitly made by the FASB in the Basis for Conclusions (BC113) to ASC 842 *Leases*.
- Contracts with a stated non-cancellable lease term that 'automatically renews' if the lessee pays a periodic renewal fee. This is an in-substance fixed term contract with optional renewal periods.
- Contracts that define the period of use as the period over which the assets are used (e.g., as long as natural gas flows through a gathering system) are a fixed term contract (i.e., terminated when production ceases) rather than a perpetual contract because the gas reserves will ultimately be depleted.

When determining whether a contract for a land easement or right of way is a lease, entities will need to assess whether there is an identified asset and whether the customer obtains substantially all of the economic benefits of the identified asset and has the right to direct the use of that asset throughout the period of use.

Frequently asked questions

Question 4-1: Does Section 20 apply to the right to place an oil pipeline in underground space for a period of time in exchange for consideration?

In June 2019, the IFRS IC discussed a contract for subsurface rights. Whilst decisions of the IFRS IC do not apply directly to entities reporting under FRS 102, due to the similarities between Section 20 and IFRS 16 in this area, we would expect the analysis set out below to be relevant to entities considering a similar fact pattern under FRS 102.

In the contract described, a pipeline operator obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

The IFRS IC noted the following in the agenda decision:

- Paragraph 3 of IFRS 16 requires an entity to apply IFRS 16 to all leases, with limited exceptions. In the contract described in the request, none of the exceptions in IFRS 16.3 and 4 apply. In particular, the IFRS IC noted that the underground space is tangible. Accordingly, if the contract contains a lease, IFRS 16 applies to that lease. If the contract does not contain a lease, the entity would then consider which other IFRS accounting standard applies. The same observations would apply to an FRS 102 reporter. Paragraph 1 of Section 20 requires an entity to apply Section 20 to all leases, with limited exceptions, none of which apply in this fact pattern (refer to 3.1 above).
- Applying IFRS 16.B9, to meet the definition of a lease, the customer must have both:
 - The right to obtain substantially all the economic benefits from the use of an identified asset throughout the period of use.

And

 - The right to direct the use of the identified asset throughout the period of use.

This requirement is consistent with Section 20, paragraph 16.

- The specified underground space is physically distinct from the remainder of the land. The contract's specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. The space being underground does not in itself affect whether it is an identified asset - the specified underground space is physically distinct in the same way that a specified area of space on the land's surface would be physically distinct. As the landowner does not have the right to substitute the underground space throughout the period of use, the IFRS IC concluded that the specified underground space is an identified asset as described in IFRS 16.B13 to B20. Whilst the guidance around identified assets and substantive substitution rights in Section 20 is less extensive, similar requirements to those set out in IFRS 16.B13 to B20 are provided in paragraphs 20.19 to 21 of FRS 102.
- The customer has the right to obtain substantially all the economic benefits from use of the specified underground space throughout the 20-year period of use. The customer has exclusive use of the specified underground space throughout that period of use.
- The customer has the right to direct the use of the specified underground space throughout the 20-year period of use because the customer has the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions. How and for what purpose the specified underground space will be used (i.e., to locate the pipeline with specified dimensions through which oil will be transported) is predetermined in the contract. The customer has the right to operate the specified underground space by having the right to perform inspection, repairs and maintenance work. The customer makes all the decisions about the use of the specified underground space that can be made during the 20-year period of use.

Consequently, the IFRS IC concluded that the contract described in the request contains a lease as defined in IFRS 16. The customer would therefore apply IFRS 16 and Section 20 in accounting for that lease.

4.1.3 Substantive substitution rights

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfil a contract with a customer, including the sum of any non-consecutive periods of time). [FRS 102 Appendix I]. A supplier's right to substitute an asset is substantive when both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use (e.g., the customer cannot prevent the supplier from substituting an asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
And
- The supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset). [FRS 102.20.20].

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date, or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. At inception of the contract, an entity should not consider future events that are not likely to occur. [FRS 102.20.21]. Section 20 does not provide any examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are excluded from the evaluation of whether a supplier's substitution right is substantive throughout the period of use. However, entities applying FRS 102 may consider the following examples provided in IFRS 16:

- An agreement by a future customer to pay an above market rate for use of the asset.
- The introduction of new technology that is not substantially developed at inception of the contract.
- A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract.
- A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract. [IFRS 16.B16].

In many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. For example, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

Section 20 further clarifies that a customer should presume that a supplier's substitution right is not substantive when the customer cannot readily determine whether the supplier has a substantive substitution right. [FRS 102.20.21]. This requirement clarifies that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive.

How we see it

We believe that suppliers cannot presume that their substitution rights are non-substantive because suppliers should have sufficient information to make such a determination.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

Illustration 4-5: Substitution rights**Scenario A**

Assume that an electronic data storage provider (supplier) provides services through a centralised data centre, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analysis: The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analysis: Because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset, the substitution right is non-substantive, and Server No. 9 would be an identified asset. In this case, neither of the conditions of a substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right.

Frequently asked questions**Question 4-2: Does a contract contain a lease when the supplier has substitution rights that are not substantive throughout the period of use?**

In March 2023, the IFRS IC discussed a fact pattern in which a customer enters into a 10-year contract with a supplier for 100 similar batteries used in electric buses. The supplier has the practical ability to substitute alternative assets throughout the contract term and would be required to compensate the customer for any revenue lost or costs incurred while the substitution takes place. At inception of the contract, it is expected that the supplier would benefit economically from substituting the battery once it has been used for three years or more but not before.

Similar to Question 4-1 above, whilst decisions of the IFRS IC do not apply directly to entities reporting under FRS 102, as a result of the similarities between Section 20 and IFRS 16 in this area, we would expect the analysis set out below to be relevant to entities considering a similar fact pattern under FRS 102.

The IFRS IC noted that the customer is able to benefit from the use of each battery together with a bus that is readily available to it, and each battery is neither highly dependent on, nor highly interrelated with the other batteries in the contract. The supplier has the practical ability to substitute alternative batteries throughout the period of use. However, because the supplier is not expected to benefit economically from substituting a battery for at least the first three years of the contract, the supplier does not have a substantive substitution right throughout the period of use.

Therefore, in the fact pattern presented, the IFRS IC concluded that each battery is an identified asset. It follows that, in evaluating whether the contract contains a lease, the requirements in IFRS 16 need to be applied to assess whether, throughout the period of use, the customer has the right to obtain substantially all the economic benefits from use, and direct the use, of each battery.

4.1.4 Right to obtain substantially all of the economic benefits from use of the identified asset

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout that period). A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). [FRS 102.20.23].

However, economic benefits arising from construction or ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset. Therefore, they are not considered when assessing whether a customer has the right to obtain substantially all the economic benefits.

When assessing the right to obtain substantially all the economic benefits from use of an asset, Section 20 states that an entity considers the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset. [FRS 102.20.24]. Section 20 does not further elaborate on this, but entities applying Section 20 may consider the following examples from IFRS 16 when considering the application of this requirement:

- If a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity considers only the economic benefits from use of the motor vehicle within that territory, and not beyond.
Or
- If a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity considers only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond. [IFRS 16.B22].

A contract may require a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration. Section 20 does not provide explicit guidance on whether those cash flows paid as consideration in such contracts should be considered to be part of the economic benefits that the customer obtains from use of the asset. However, this matter is explicitly addressed in IFRS 16, which states that if a customer is required to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, such cash flows are considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all the economic benefits from the use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space. [IFRS 16.B23].

How we see it

Whilst Section 20 of FRS 102 does not include the explicit requirement set out in paragraph B23 of IFRS 16, in our view, the application of paragraph 23 of Section 20 is intended to be consistent with IFRS 16. As such, if a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration are considered to be part of the economic benefits that the customer obtains from use of the asset.

4.1.5 Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- The customer has the right to direct how and for what purpose the asset is used throughout the period of use in a manner that affects the economic benefits derived from its use.
Or
- The relevant decisions about how and for what purpose an asset is used are predetermined and the customer either: (1) has the right to operate the asset (or to direct others to operate the asset in a manner that it determines), throughout the period of use, without the supplier having the right to change those operating instructions; or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use. [FRS 102.20.25].

4.1.5.A The right to direct how and for what purpose an asset is used throughout the period of use

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used throughout the period of use in a manner that affects the economic benefits derived from its use. [IFRS 102.20.25(a)].

Section 20 does not provide further guidance on what is meant by 'the right to direct how and for what purpose the asset is used'. However, entities applying Section 20 may refer to the additional guidance in IFRS 16 which explains that a customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. [IFRS 16.B25].

Whilst Section 20 does not refer to the right to 'change' how and for what purpose the asset is used, the following examples of decision making rights, provided in paragraph B26 of IFRS 16, may nonetheless provide useful indicators for FRS 102 reporters to refer to:

- The right to change the type of output that is produced by the asset (e.g., deciding whether to use a shipping container to transport goods or for storage, deciding on the mix of products sold from a retail unit).
- The right to change when the output is produced (e.g., deciding when an item of machinery or a power plant will be used).
- The right to change where the output is produced (e.g., deciding on the destination of a truck or a ship, deciding where a piece of equipment is used or deployed).
- The right to change whether the output is produced and the quantity of that output (e.g., deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

The following are examples of decision-making rights that do not grant the right to direct how and for what purpose an asset is used:

- Maintaining the asset
- Operating the asset

Although the decisions about maintaining and operating the asset are often essential to the efficient use of that asset, the right to make those decisions, in and of itself, does not result in the right to direct how and for what purpose the asset is used throughout the period of use.

The customer does not need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel. However, as discussed below, the right to operate an asset will often provide the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

How we see it

We believe that the assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

4.1.5.B The relevant decisions about how and for what purpose an asset is used are predetermined

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when the most relevant decisions about how and for what purpose an asset is used are predetermined by contractual restrictions on the use of the asset (e.g., the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed). This could also be the case when the most relevant decisions about how and for what purpose an asset is used are, in effect, predetermined by the design of the asset. In such cases, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- Has the right to operate the asset (or to direct others to operate the asset in a manner it determines) throughout the period of use without the supplier having the right to change those operating instructions.

Or

- Designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. [FRS 102.20.25(b)].

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. Entities applying Section 20 may wish to refer to Example 9 in IFRS 16 which illustrates the evaluation of whether a customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Illustration 4-6 below explores the application of the requirements in paragraph 25 of Section 20 to a scenario in which many decisions are predetermined, applying analysis similar to that performed by the IFRS IC in their January 2020 agenda decision concerning whether the customer has the right to direct the use of a ship throughout the five-year term of a contract.

Illustration 4-6: The right to direct the use of a ship

Customer A has a contract for the use of a ship for a period of 5 years. Based on the terms of the contract:

- Customer A has determined that there is an identified asset (the ship) applying paragraphs 19 to 22 of Section 20.
- Customer A has the right to obtain substantially all the economic benefits from use of the ship throughout the five-year period through exclusive use of the ship.
- Many, but not all, decisions about how, and for what purpose, the ship is used are predetermined in the contract. The customer has the right to make the remaining decisions about how, and for what purpose, the ship is used throughout the period of use. Specifically, it has decision-making rights with respect to the order of the voyages to the designated ports during the contract term. This decision-making right affects the economic benefits to be derived from use of the ship.
- The supplier operates and maintains the ship throughout the period of use.

Analysis: In the fact pattern, because not all relevant decisions about how and for what purpose the ship is used are predetermined, Customer A considers paragraph 25(a) of Section 20 in assessing whether it has the right to direct the use of the ship. This paragraph specifies that a customer has the right to direct the use of an identified asset throughout the period of use if it has "...the right to direct how and for what purpose the asset is used throughout the period of use, in a manner that affects the economic benefits derived from its use".

Within the scope of its right of use defined in the contract, Customer A can direct how and for what purpose the ship is used as it can change the order of the voyages to the designated ports during the contract term. As set out above, this decision-making right is most relevant, as it affects the economic benefits to be derived from the use of the ship. Despite many decisions about how and for what purpose the ship is used being predetermined, such decisions define the scope of the customer's right of use. As such, Customer A has the right to make the decisions that are most relevant to directing how and for what purpose the ship is used.

Although the operation and maintenance of the ship are essential to its efficient use, the supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used.

Therefore, Customer A has the right to direct the use of the ship throughout the period of use. Consequently, the contract contains a lease.

4.1.5.C Specifying the output of an asset before the period of use

Section 20 does not specifically address situations in which a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use. However, if a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, then it does not have the right to direct the use of that asset, unless it designed the asset, or specific aspects of the asset. [FRS 102.20.25(b)(ii)].

If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (e.g., the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

4.1.5.D Protective rights

A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may: (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset; (ii) require a customer to follow particular operating practices; or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but are not expected, in isolation, to prevent the customer from having the right to direct the use of an asset.

Illustration 4-7: Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a three-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (e.g., it breaks down).

Under the contract:

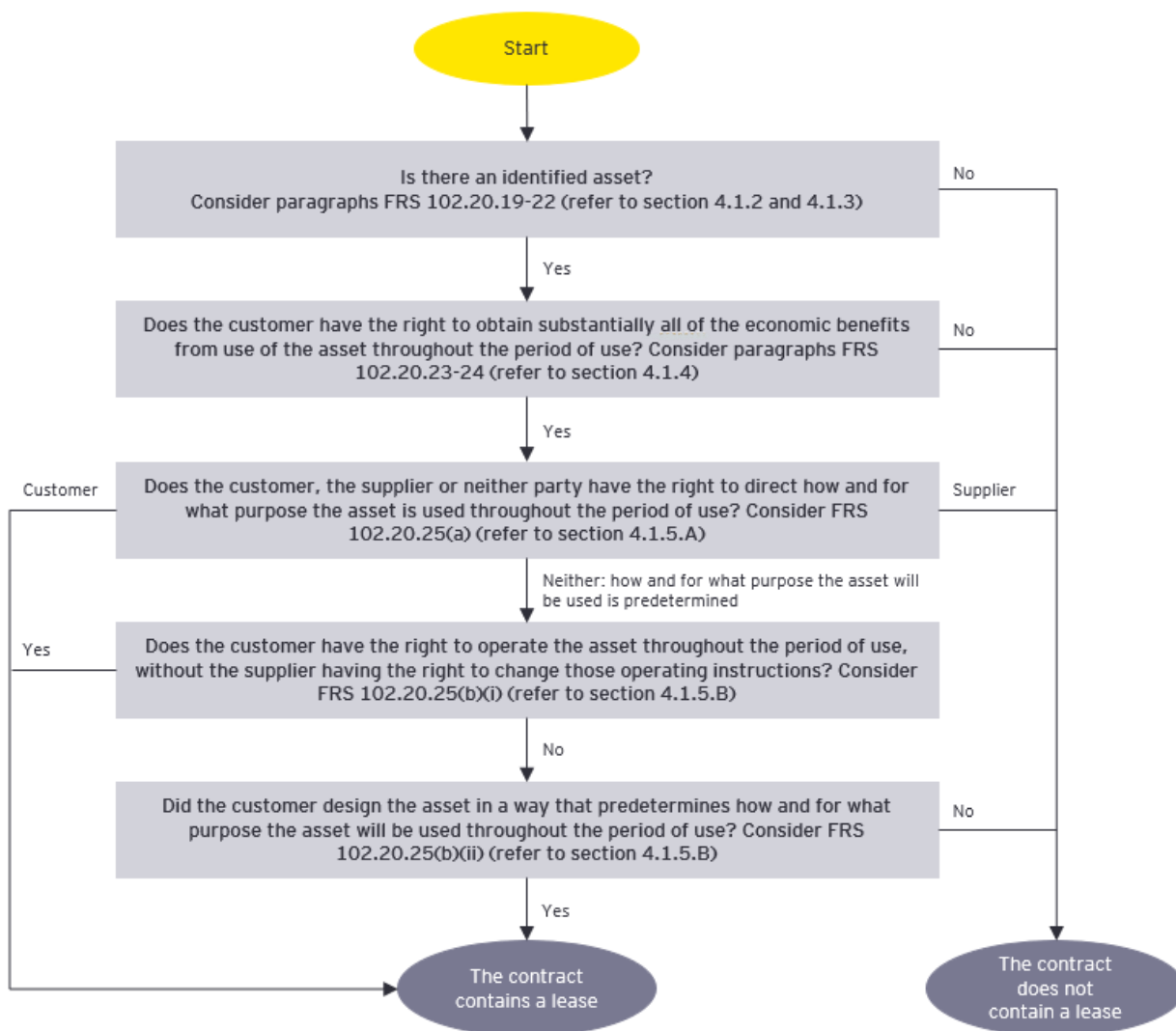
- Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (e.g., hires a driver).
- Customer X decides how to use the vehicle (within contractual limitations, discussed below). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.

Analysis: Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer X has the right to direct the use of the vehicle because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

4.1.6 Flowchart

The following flowchart is similar to one included in IFRS 16's application guidance, [IFRS 16.B31], adapted to refer to the relevant Section 20 requirements. It depicts the decision-making process for determining whether an arrangement is or contains a lease:



4.1.7 Reassessment of the contract

Under Section 20, an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed. [FRS 102.20.18]. A change in the terms and conditions of a contract does not include the exercise of an option (e.g., renewal option) or failure to exercise an option that is included in the contract.

4.1.8 Intra-group arrangements

It is not uncommon in groups for one legal entity to make an asset or assets available for use by another group company. For example, in some groups one legal entity may own properties which it leases to other companies across the group. Similarly, sometimes group companies may share properties or facilities. These arrangements may be formally documented, but this is not always the case.

There is no scope exclusion in Section 20 for intra-group arrangements and therefore, such arrangements may meet the definition of lease to be accounted for under Section 20. However, it is important to be aware that a contract which creates enforceable rights and obligations must exist in order for the definition of a lease to be met. This depends on the substance of arrangements, rather than their form. If an arrangement between group companies does not create enforceable rights and obligations, the entity or entities using an underlying asset may not be a party to a lease and therefore would not account for the arrangement under Section 20.

4.2 Identifying and separating lease and non-lease components of a contract and allocating contract consideration

A contract may contain a number of components, some of which relate to the lease of assets and others relating to non-lease elements, such as services. [FRS 102.20.27]. See below for further guidance on:

- Identifying and separating lease components of a contract (refer to 4.2.1 below).
- Identifying and separating lease from non-lease components of a contract (refer to 4.2.2 below).
- Determining and allocating the consideration in the contract - lessees (refer to 4.2.3 below).
- Determining and allocating the consideration in the contract - lessors (refer to 4.2.4 below).
- Examples - Identifying and separating components of a contract and determining and allocating the consideration in the contract (refer to 4.2.5 below).

4.2.1 Identifying and separating lease components of a contract

Extract from FRS 102

20.28 For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 20.33. [FRS 102.20.28]

For contracts that contain the rights to use multiple assets (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).
- And
- The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. [FRS 102.20.29].

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

A contract may include an amount payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease, that do not transfer a good or service to the lessee. Such amounts payable do not give rise to a separate component of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract. [FRS 102.20.30].

Illustration 4-8: Identifying and separating lease components

Scenario A

Assume that a lessee enters into a lease of an excavator and the related accessories (e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.

Analysis: From the perspective of the lessee, the contract contains one lease component. The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories.

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (e.g., to transport iron ores at another mine).

Analysis: From the perspective of the lessee, the contract contains two lease components: a lease of the excavator (together with the accessories) and a lease of the loading truck. Because the loading truck could be deployed for other uses independent of the excavator, the lessee can benefit from the loading truck on its own or together with other readily available resources. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

Section 20 does not include any specific guidance in respect of contracts that involve the right to use land and land improvements (e.g., buildings). In contrast, IFRS 16 includes specific guidance on this matter which requires a lessor to classify (refer to 7.1 below) and account for the right to use land as a separate lease component, unless the accounting effect of doing so is immaterial to the lease. [IFRS 16.B57]. Despite the absence of a paragraph directly equivalent to paragraph B57 of IFRS 16, Section 20 nonetheless requires entities to account for each lease component within the contract separately, if the conditions in paragraph 29 of Section 20 are met (see above).

Separation of the land may not be necessary when the amount that would be recognised for the land lease component is immaterial to the lease.

How we see it

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, when an entity only leases part of the building (e.g., one floor of a multi-storey building) the land may not be a separate lease component as the lessee does not control substantially all the benefits of the shared land.

4.2.2 Identifying and separating lease from non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other sections of FRS 102 (except when a lessee applies the practical expedient as discussed in 4.2.2.B below). [FRS 102.20.28, FRS 102.20.34]. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to Section 23 by lessors (suppliers). Non-lease components are also within the scope of Section 21 *Provisions and Contingencies*, as discussed in Chapter 24 at 3.3.1.A.

In order to account for non-lease components separately entities are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis (refer to 4.2.3.B and 4.2.4.B below). [FRS 102.20.31].

Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs a lessor charges a lessee). These items are not considered separate lease or non-lease components, and lessees and lessors do not allocate consideration in the contract to these items (refer to 4.2.2.A and 4.2.2.B below). [FRS 102.20.30].

However, if the lessor provides services (e.g., maintenance, supply of utilities) or operates the underlying asset (e.g., vessel charter, aircraft wet lease), the contract will generally contain non-lease components.

4.2.2.A Payments that do not transfer a good or service to the lessee

Under Section 20, payments made by the lessee to the lessor for maintenance activities, including common area maintenance (e.g., cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the tenant (e.g., providing utilities or rubbish removal) are considered non-lease components because they provide the lessee with a service.

In some leases, a lessee also may make payments to or on behalf of the lessor to reimburse the lessor for costs that relate to the leased asset but do not transfer a good or service to the lessee. Examples may include payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is, or payments made for insurance that protects the lessor's investment in the asset where the landlord will receive the proceeds from any claim. Under Section 20, such costs are not separate components of the contract because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components). [FRS 102.20.30]. Entities also need to evaluate whether such payments are fixed (or in-substance fixed) lease payments or variable lease payments (refer to 5.5 below).

Illustration 4-9: Activities that are not components of a lease contract**Scenario A**

A lessee enters into a three-year lease of equipment, with fixed annual payments of £12,000. The contract itemises the fixed annual payments as follows: £9,000 for rent, £2,500 for maintenance and £500 for administrative tasks.

Analysis: The contract contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee. Therefore, the total consideration in the contract of £36,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

Scenario B

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

Analysis: The contract still contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term. Therefore, the total consideration in the contract will be allocated to the lease component (equipment) and the non-lease component (maintenance). Refer to 6.2.1 below for further discussion on the inclusion of restoration costs to the initial measurement of the right-of-use asset.

4.2.2.B Practical expedient - lessees

Section 20 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. [FRS 102.20.33]. The practical expedient does not allow lessees to account for multiple lease components of a contract (refer to 4.2.1 above) as a single lease component. Refer to 6 below for a discussion of measurement of right-of-use assets and lease liabilities.

How we see it

Although it is not explicitly stated, we believe that for the purposes of applying the practical expedient, non-lease components which can be combined with lease components are those components that relate to services contained within the lease contract. Therefore, when a lease includes a component related to the purchase of inventory or another asset such as property, plant and equipment or an intangible asset, we believe an entity should separate asset purchases from the lease components and other non-lease components.

The separate asset purchases would not be combined with lease and other non-lease components, even if the entity has elected to apply the practical expedient to combine lease and non-lease components to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component as the purchase of a physical good is not a 'non-lease component associated with that lease component'.

Lessees that make the policy election to account for each separate lease component of a contract and any associated non-lease components as a single lease component, allocate all of the contract consideration to the lease component. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset is higher than if the policy election was not applied.

Section 20 does not include an equivalent practical expedient for lessors, and therefore lessors are always required to allocate the consideration in the contract between the lease and non-lease components.

4.2.3 Determining and allocating the consideration in the contract - lessees

4.2.3.A Determining the consideration in the contract

Section 20 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the FRS 102 Glossary.

How we see it

We believe that the consideration in a contract for a lessee includes the lease payments as defined in Appendix I to FRS 102 (described in 5.5 below) as well as variable payments that do not depend on an index or a rate and any other amounts in the contract that are not included in lease payments. Only those amounts that meet the definition of lease payments are included in the lease liability at their present value (refer to 6.2.2 below).

4.2.3.B Allocating the consideration in the contract - lessees

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient (refer to 4.2.2.B above) to account for each separate lease component of a contract and any associated non-lease components as a single lease component are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.

[FRS 102.20.31, FRS 102.20.32].

Illustration 4-10: Allocating contract consideration to lease and non-lease components - lessees

A lessee enters into a lease of equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	£80,000
Maintenance	£10,000
Total	£90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:

Lease	£85,000
Maintenance	£15,000
Total	£100,000

Analysis: The stand-alone price for the lease component represents 85% of total estimated stand-alone prices. The lessee allocates the consideration in the contract (£90,000), as follows:

Lease	£76,500 ⁽¹⁾
Maintenance	£13,500 ⁽²⁾
Total	£90,000

(1) $85\% \times £90,000$

(2) $15\% \times £90,000$

4.2.4 Determining and allocating the consideration in the contract - lessors

4.2.4.A Determining the consideration in the contract - lessors

As discussed in 4.2.3.A above, Section 20 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the FRS 102 Glossary.

How we see it

We believe that the consideration in a lease contract for a lessor would include the following:

- Lease payments (refer to 5.5).
- Any other fixed payments (e.g., monthly service charges, non-lease components such as maintenance) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee.
- Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date (refer to 5.5.3 below).
- Any other variable payment amounts that would be included in the transaction price in accordance with the requirements on variable consideration in Section 23.

Variable consideration is described broadly in Section 23 and can take many forms. Consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. It is important for lessors to appropriately identify the different types of variable consideration included in the contract because estimating variable consideration requires lessors to apply a constraint to each type of variable consideration. Refer to Chapter 25 at 6.2 for further discussion on variable consideration under Section 23.

4.2.4.B Allocating the consideration in the contract - lessors

When applying Section 20, lessors are required to apply paragraphs 65 to 74 of Section 23 to allocate the consideration in the contract between the lease and non-lease components on a relative stand-alone selling price basis. In addition, lessors are required to apply paragraphs 75 to 77 of Section 23 to allocate any subsequent changes in the consideration of the contract between the lease and non-lease components. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price. [FRS 102.23.68, FRS 102.23.69]. Paragraph 70 of Section 23 provides suitable methods for estimating the stand-alone selling price. [FRS 102.20.36]. Refer to Chapter 25 at 7.1 for further discussion on determining stand-alone selling prices under Section 23.

How we see it

Personnel responsible for an entity's revenue recognition policies (including revenue recognition policies associated with arrangements that include a lease) may need to obtain information from personnel beyond those in the accounting or finance departments to estimate stand-alone selling prices. That is, they may need to gain information and an understanding of an entity's pricing decisions in order to determine estimated stand-alone selling prices, especially when there are limited or no observable inputs.

4.2.5 Examples - Identifying and separating components of a contract and determining and allocating the consideration in the contract

The following example is based on Illustrative Example 12 in IFRS 16. It illustrates how lessees identify and separate lease and non-lease components of a contract, and determine and allocate the consideration in the contract. [IFRS 16.IE4, IFRS 16.IE Example 12].

Illustration 4-11: Lessee allocation of consideration to lease and non-lease components of a contract

Lessor leases a bulldozer, a truck and a long-reach excavator to Lessee to be used in Lessee's mining operations for four years. Lessor also agrees to maintain each item of equipment throughout the lease term. The total consideration in the contract is £600,000, payable in annual instalments of £150,000, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. The variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. The consideration includes the cost of maintenance services for each item of equipment.

Lessee accounts for the non-lease components (maintenance services) separately from each lease of equipment applying paragraph 28 of Section 20. Lessee does not elect the practical expedient in paragraph 33. The lessee considers the requirements in paragraph 29 of Section 20 and concludes that the lease of the bulldozer, the lease of the truck and the lease of the long-reach excavator are each separate lease components. This is because:

- Lessee can benefit from use of each of the three items of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or excavator to use in its operations).
- And
- Although Lessee is leasing all three items of equipment for one purpose (i.e., to engage in mining operations), the machines are neither highly dependent on, nor highly interrelated with, each other. Lessee's ability to derive benefit from the lease of each item of equipment is not significantly affected by its decision to lease, or not lease, the other equipment from Lessor.

Consequently, Lessee concludes that there are three lease components and three non-lease components (maintenance services) in the contract. Lessee applies the guidance in paragraphs 31-32 of Section 20 to allocate the consideration in the contract to the three lease components and the non-lease components.

Several suppliers provide maintenance services for a similar bulldozer and a similar truck. Accordingly, there are observable standalone prices for the maintenance services for those two items of leased equipment. Lessee is able to establish observable stand-alone prices for the maintenance of the bulldozer and the truck of £32,000 and £16,000, respectively, assuming similar payment terms to those in the contract with Lessor. The long-reach excavator is highly specialised and, accordingly, other suppliers do not lease or provide maintenance services for similar excavators. Nonetheless, Lessor provides four-year maintenance service contracts to customers that purchase similar long-reach excavators from Lessor. The observable consideration for those four-year maintenance service contracts is a fixed amount of £56,000, payable over four years, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. That variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. Consequently, Lessee estimates the stand-alone price of the maintenance services for the long-reach excavator to be £56,000 plus any variable amounts. Lessee is able to establish observable stand-alone prices for the leases of the bulldozer, the truck and the long-reach excavator of £170,000, £102,000 and £224,000, respectively.

Lessee allocates the fixed consideration in the contract (£600,000) to the lease and non-lease components as follows:

£	Bulldozer	Truck	Long-reach excavator	Total
Lease	170,000	102,000	224,000	496,000
Non-lease				104,000
Total fixed consideration				600,000

Lessee allocates all of the variable consideration to the maintenance of the long-reach excavator, and, thus, to the non-lease components of the contract. Lessee then accounts for each lease component applying the guidance in Section 20, treating the allocated consideration as the lease payments for each lease component.

4.3 Contract combinations

Section 20 requires that two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty) be considered a single contract if any one of the following criteria is met:

- The contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights to use the underlying assets conveyed in the contracts (or some of the rights to use underlying assets conveyed in each of the contracts) are a single lease component (refer to 4.2.1 above). *[FRS 102.20.14]*.

A lease-leaseback transaction, also referred to as a lease-in lease-out (LILO) transaction, in which the owner of an asset leases the asset to a third party and then leases it back, often for tax-driven purposes, is an example of when the contract combination guidance should be followed. When the contract combination guidance is met in a lease-leaseback transaction, it is often determined that a lease does not exist, as the right to control the use of the asset is not conveyed from the owner to the third party when both the original lease out and the leaseback are considered a single arrangement. For example, an entity leases its medical equipment with a 10-year useful life to a third party and then leases the equipment back for the first seven years. In this case, the right to control the use of the equipment is not transferred to the third party until the completion of the leaseback period (i.e., the first seven years). Therefore, the entity would record the transaction as a financing during the leaseback period and then account for the lease to the third party at the end of the leaseback period (and allocate the consideration in the contract accordingly).

5 Requirements of Section 20 for leases: Key concepts

Lessees and lessors generally apply the same key concepts for the purposes of identifying, recognising and measuring lease contracts.

5.1 Inception of a contract

At the inception of a contract, an entity assesses whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs 19 to 26 of Section 20 set out guidance on the assessment of whether a contract is, or contains, a lease. [FRS 102.20.15].

Section 20 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract. The inception date of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease. [FRS 102 Appendix I].

After the inception of the lease, but before the commencement date (refer to 5.2 below), the requirements in Section 21 apply to any contract (and, hence, any lease contract) that becomes onerous as defined in that standard (refer to Chapter 24 at 3.3.1.A).

5.2 Commencement date of the lease

Extract from FRS 102

Appendix I

Glossary

commencement date of the lease (commencement date)	The date on which a lessor makes an underlying asset available for use by a lessee.
underlying asset	An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

The commencement date is the date on which the lessor makes an underlying asset (i.e., the asset that is subject to the lease) available for use by the lessee. [FRS 102 Appendix I]. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (e.g., during the period a lessee uses the leased space to construct its own leasehold improvements). If a lessee takes possession of, or is given control over, the use of the underlying asset before it begins operations or making lease payments under the terms of the lease, the lease term has commenced even if the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date. The timing of when lease payments begin under the contract does not affect the commencement date of the lease. For example, a lessee (except for a lessee applying the short-term lease or low-value asset exemption discussed in 6.1.1 below and 6.1.2 below) initially recognises a lease liability and related right-of-use asset on the commencement date and a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

5.3 Lessee involvement with the underlying asset before the commencement date

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

If the lessee incurs costs relating to the construction or design of an underlying asset, the lessee accounts for those costs applying other sections of FRS 102, such as Section 17 *Property, Plant and Equipment*. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments.

Section 20 does not address situations in which the lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. IFRS 16 contains specific guidance on such transactions. Paragraph B46 of IFRS 16 clarifies, if the lessee controls (or obtains control of) the underlying asset before the asset is transferred to the lessor, the transaction is a sale and leaseback. The guidance in IFRS 16 is expected to be equally relevant to entities applying the hierarchy on selecting accounting policies as set out in Section 10. [IFRS 16.B45-IFRS 16.B47].

5.4 Lease term and purchase options

5.4.1 Lease term

The lease term begins at the lease commencement date and is determined on that date based on the non-cancellable term of the lease, together with both of the following:

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.
- The periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. If only the lessor has the right to terminate the lease, the non-cancellable period of the lease includes the period covered by the lessor's option to terminate the lease. [FRS 102.20.38, FRS 102 Appendix I].

Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. As a result of the definition of lease term, when a lease contains options resulting in the lessee being able to choose between a shorter or a longer period, the lease term is assessed to be the shorter period unless the lessee is reasonably certain to choose the longer period. [FRS 102.20.40]. This is the case regardless of whether the option is structured as a 'termination option' or an 'extension option'. The assessment of lease term is always based on whether the lessee is reasonably certain to continue to use the asset for the longer period.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor. [FRS 102.20.37].

At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. [FRS 102.20.40]. Examples of factors to consider include, but are not limited to:

- Contractual terms and conditions for the optional periods compared with market rates.
- Significant leasehold improvements expected to have significant economic benefit when the option becomes exercisable.
- Costs relating to the termination of the lease.
- The importance of that underlying asset to the lessee's operations.

And

- Conditionality associated with exercising the option. [FRS 102.20.41].

5.4.1.A Evaluating lease term and purchase options

When evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not terminate the lease or to purchase the underlying asset, it will be necessary for lessees and lessors to assess all relevant factors that create an economic incentive for the lessee to exercise lease renewal, termination or purchase options. The phrase reasonably certain is generally interpreted as a high threshold.

The longer the period from commencement of the lease (refer to 5.2 above) to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether the exercise of the option is reasonably certain. The difficulty arises from several factors. For example, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

The further into the future that the option date is, the lower the option price must be in relation to the estimated future fair value to conclude that the lessee is reasonably certain to exercise the option. The difference between the option price and the estimated future fair value of an asset that is subject to significant changes in value also should be greater than would be the case for an asset with a relatively stable value.

An artificially short lease term (e.g., a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to not exercise a purchase or exercise a renewal option. For example, an entity that leases a specialised facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the entity while it searched for a replacement asset.

An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments (refer to 5.5.1 below), although not explicitly stated in Section 20, one may typically assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease (since any cost saving associated with ending the lease at the option date is insignificant).

The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period which it has typically used similar assets may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. [FRS 102.20.42].

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centres to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods, as shown in Illustration 5-1 Scenario C below.

Illustration 5-1: Determining the lease term

Scenario A

Entity P enters into a lease for equipment that includes a non-cancellable term of four years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

Analysis: At the lease commencement date, the lease term is four years.

Scenario B

Entity Q enters into a lease for a building that includes a non-cancellable term of four years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realised through continued occupancy of the leased property.

Analysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period. At lease commencement, Entity Q concludes that the lease term is six years.

Scenario C

Entity R enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity R for only the months of October, November and December during a non-cancellable term of five years. The lessor agrees to provide the same retail space for each of the five years.

Analysis: At the lease commencement date, the lease term is 15 months (three months per year over the five annual periods specified in the contract).

Scenario D

Entity S enters into a lease for an office building with a stated term of 10 years, subject to a lessee only break clause (termination option) at the end of year 5. The rent on the property would be reviewed to a market rate in the event that the break option is not exercised. Entity S pays for leasehold improvements to the building to configure the office space. The leasehold improvements are expected to have a useful life of five years. There are no termination penalties and there are no other factors indicating that Entity S is reasonably certain to remain in the property beyond the end of the non-cancellable period of 5 years.

Analysis: In this example the option is structured as a termination option, but nonetheless, the considerations are the same as for renewal options. The lessee must assess whether it is reasonably certain not to exercise the termination option i.e., whether it is reasonably certain to choose to remain in the property for the longer period of 10 years. At the lease commencement date, Entity S determines it not reasonably certain to not exercise the termination option, therefore the lease term is 5 years.

5.4.1.B Cancellable leases**Extract from FRS 102**

20.39 In assessing the length of the non-cancellable period of a lease, an entity shall determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

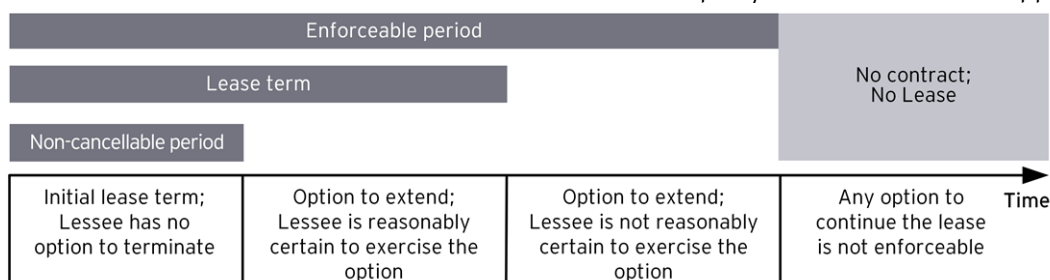
Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease.

[FRS 102.20.38]. If only the lessee has the right to terminate a lease, that right is a termination option that is considered when determining the lease term (refer to 5.4.1 above).

An arrangement is not enforceable if both the lessor and lessee each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty. The question arises as to whether 'penalty' should be interpreted to include only the contractual amount payable by one party to the other if the termination option is exercised (i.e., the narrow interpretation) or whether significant economic disincentives should also be considered a penalty (i.e., the wide interpretation). With respect to the determination of the lease term, Section 20 provides a number of factors to consider, but this list is not exhaustive, and we would expect an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option. This suggests that it may also be appropriate to consider all aspects of termination penalties, whether contractual or financial in nature.

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity applies the definition of a contract in the Glossary to FRS 102 and determines the period for which it is enforceable. As above, a lease is no longer enforceable when the lessee and lessor each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty. [FRS 102.20.39].

To determine the lease term, an entity determines the non-cancellable period and the enforceable period. It then determines where the lease term falls, depending on the likelihood of exercising the options to extend or terminate using the reasonably certain threshold. In November 2019, the IFRS IC issued an agenda decision about how to determine the lease term of a cancellable lease. In their associated agenda paper, they included the diagram below. This provides a useful summary of the impact of multiple operational periods on the assessment of lease term which would be equally relevant to entities applying Section 20¹⁰⁷.



¹⁰⁷ [AP4: Lease term and useful life of leasehold improvements \(IFRS 16 and IAS 16\)–Agenda decision to finalise \(November Interpretations Committee meeting paper\)](#)

In many jurisdictions, property leases are subject to local property laws in addition to the contractual terms of the lease arrangement. This is the case in the UK, where some commercial property leases are subject to the provisions of the Landlord and Tenants Act 1954 ('LTA'). The LTA grants statutory rights to a new tenancy in some circumstances once the lease expires.

As is the case for IFRS 16, there is no guidance in Section 20 addressing the accounting for such statutory rights offered to tenants. However, entities will need to consider the implications of any rights granted to them as a consequence of the LTA, in particular, whether an enforceable contract still exists on expiry of the lease term and if so, for what period the lease is enforceable and what the non-cancellable period of the lease is. In the case of IFRS reporters, diversity has been observed in practice with regards to the accounting for leases where occupation continues beyond the end of their contractual term, including when the LTA applies. It has been observed that some entities treat such leases as short-term once the contractual term has expired, expensing the rental cost as incurred until they vacate, or a new lease is negotiated. Other entities have accounted for these arrangements on the same basis as the expired lease, where eventual renewal is considered reasonably certain. Where such leases are material to an entity, disclosure of how they are accounted for, and of any related significant judgements should be provided.

Section 20 applies to contracts that are referred to as 'cancellable', 'month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of leases generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (e.g., the contract will roll monthly until the lessee or the lessor elect to terminate the contract). In these situations, an entity needs to consider carefully for what period the lease is enforceable, and what the non-cancellable period of the lease is. If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal option, there may be other factors to consider in order to determine whether the lessee is reasonably certain to extend the lease, including economic disincentives discussed above.

Illustration 5-2: Cancellable leases

A lease contract has an initial non-cancellable period of one year and an extension for an additional year if both the lessee and the lessor agree. There is no penalty if the lessee and the lessor do not agree to extend for the additional year. The initial one-year non-cancellable period meets the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period does not meet the definition of a contract because both the lessee and the lessor could unilaterally elect to not extend the arrangement without a more than insignificant penalty. That is, at lease commencement, neither party has enforceable rights and obligations beyond the initial non-cancellable period.

5.4.2 Reassessment of the lease term and purchase options

5.4.2.A Reassessment of the lease term and purchase options- lessees

After lease commencement (refer to 5.2 above), Section 20 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. Lessees are required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that:

- Is within the control of the lessee.
- Affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term. [FRS 102.20.43].

Section 20 does not provide examples of such significant events or changes in circumstances within the lessees control, but entities may refer to IFRS 16 which states that examples include:

- Constructing significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option becomes exercisable.
- Making significant modifications or customisations to the underlying asset not anticipated at the commencement date.
- Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset).
- Subleasing the underlying asset for a period beyond the exercise date of the option. [IFRS 16.B41].

Changes in market-based factors (e.g., a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and they therefore do not trigger a reassessment by themselves.

Section 20 also requires lessees to revise the lease term if there is a change in the non-cancellable period of a lease. Such a change could arise from the lessee exercising an option not previously included in the determination of the lease term or not exercising an option previously included in the determination of the lease term. [FRS 102.20.44].

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances. Additionally, if the reassessment of lease term or the exercise of a purchase option results in a change, the lessee would remeasure the lease liability, using revised inputs (e.g., discount rate) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, the lessee would recognise any remaining amount in profit or loss (refer to 5.5.12 below).

5.4.2.B Reassessment of the lease term and purchase options - lessors

Section 20 requires the lessor to revise the lease term if there is a change in the non-cancellable period of a lease. Such a change could arise from the lessee exercising an option not previously included in the determination of the lease term or not exercising an option previously included in the determination of the lease term. [FRS 102.20.44].

5.5 Lease payments

Lease payments are payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term and include the following amounts:

- Fixed (including in-substance fixed) payments, less any lease incentives (refer to 5.5.1 below and 5.5.2 below).
- Variable lease payments that depend on an index or a rate (refer to 5.5.3 below).
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that option (refer to 5.5.4 below).
- Payments of penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease (refer to 5.5.5 below).
- Amounts expected to be payable by the lessee under residual value guarantees (lessee only) (refer to 5.5.6 below).
- Residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee (lessor only) (refer to 5.5.7 below). [FRS 102 Appendix I].

Lease payments generally also include payments made by a lessee to a third party on behalf of the lessor. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component (refer to 4.2.2.B above).

Section 20 does not specifically address non-cash consideration that may be part of the consideration provided to the lessor. For example, a lessee may lease land to construct its own building and agree to transfer, at the end of the construction period, certain equipment used in construction. The transfer of such equipment supplements the cash consideration for use of the underlying land.

How we see it

We believe that non-cash consideration provided to the lessor is included in total consideration for purposes of initially recognising and measuring lease related assets and liabilities. This is because the total cost to the lessee, negotiated by the lessee and lessor, includes all forms of consideration, including any non-cash consideration. Applying this to the example above, the non-cash consideration is treated as a fixed payment, as the contract requires delivery of the equipment at the end of the construction period. Therefore, the consideration is measured at lease commencement at the fair value of the promise to deliver, at the end of the lease term, the equipment as stipulated in the contract.

5.5.1 In-substance fixed lease payments

Extract from FRS 102

- 20.52** In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:
- (a) there is no genuine variability, for example:
 - (i) payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; or
 - (ii) payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved;
 - (b) there is more than one set of payments that could be made, but only one of those sets is realistic; or
 - (c) there is more than one realistic set of payments that could be made, but one of these sets must be paid. In this case, the set of payments with the lowest discounted amount shall be selected.

[FRS 102.20.52]

Some lease agreements include payments that are described as variable, or may appear to contain variability, but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments are included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities. [FRS 102.20.51(a)].

5.5.2 Lease incentives

Extract from FRS 102

Appendix I

Glossary

lease incentives

Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessees, lease incentives that are received by the lessee at or before the lease commencement date reduce the initial measurement of a lessee's right-of-use asset. [FRS 102.20.47(b)].

In some circumstances, a lease incentive may reduce the initial measurement of the right-of-use asset below zero. For example, this may occur if all the consideration is variable lease payments that do not depend on an index or rate, such as payments based on usage of the asset, and the lessee receives a lease incentive upfront, such as a cash payment from the lessor.

How we see it

We believe that when, as a result of the lease incentive, the initial measurement of the right-of-use asset is reduced to less than zero, the excess amount of the lease incentive is deferred and allocated over the lease term.

Paragraph 65 of Section 20, discussed at 6.4 below, relates to the remeasurement of a lease liability and the related adjustment to the previously recognised right-of-use asset. However, this paragraph applies to remeasurements after the commencement date, not to lease incentives at lease commencement.

Lease incentives that are receivable by the lessee at lease commencement date reduce a lessee's lease liability (and therefore, the right-of-use asset as well). *[FRS 102.20.51(a)].*

How we see it

We believe that lease incentives received or receivable at the date of a lease modification would also reduce the measurement of the right-of-use asset and the lease liability (if receivable) at the effective date of the modification.

For lessors, lease incentives that are paid or payable to the lessee are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and, thereby, the initial measurement of the lessor's net investment in the lease. *[FRS 102.20.96(a)].* For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term (refer to 6 and 7 below, for lessees and lessors respectively).

5.5.3 Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate include, for example, payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate or payments that vary to reflect changes in market rental rates. *[FRS 102.20.53].* The payments are included in the lease payments for the purposes of determining the lease liability, and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). *[FRS 102.20.54].*

A lessee remeasures the lease liability by discounting the revised lease payments if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee remeasures the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect). A lessee determines the revised lease payments for the remainder of the lease term based on the revised contractual payments. *[FRS 102.20.68(b)].*

In applying paragraph 68 of Section 20, a lessee uses an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee uses a revised discount rate that reflects changes in the interest rate. *[FRS 102.20.69].*

Illustration 5-3: Variable lease payments that depend on an index or rate

Entity A enters into a 10-year lease of property. The lease payment for the first year is £1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Analysis: At the lease commencement date, the lease payments are £1,000 per year for 10 years. Entity A does not take into consideration the potential future changes in the index. At the end of year one the payments have not changed, so the liability is not updated. At the end of year two, when the lease payments change, Entity A updates the remaining eight lease payments to £1,080 per year ($£1,000 \div 100 \times 108$) and does not change its discount rate to remeasure the lease liability (and right-of-use asset).

Lease contracts, particularly those relating to property, may include market rent reviews at future dates. The following Illustration shows how these clauses may be treated.

Illustration 5-4: Property leases with market rent reviews

Entity A enters into a 5-year lease of property. The lease payment for the first year is £1,000. In years 2 and 3, there is a fixed escalation of 4%. At the beginning of year 4, there is a market rent review that will determine the lease payment in years 4 and 5.

Analysis: The lease payments included in the lease liability and right-of-use asset at the lease commencement date are determined, as follows:

- Year 1 - £1,000
- Year 2 - £1,000 + 4% fixed escalation = £1,040
- Year 3 - £1,040 + 4% fixed escalation = £1,082

The market rent review applicable to years 4 and 5 is a variable lease payment that depends on an index or a rate (as described in FRS 102.20.53). Entity A assesses the market rent at commencement date for the lease of the property for a period of two years, which is the length of the remaining lease term. This is determined to be £1,035 per annum for years 4 and 5.

5.5.4 The exercise price of a purchase option

If the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease payment. That is, entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (refer to 5.4 above).

5.5.5 Payments for penalties for terminating a lease

If it is reasonably certain that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is excluded from the lease payments. Otherwise, the lease termination penalty is included as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options.

5.5.6 Amounts expected to be payable under residual value guarantees - lessees only

Section 20 requires lessees to include amounts expected to be payable to the lessor under residual value guarantees as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee's guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation.

A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee (refer to 6.4 below). [FRS 102.20.68(a)].

Illustration 5-5: Residual value guarantee included in lease payments

Entity R (lessee) enters into a lease and guarantees that the lessor will realise £15,000 from selling the asset to another party at the end of the lease. At lease commencement, based on Entity R's estimate of the residual value of the underlying asset, Entity R determines that it expects that it will owe £6,000 at the end of the lease.

Analysis: Because it is expected that it will owe the lessor £6,000 under the residual value guarantee, Entity R includes that amount as a lease payment.

How we see it

Section 20 does not state how frequently reassessment should occur for expected changes under residual value guarantees. We would expect entities to apply judgement to determine the frequency of reassessment based on the relevant facts and circumstances.

5.5.7 Residual value guarantees - lessors only

Section 20 requires lessors to include in the lease payments any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. [FRS 102.20.96(c)]. This amount included in the lease payments is different from that for a lessee which only includes the amount expected to be payable (refer to 5.5.6 above).

5.5.8 Variable lease payments that do not depend on an index or rate

Variable lease payments that do not depend on an index or rate and are not in substance fixed (refer to 5.5.1 above), such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), are not included as lease payments. Instead, they are recognised in profit or loss (unless they are included in the carrying amount of another asset in accordance with other applicable sections of FRS 102) in the period in which the event that triggers the payment occurs. [FRS 102.20.64(b)].

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the right-of-use asset).

How we see it

In some cases, a contract specifies that when a contingency is resolved, the lessee is required to make an immediate catch-up payment. The catch-up payment relates specifically to the lessee's prior use of the asset. In this case, we believe, when the contingency is resolved, the catch-up obligation is recognised as part of the lease liability and is expensed immediately (rather than adjusting the right-of-use asset).

Illustration 5-6: Variable lease payments that do not depend on an index or rate

Entity A is a medical equipment manufacturer and a supplier of the related consumables. Customer B operates a medical centre. Under the agreement entered into by both parties, Entity A grants Customer B the right to use a medical laboratory machine at no cost and Customer B purchases consumables for use in the equipment from Entity A at £100 each. The consumables can only be used for that equipment and Customer B cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer B estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer B has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analysis: There are two components in the arrangement, a lease of equipment and the purchase of consumables.

Even though Customer B may believe that it is highly unlikely to purchase fewer than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (Entity A and Customer B) and lease classification (Entity A).

Entity A and Customer B would allocate the payments associated with the future payments to the lease and consumables component of the contract.

Lease payments do not include payments allocated to the non-lease components of a contract. However, lease payments include amounts that would otherwise be allocable to the non-lease components (other than the purchase of goods) of a contract when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component (refer to 4.2.2.B above).

5.5.9 Security deposits

At the commencement of a lease, a lessee may be required to pay a security deposit to the lessor. As long as the deposit is a true deposit and not a prepaid lease payment, the deposit gives the lessee a right to receive the money back in cash from the lessor and is, therefore, a financial asset for the lessee and a financial liability for the lessor.

The deposit may be accounted for in accordance with either Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues* of FRS 102, IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*, depending on the accounting policy choice made under paragraph 2 of Section 11 and Section 12 of FRS 102 (refer to Chapter 11). If an entity applies Section 11 and 12, it is likely that the deposit would meet the definition of a basic financial instrument and be accounted for under Section 11. Basic financial instruments within the scope of Section 11 will be initially measured at the transaction price, adjusted for transaction costs, except in the case of 'financing transactions'. A financing transaction is an arrangement for which payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate. FRS 102 provides the example of a seller providing interest-free credit to a buyer for the sale of goods or an interest-free or below market interest rate loan made to an employee. Sections 11 and 12 require financing transactions to be initially measured at the present value of the future payments, discounted at a market rate of interest for a similar debt instrument as determined at initial recognition and adjusted for transaction costs.

If the entity applies IAS 39 or IFRS 9 the deposit must initially be accounted for at fair value. The fair value of the deposit is determined based on the prevailing market rate of interest for a similar loan to the lessor, considering the lessor's credit-worthiness and, depending on facts and circumstances, any additional security available to the lessee.

When the deposit earns interest below the market rate (and thus is expected to be a 'financing transaction' under Sections 11 and 12) the excess of the principal amount of the deposit over the present value of the future payments, discounted at a market rate of interest, is accounted for by both the lessee and lessor as a prepaid lease payment. It is therefore considered by the lessor in determining whether the lease is an operating or finance lease. The lessee includes this amount in the cost of its right-of-use asset at the lease commencement date. For the lessor, if the lease is classified as an operating lease, the prepaid lease payment is included in the total lease payments that are recognised as income on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. If the lease is classified as a finance lease, the lessor includes the prepaid lease payment in the consideration for the lease (i.e., lease payments) and, therefore, in the determination of the gain or loss on derecognition of the underlying asset, if any.

Interest on the deposit is accounted for using the effective interest method by both the lessee and the lessor.

Illustration 5-7: Accounting for deposits paid by a lessee to a lessor

A lessee is required to pay a deposit of £100 to the lessor at lease commencement, for which no interest accrues to the lessee. The fixed lease term is 10 years. The market interest rate is 5% per annum (i.e., that is the interest rate the lessor would have to pay each year if it borrowed £100 for a 10-year term from a third party). The entity applies Section 11 and 12 in accounting for financial instruments.

Analysis:

Lessee accounting

At lease commencement:

Dr	Deposit receivable*	£61	
Dr	Right-of-use asset	£39	
	Cr Cash		£100

To record the deposit receivable at the present value of the future payments on initial recognition and to record the prepaid lease payment as part of the right-of-use asset. There is no impact on profit or loss at lease commencement.

* Deposit of £100 discounted at the market rate of interest (5% per annum) for the lease term of 10 years)

Year 1:

Dr	Deposit receivable#	£3	
	Cr Interest income		£3

To recognise interest income on the deposit using the effective interest method

Dr	Depreciation expenses	£4	
	Cr Right-of-use asset		£4

To depreciate over the ten-year lease term the additional rent included in the right-of-use asset

Estimated based on a 5% per annum effective interest rate

Lessor accounting in an operating lease*At lease commencement:*

Dr	Cash	£100	
	Cr	Deferred lease income	£39
	Cr	Deposit payable	£61

To record the deposit payable at the present value of the future payments on initial recognition and to record the prepaid lease payment as part of deferred lease income.

There is no impact on profit or loss at lease commencement.

Year 1:

Dr	Interest expense	£3	
	Cr	Deposit payable	£3

To recognise interest expense on the deposit using the effective interest method.

Dr	Deferred lease income	£4	
	Cr	Rental income	£4

To recognise the additional rent on a straight-line basis over the lease term

Lessor accounting in a finance lease

Assume the carrying amount of the underlying asset is £600; the initial carrying amount of the net investment in the lease (i.e., the present value of the lease payments not yet received at the commencement date) is £700; total lease payments including the effect of discounting the deposit is £739, and the present value of the unguaranteed residual value is £60.

At lease commencement:

Dr	Cash	£100	
Dr	Net investment in the lease	£760	
	Cr	Underlying asset	£600
	Cr	Deposit payable	£61
	Cr	Gain on disposal	£199

To recognise the lease transaction at commencement of the lease.

Year 1:

Dr	Interest expense	£3	
	Cr	Deposit payable	£3

To recognise interest expense on the deposit using the effective interest method. The additional journals to adjust the net investment in the lease for accrued interest and cash receipts have been excluded for simplicity.

5.5.10 Non-recoverable value added tax (VAT) and property taxes

When a lessee enters into a lease contract the lessor may be required to charge the lessee VAT in accordance with the local tax regulations. In many jurisdictions, the lessor charges VAT on behalf of the tax authority and payment is remitted to the tax authority. Additional background on VAT on UK based leases is provided below, but similar principles apply to non-recoverable VAT levied in other jurisdictions that operate in a similar manner.

Subject to registration thresholds, the supply of goods and services in the UK will be subject to UK VAT at the prevailing rate (i.e., standard rate, reduced rate, zero rate or exempt). An entity making taxable supplies is entitled to reclaim VAT they are charged on costs incurred for a business purpose (subject to further evidential/administrative conditions). Where a UK VAT registration obligation has been triggered, that entity will also be required to file VAT returns and maintain relevant VAT records. With regards to leases, different VAT rules apply to different types of leases. For example (non-exhaustive list):

- Residential property leases in the UK are typically exempt from VAT, which means lessors do not charge VAT on those leases, and the lessor is not eligible to reclaim VAT incurred on expenses directly attributable to those supplies.

- Similarly, commercial property leases in the UK are typically exempt from VAT (and the lessor is not eligible to reclaim VAT incurred on expenses directly attributable to those supplies), unless the lessor has opted to tax the property. By opting to tax the property all supplies made by the lessor of its interest in the property will be normally be subject to VAT at the standard rate, and in this case, the lessor is eligible to reclaim VAT incurred on expenses directly attributable to those supplies. There are special rules that apply which may mean the option to tax is disapplied depending on the parties involved.
- In contrast, VAT is typically charged (at the standard rate) on lease payments for leases of plant and equipment where the place of supply is the UK, and in this case, the lessor is eligible to reclaim VAT incurred on expenses directly attributable to those supplies.

Therefore, when a lessee enters into a lease contract, depending on the type of lease and the circumstances of the lessor, the lessor may be required to charge the lessee VAT and collect it on behalf of the HM Revenue and Customs ('HMRC'). Where a lessee has been charged VAT on a lease, the lessee needs to consider its own VAT position and whether it can reclaim VAT on the costs incurred. In some cases, due to the nature of a lessee's operations, the lessee may only be able to recover a portion of the VAT charged on purchased goods or services, which would include VAT payments made on leases. In these cases, the VAT paid (or a portion of the VAT paid) is non-refundable.

Section 20 of FRS 102 is silent on how irrecoverable VAT on leases should be accounted for. The key question is whether the irrecoverable VAT meets the definition of a lease payment and therefore included in the calculation of the lease liability. In the UK, whilst a lease agreement may require the lessee to make payments to the lessor which include VAT, the VAT is a tax which the lessor must collect and remit to HMRC. In circumstances such as this, the total payment made by the lessee to the lessor comprises two components. One component is a payment from the lessee to the lessor in exchange for the right to use the underlying asset (a lease payment), whilst the other component (the VAT component) is a levy to be remitted by the lessor to the tax authority. As a result, in our view, the VAT charged is not generally a lease payment. In addition, from a lessee's perspective, typically the lessee only incurs a liability for the VAT when the lessor invoices the lease payment. Therefore, the payments do not meet the definition of an initial direct cost as they are incurred as a consequence of using the asset during the lease term, not obligations that arise to obtain the lease. Therefore, we would typically expect entities to recognise a liability to make the VAT payments when they are invoiced.

How we see it

Generally, we expect that lessees will not include non-recoverable VAT in lease payments.

In the UK there are a number of taxes levied on property owners and occupiers, which may include stamp duty, capital gains tax when a property is sold, council tax (for residential property) and business rates (for commercial properties). For residential property, unless stated in the lease agreement, tenants are usually responsible for paying council tax, but there are some exceptions. Similarly, for commercial property the tenant is usually responsible for paying the business rates to the local authority, although there are instances where a landlord may take on the responsibility of paying business rates. This might be the case as a result of the specific terms in the lease, or for example, where there is a multi-let property and the landlord is responsible for common areas. As such, lessees of UK properties may often pay property taxes directly, but there may be instances in which the lessor is responsible for paying the rates.

Where the lessor is responsible for paying property taxes, the lease contract may specify that the lessee pays an additional amount to cover the lessor's property tax costs. Property tax that is reimbursable by the lessee to the lessor as the owner of the building, according to the contract, does not transfer any goods or services to the lessee and, as such, it is not a separate component of the contract. Rather, it is part of the total consideration and should be allocated to the separately identified components of the contract. If any portion of the reimbursable amount meets the definition of a lease payment (for example, because the lessee pays a fixed amount designed to cover the landlord's costs, or because although the cost is variable, the first-year tax reimbursement is known at lease commencement) it is included in the lease liability. If the reimbursable amount is variable and does not depend on an index or rate (for example, because it depends on the actual tax owed by the lessor as determined by the taxing authority each period) it is accounted for as a variable payment that does not depend on an index or rate as described in 5.5.8 above. Unlike the non-recoverable VAT payments discussed above, where it is the landlord who is obligated to pay the property tax, the property tax reimbursable by the lessee to the lessor is not a collection of tax by the lessor on behalf of the tax authority. The obligation to pay the property tax in those circumstances rests with the lessor (regardless of whether the lessee ends up making any payments to the lessor and the lessee's payment to the lessor simply compensates the lessor for the use of the building).

5.5.11 Co-tenancy clauses

A co-tenancy clause is a clause in a lease contract that could result in changes in a lessee's lease payments if certain events involving other tenants occur (e.g., if key tenants, or a certain number of tenants, leave a retail shopping centre). A co-tenancy clause, if triggered, may temporarily reduce a lessee's lease payments or contractually change the lease payments from fixed lease payments to variable lease payments (e.g., payments that were previously fixed are changed to a percentage of sales). Generally, when the co-tenancy clause is resolved (e.g., the anchor tenant is replaced or occupancy levels return to a stated percentage), the lease payments will revert to the previous amounts.

Section 20 requires a lessee to remeasure lease payments when a contingency, upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based, is resolved and those payments now meet the definition of lease payments. A co-tenancy clause would typically result in the inverse scenario because it would temporarily lower the lease payment or temporarily cause fixed payments to become variable.

How we see it

If after lease commencement, a co-tenancy clause is triggered, we believe a lessee generally would not remeasure the lease payments. We believe any temporary change in lease payments that results from a co-tenancy clause being triggered should be recognised in profit or loss similar to variable lease payments.

However, in certain circumstances, when it is likely the co-tenancy clause will not be resolved (e.g., the lease space is an ageing shopping centre with a low likelihood of locating replacement tenants that comply with the clause), we believe a lessee may reasonably conclude it should remeasure the lease payments.

In the example where the lease space is an ageing shopping centre with a low likelihood of locating replacement tenants that comply with the clause and the lessee concludes it should remeasure the lease payments, the lessee would reduce the existing lease liability with an adjustment to the right-of-use asset. The effect of a co-tenancy clause when reassessing lease payments will depend on facts and circumstances.

5.5.12 Reassessment of the lease liability

Section 20 contains specific requirements about how to remeasure the lease liability to reflect changes to the lease payments (refer to 6.4 below). A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss. [FRS 102.20.65].

5.6 Discount rates

Extract from FRS 102

Appendix I

Glossary

interest rate implicit in the lease

The rate of interest that causes the present value of:

- (a) the lease payments and
- (b) the unguaranteed residual value to equal the sum of:
 - (i) the fair value of the underlying asset; and
 - (ii) any initial direct costs of the lessor.

lessee's incremental borrowing rate

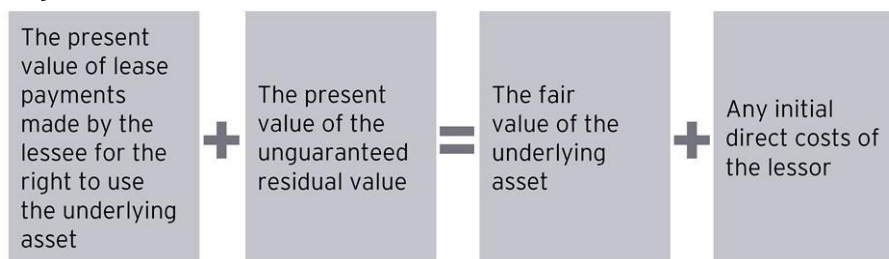
The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

lessee's obtainable borrowing rate

The rate of interest that a lessee would have to pay to borrow over a similar term, an amount similar to the undiscounted value of the lease payments to be included in the measurement of the lease liability.

Discount rates are used to determine the present value of the lease payments, which are used to determine lease classification by lessors (refer to 7.1 below) and to measure a lessor's net investment in the lease and a lessee's lease liability.

For a lessor, the discount rate for the lease is the interest rate implicit in the lease, which is the rate that causes the following:



Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term (refer to 7.2 and 5.7 below).

For lessees, lease payments are discounted using the interest rate implicit in the lease as described above if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses either:

- The lessee's incremental borrowing rate
- Or
- The lessee's obtainable borrowing rate

The lessee can choose whether to apply the incremental borrowing rate or the obtainable borrowing rate on a lease-by-lease basis, if the interest rate implicit in the lease cannot be readily determined. [FRS 102.20.49]. An additional simplification is available to public benefit entities that are unable readily to determine any of the three rates (refer to 5.6.3 below).

How we see it

The interest rate implicit in the lease is not necessarily the rate stated in the contract and reflects, among other things, the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the interest rate implicit in the lease, in which case, they will need to determine either the incremental borrowing rate or the obtainable borrowing rate.

The term readily determinable is not equivalent to estimable. Therefore, when the interest rate implicit in the lease can only be determined by using estimates and/or assumptions, then the interest rate implicit in the lease is not readily determinable.

The lessee's incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. [FRS 102 Appendix I].

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the right-of-use asset, not the underlying asset. For example, in the case of a five-year property lease, the lessee considers borrowings with a similar term to the five year right-of-use asset, not the property itself, which may have a significantly longer life. Observable rates, such as a property yield can be used as a starting point to determine the incremental borrowing rate, but adjustments need to be considered for an asset with a value similar to the right-of-use asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that in some cases significant judgement will be needed to determine the incremental borrowing rate.

The lessee's obtainable borrowing rate is the rate of interest that the lessee would have to pay to borrow over a similar term, an amount similar to the undiscounted value of the lease payments to be included in the measurement of the lease liability. [FRS 102 Appendix I].

The concept of the 'obtainable borrowing rate' is unique to FRS 102 and therefore the option for lessees to use this rate is a difference between the requirements of Section 20 and those in IFRS 16. The obtainable borrowing rate represents a broadly similar concept to the incremental borrowing rate, but the FRC referred to it as a 'proportionate simplification', as it expects the lessee's obtainable borrowing rate to be simpler to determine. [FRS 102.B20.12(a)]. Similar to the incremental borrowing rate, in determining the obtainable borrowing rate the lessee considers borrowings with a similar term to the lease term. However, unlike the incremental borrowing rate, the obtainable borrowing rate only requires consideration of the rate at which the entity could borrow a similar monetary amount over the relevant term and not the wider considerations required in determining incremental borrowing rates, such as the nature or location of the

asset which would need to be captured when assessing similar security and economic environment. Again, observable rates can be used as a starting point to determine the obtainable borrowing rate, but appropriate adjustments need to be made (for example, to reflect the monetary amount and term of the lease).

How we see it

Market interest rates, particularly risk-free rates, can be negative. Section 20 does not contain a floor of zero for the discount rate and therefore it is possible that a lessee's incremental borrowing rate or obtainable borrowing rate could be below zero. However, as stated above, observable borrowings with negative nominal interest rates may be a starting point and entities will need to consider relevant sources of adjustment to determine its own incremental or obtainable borrowing rate.

In certain cases, particularly for high value assets, the incremental borrowing rate or obtainable borrowing rate may be lower than the lessee would expect the lessor's interest rate implicit in the lease to be, because the lessor is exposed to the residual value risk of the asset at the end of the lease term. This asset risk premium is not adjusted for as it does not meet the definition of the incremental or obtainable borrowing rate in Section 20.

As explained above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, taking into account various factors including the economic environment. This is generally a nominal discount rate. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency. Leases denominated in a foreign currency are discussed further in 6.6.2 below. The requirement to reflect the rate of interest that a lessee would have to pay in a similar economic environment is not a feature of the definition of obtainable borrowing rate, and therefore this is an area in which determining the obtainable borrowing rate may be simpler than determining incremental borrowing rate. Entities must nonetheless be mindful of the general requirements of FRS 102's Conceptual Framework, including the fundamental qualitative characteristics of relevance (including materiality) and faithful representation. [FRS 102.2.9, FRS 102.2.12]. Therefore, it may be necessary to consider other factors in determining OBR, if failure to do so could result in the use of an inappropriate discount rate. An example of an inappropriate rate might be application of a Turkish Lira discount rate to a lease denominated in Pounds Sterling.

One question which may arise is whether a lessee's incremental or obtainable borrowing rate is required to reflect the interest rate on a loan with both a similar maturity to the lease and a similar payment profile to the lease. Specifically, whether an entity should use the interest rate for an amortising loan (whereby the principal and interest are paid down over time) or the interest rate for a bullet repayment loan, (whereby the interest is paid over time with a single bullet payment of the principal at the end of the loan). Interest rates for bullet repayment loans are often higher than those for amortising loans.

The definition of a lessee's incremental or obtainable borrowing rate in Section 20 does not explicitly require a lessee to determine its incremental or obtainable borrowing rate to reflect the interest rate on a loan with a similar payment profile to the lease payments. However, a similar question was considered by the IFRS IC in respect of the determination of incremental borrowing rate for IFRS reporting entities, and the Committee noted that it would be consistent with the IASB's objective (when developing the definition of incremental borrowing rate) for a lessee to refer, as a starting point, to a readily observable rate for a loan with a similar payment profile to that of the lease.

How we see it

Given the lack of prescriptive guidance, we believe that the use of an amortising loan rate that has a similar payment profile to the lease is always acceptable. The use of other rates (e.g., bullet loan rates) may also be acceptable depending on the facts and circumstances (e.g., when the use of such rates aligns with the lessee's normal borrowing practices).

5.6.1 Determination of the incremental or obtainable borrowing rate by a subsidiary with centralised treasury functions

Some groups maintain centralised treasury functions and all funding requirements for the group are managed by the parent entity. Under Section 20, subsidiaries participating in a centralised treasury function cannot default to their parent's incremental or obtainable borrowing rate. Rather, all facts and circumstances should be considered to determine the subsidiary/lessee's incremental or obtainable borrowing rate. The existence of guarantees of the subsidiary's obligations may result in a rate that is similar to the parent's rate as if the parent had entered into the lease directly.

5.6.2 Reassessment of the discount rate

The discount rate for a lessee is reassessed in the following situations:

- A change in the lease term.
- A change in the assessment of an option to purchase the underlying asset.
- A modification that is not accounted for as a separate lease and does not meet any of the conditions set out in paragraph 72 of Section 20 (see below).
- A change in lease payments resulting from a change in floating interest rates.

For a lease modification that is not accounted for as a separate lease, the lessee is required to remeasure the lease liability by discounting the revised lease payments using a revised discount rate, except when any of the following conditions are met, in which case the lessee may use an unchanged discount rate:

- The additional consideration from the lease modification is insignificant to the total consideration of the original lease.
- The lease modification decreases the scope of the lease by removing the right to use one or more underlying assets, and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope.

Or

- The lease modification decreases the consideration payable for the remaining term of the lease, but does not decrease the scope of the lease by removing the right to use one or more underlying assets.

Refer to 5.5.12 above and 6.5 below.

An additional simplification is available to public benefit entities (refer to 5.6.3 below).

Section 20 does not include specific requirements on the reassessment of the discount rate for lessors.

5.6.3 Public benefit entities - additional simplification

Section 20 provides an additional simplification for public benefit entities in respect of determining the discount rate. This option sets out that if a public benefit entity is unable to readily determine either the interest rate implicit in the lease, the incremental or obtainable borrowing rate for a lease, it uses the rate of interest otherwise obtainable by the public benefit entity on deposits held with financial institutions. This additional simplification was provided on the basis that some public benefit entities are not able to borrow.

[FRS 102.PBE20.50].

5.7 Initial direct costs

Extract from FRS 102

Appendix I

initial direct costs

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

Under Section 20, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, certain payments made to an existing lessee to incentivise that lessee to terminate its lease). Lessees and lessors apply the same definition of initial direct costs.

5.7.1 Lessor accounting for initial direct costs

Section 20 requires lessors, other than manufacturer or dealer lessors, to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement. [FRS 102.20.95].

Section 20 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income. [FRS 102.20.108].

5.7.2 Lessee accounting for initial direct costs

Section 20 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

Certain costs associated with acquiring an asset within the scope of Section 17 are required to be capitalised upon initial recognition (refer to Chapter 20 at 3.4.1.A). However, Section 20 does not address the accounting for costs incurred by lessees that are directly attributable to bringing a right-of-use asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

How we see it

To the extent that costs related to acquiring a right-of-use asset are not subject to capitalisation under other sections of FRS 102 (e.g., Section 17), it remains to be seen in practice whether they are charged to profit or loss when incurred or capitalised by analogy to Section 17. For example, a lessee may incur costs when leasing an asset, by paying a third party to ship the asset, prepare the site and install the underlying asset. We believe lessees may analogise to Section 17 to determine if such costs can be capitalised.

5.8 Economic life

Section 20 sets out examples of situations that individually or in combination would normally lead to a lease being classified by a lessor as a finance lease. One of the examples is that "...the lease term is for the major part of the economic life of the underlying asset even if title is not transferred". [FRS 102.20.88(c)]. However, neither Section 20 nor the FRS 102 Glossary define the term 'economic life'. Entities may wish to refer to the definition provided in Appendix A to IFRS 16, which defines economic life as "Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users." [IFRS 16.Appendix A].

5.9 Fair value

Extract from FRS 102

20.4 Except in the scope of references to Section 16 *Investment Property*, this section uses the term 'fair value' in a way that differs in some respects from the definition of fair value in Appendix I Glossary. For the purposes of applying the lessor accounting requirements in this section, fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [FRS 102.20.4]

6 Requirements of Section 20 for leases: Lessee accounting

6.1 Initial recognition

At the commencement date, a lessee recognises a right-of-use asset and a lease liability. [FRS 102.20.45].

Section 20 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the right-of-use asset) during the lease term for all leases, except for short-term leases (refer to 6.1.1 below) and leases of low-value assets (refer to 6.1.2 below) if they choose to apply such exemptions. [FRS 102.20.5].

6.1.1 Short-term leases

A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease. [FRS 102 Appendix I].

The short-term lease exemption can be made by class of underlying asset to which the right of use relates. [FRS 102.20.7]. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. [FRS 102 Appendix I].

A lessee that makes this accounting policy election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee is required to apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit. [FRS 102.20.6].

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term in the same manner as all other leases (refer to 5.4 above). That is, the lease term includes the non-cancellable term of the lease, periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. [FRS 102.20.38]. As the determination is made at commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months. In addition, to qualify as a short-term lease, the lease cannot include an option to purchase the underlying asset.

A lease that at commencement qualified as a short-term lease is considered to be a new lease if there is a lease modification or a change in a lessee's assessment of the lease term (e.g., the lessee exercises an option not previously included in the determination of the lease term). [FRS 102.20.8]. The new lease is evaluated to determine whether it qualifies for the short-term exemption, similar to any other new lease.

A lessee that makes the short-term lease accounting policy election must provide certain quantitative and qualitative disclosures about short-term leases (refer to 6.8 below).

Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy. A lessee evaluates any potential change in its accounting policy in accordance with Section 10.

Illustration 6-1: Short-term lease

Scenario A

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

Analysis: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease as a short-term lease.

Scenario B

Assume the same facts as Scenario A except, at the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

Analysis: The lease term is 12 months or less, i.e., nine months. Therefore, the lessee may (subject to its accounting policy, by class of underlying asset) account for the lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis and does not recognise a lease liability or right-of-use asset on its statement of financial position.

6.1.2 Leases of low-value assets

Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets). This election can be made on a lease-by-lease basis. [FRS 102.20.7.8]. A lessee that makes this election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit. [FRS 102.20.6].

The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the exemption regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. The value of lease payments has no bearing on the assessment of whether an underlying asset is of low value. [FRS 102.20.9]. There is no limit to the number of individual assets that can be considered as low-value for the purpose of the recognition exemption.

An underlying asset can only be of low-value only if:

- The lessee can benefit from use of the underlying asset on its own, or together with other resources that are readily available to the lessee.

And

- The underlying asset is not highly dependent on, or highly interrelated with, other assets. [FRS 102.20.10].

For example, an entity may lease a truck for use in its business and the lease includes the use of the tyres attached to the truck. To use the tyres for their intended purpose, they can only be used with the truck and as such, they are dependent on, or highly interrelated with the truck. Therefore, the tyres would not qualify for the low-value asset exemption.

Examples of underlying assets that would not be of low value include:

- Cars, vans, buses, coaches, trams, trucks and lorries
- Cranes, excavators, loaders and bulldozers
- Telehandlers and forklifts
- Tractors, harvesters and related attachments
- Boats and ships
- Railway rolling stock
- Aircraft and aero engines
- Land and buildings
- Production line equipment [FRS 102.20.11]

The list is not exhaustive and the FRC in FRS 102 Factsheet 11 *Lease accounting for lessees*¹⁰⁸, note that entities need to consider whether a leased asset is of similar value to those on this list.

Section 20 focuses on highlighting examples of assets which are not of low value and does not provide examples of low-value assets. As discussed at 2.5 above, this differs from IFRS 16 which states that examples of low-value assets can include tablet and personal computers, small items of office furniture and telephones. Application of the recognition exemption to, at least, leases of such assets under Section 20 would be acceptable. [FRS 102.B20.10]. The FRC expects that, as a result of this greater flexibility in defining low-value assets, FRS 102 preparers will be able to apply the on-balance sheet lease accounting model to a smaller proportion of their leases, substantively reducing the impact of applying this new model.

[FRS 102.B20.11].

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset (refer to 8 below). [FRS 102.20.12].

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6.2 Initial measurement

6.2.1 Right-of-use assets

At the lease commencement date, a lessee measures the right-of-use asset at cost, which consists of all of the following:

- The amount of the initial measurement of the lease liability (refer to 6.2.2 below).
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (refer to 5.5.2 above).
- Any initial direct costs incurred by the lessee (refer to 5.7.2 above).
- Any amount recognised in accordance with Section 21 at the commencement date as an estimate of the costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which the underlying asset is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.
- Any amount recognised at the commencement date in accordance with Section 24 (refer to Chapter 26 at 6.2), or for a public benefit entity, paragraphs PBE34.64 to PBE34.74 (refer to Chapter 36 at 6.4), when a lease component contains a government grant or non-exchange transaction. [FRS 102.20.35, FRS 102.20.46, FRS 102.20.47].

On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the right-of-use asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories are accounted for under Section 13 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with Section 21. [FRS 102.20.48].

In practice, some arrangements may contain both a lease and a non-exchange component. This may be the case, for example, if a lessor chooses to accept lower rent for the philanthropic intention of providing a benefit to a public benefit entity. A government grant could also be provided in the form of a lease at below-market rates; in this case the lessee may or may not be a public benefit entity. However, other situations which at face value might appear to be 'below market' would not indicate a non-exchange component, for example if a lessor discounted the rentals on a retail premises for the primary reason of keeping the premises occupied, regardless of whether or not the lessee was a public benefit entity. [FRS 102.B20.15].

As discussed at 2.3 above, Section 20 requires a lessee to use the information readily available to it to identify whether a lease contains a non-exchange component. The FRC expects that such situations may not be common in practice. When such a non-exchange component is identified, the lessee is required to account for the incoming resources in accordance with the requirements of Section 34, recognising the income as a contribution to the cost of the right-of-use asset. This represents that, because of the non-exchange component, the value of the right-of-use asset will be higher than the contractual lease payments would imply. [FRS 102.B20.16]. The same logic would also be relevant where a government grant is provided in the form of a lease at below-market rates to a lessee who may or may not be a public benefit entity.

In certain retail property leases, a lessee may sign a lease contract with a lessor and also make a payment to the existing lessee in return for vacating the property. This is sometimes referred to as key money. The existing lessee is released from all obligations under the lease contract with the lessor (i.e., this is not a sublease arrangement). The new lessee also has the right to transfer its rights and obligations in the lease contract to another party in exchange for payment, which would also release the new lessee from all obligations with the lessor. On initial recognition of the lease contract, the payment to the previous lessee is accounted for as an initial direct cost (refer to 5.7.2 above) and is therefore included in the measurement of the right-of-use asset. The payment is not in the scope of Section 18. The new lessee applies the requirements described in 6.3.1 below to the subsequent measurement of the right-of-use asset.

6.2.2 Lease liabilities

Extract from FRS 102

- 20.49** At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall choose, on a lease-by-lease basis, to apply either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate. [FRS 102.20.49]

At the commencement date, a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in 4.2 and 5 above to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease. [FRS 102.20.49, FRS 102.20.51].

Illustration 6-2 below, based on Examples 3a to 3d from the FRC's FRS 102 Factsheet 11 *Lease accounting for lessees*, reflects how the various payments a lessee may be required to make under the terms of a lease are reflected in the measurement of the lease liability.

Illustration 6-2: Lease payments to be reflected in measurement of the lease liability

Scenario A

A lessee enters into a five-year property lease on 1 January 20X6, with annual lease payments of £10,000 (paid in advance), a six-month rent-free period, and a cash lease incentive of £3,000 received at the start of the lease (as opposed to receivable in the future). The lease also includes an additional turnover rent, payable in arrears, of 5% of the sales made by the lessee using the leased property.

The lease payments to be reflected in the calculation of the lease liability are as follows:

Date	Lease payment £
1 July 20X6	5,000
1 January 20X7	10,000
1 January 20X8	10,000
1 January 20X9	10,000
1 January 20Y0	10,000

The turnover rent is a variable lease payment that does not depend on an index or rate, and is therefore not included in the measurement of the lease liability.

The cash incentive of £3,000 is not included in the calculation of the lease liability, but is deducted from the cost of the right-of-use asset. [FRS 102.20.47(b)]. The benefit of the lease incentive is therefore recognised as reduced depreciation of the right-of-use asset.

Scenario B

A lessee enters into a three-year lease for a lorry, with monthly lease payments of £1,000 structured as a £10 fixed payment and a £990 variable payment that becomes due if the lorry is proven to be capable of being driven at any point during the lease term.

Whilst, in form, this payment is variable, it is judged that it has no genuine possibility of not occurring, and so constitutes an in-substance fixed lease payment, and is included in the measurement of the lease liability (refer to 5.5.1 above).

Scenario C

A lease contract states that the lease payment, which is set initially at a market level, will increase every third year to align to market increases in rent. This is an example of a variable lease payment that depends on an index or rate. [FRS 102.20.53].

The initial measurement of the lease liability does not include any amount in respect of the future market rent adjustment. The lease liability is measured initially using the index or rate at the commencement date [FRS 102.20.51(b)], and so reflects the initial market-based lease payment, but does not reflect, or contain any, assumptions about, changes to the index or rate after that date (refer to 5.5.3 above). [FRS 102.20.54].

Subsequently, the lease liability is remeasured, in line with paragraph 68(b) of Section 20, when there is a change in the cash flows resulting from a change in an index or rate. A corresponding adjustment is made to the right-of-use asset, in line with paragraph 56(b) of Section 20 (refer to 6.4 below).

Scenario D

A lessee signs a ten-year lease with annual payments of £10,000 and a break clause at five years, accompanied by a £5,000 penalty if exercised. It assesses that it is reasonably certain not to exercise the break clause; therefore the lease term is ten years and the total lease payments are £100,000.

Illustration 6-3 below, based on Example 4 from the FRC FRS 102 Factsheet 11, reflects how a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term.

Illustration 6-3: Measurement of the lease liability

A lessee enters into a five-year property lease on 1 January 20X6, with annual lease payments of £10,000 (paid in arrears).

The lessee concludes that it cannot readily determine the interest rate implicit in the lease. It chooses to determine its obtainable borrowing rate instead, taking into account a quote from its bank to borrow £50,000 over a similar term, it concludes that the obtainable borrowing rate is 7%.

The table below sets out the undiscounted and discounted cash flows:

Date	Lease payment	Discount factor	Discounted amount
	£		£
31 December 20X6	10,000	1.070	9,346
31 December 20X7	10,000	1.145	8,734
31 December 20X8	10,000	1.225	8,163
31 December 20X9	10,000	1.311	7,629
31 December 20Y0	10,000	1.403	7,130
	<u>50,000</u>		<u>41,002</u>

The lessee therefore recognises a lease liability of £41,002 at the commencement date.

6.3 Subsequent measurement

6.3.1 Right-of-use assets

A lessee subsequently measures the right-of-use asset using a cost model, unless it applies one of the other measurement models discussed in 6.3.1.B below. [FRS 102.20.55].

6.3.1.A Cost model

To apply the cost model, a lessee measures the right-of-use asset at cost:

- Less any accumulated depreciation and any accumulated impairment losses.
- And
- Adjusted for any remeasurement of the lease liability described in 6.4 below. [FRS 102.20.56].

A lessee applies the depreciation requirements in Section 17 in depreciating the right-of-use asset [FRS 102.20.57], subject to the following requirements:

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee depreciates the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee depreciates the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. [FRS 102.20.58]. The leased asset is depreciated from the commencement date of the lease even if the lessee chooses not to use the asset from the commencement date, for example, because leasehold improvements are being constructed.

Depreciation of the right-of-use asset is recognised in a manner consistent with existing requirements for property, plant and equipment. Section 17 is not prescriptive about the methods of depreciation, mentioning straight line, diminishing balance and units of production as possibilities. The overriding requirement of Section 17 is that the depreciation charge reflects the pattern of consumption of the benefits the asset brings over its useful life.

Section 17 also requires that if major components of an item of property, plant and equipment have significantly different patterns of consumptions of economic benefits, an entity allocates the amount initially recognised with respect to an item of property, plant and equipment to its major components and separately depreciates each such part. [FRS 102.17.16]. In many cases, the right-of-use asset will relate to one underlying asset or significant part and so a component approach may not be necessary. However, entities will need to assess whether it should be applied for right-of-use assets that have significant parts with different useful economic lives.

A lessee applies Section 27 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified. [FRS 102.20.59].

6.3.1.B Other measurement models

A lessee applies the fair value model in Section 16 to right-of-use assets that meet the definition of investment property unless the investment property is rented to another group entity and chooses to account for the property by transferring them to right-of-use assets and applying the cost model.

[FRS 102.20.60].

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in Section 17, the lessee may elect to apply that revaluation model to all the right-of-use assets that relate to that class of property, plant and equipment. [FRS 102.20.61].

6.3.2 Lease liabilities

Extract from FRS 102

20.62 After the commencement date, a lessee shall measure the lease liability by:

- (a) increasing the carrying amount to reflect interest on the lease liability;
- (b) reducing the carrying amount to reflect the lease payments made; and
- (c) remeasuring the carrying amount to reflect any reassessment (as set out in paragraphs 20.65 to 20.69) or lease modifications (as set out in paragraphs 20.70 to 20.73), or to reflect revised in-substance fixed lease payments (see paragraph 20.52).

[FRS 102.20.62]

Interest on the lease liability in each period during the lease term, is the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate determined at commencement unless a reassessment requiring a change in the discount rate or lease modification has been triggered (refer to 6.4 and 6.5 below). [FRS 102.20.63].

Illustration 6-4 below, based on Example 5 from the FRC FRS 102 Factsheet 11, reflects how a lease liability is accounted for subsequent to initial recognition.

Illustration 6-4: Subsequent measurement of the lease liability

Based on the fact pattern in Illustration 6-3 above, a table can be constructed showing how the lease liability unwinds over the lease term. The interest expense is equal to the interest rate (7%) multiplied by the opening balance for the period.

The table below sets out how the lease liability unwinds over the lease term.

Date	Opening balance	Lease payment	Interest expense	Closing balance
	£	£	£	£
31 December 20X6	41,002	(10,000)	2,870	33,872
31 December 20X7	33,872	(10,000)	2,371	26,243
31 December 20X8	26,243	(10,000)	1,837	18,080
31 December 20X9	18,080	(10,000)	1,266	9,346
31 December 20Y0	9,346	(10,000)	654	0
		(50,000)	8,998	

In respect of the right-of-use asset, the initial balance would also be £41,002 (assuming no other adjustments to be made in line with paragraph 47 of Section 20 (refer to 6.2.1 above), which would typically be depreciated on a straight-line basis over the five-year lease term.

The total expense recognised in profit or loss is therefore interest of £8,998 plus depreciation of £41,002, which equals the total cash flows of £50,000.

In practice, discounting can be done in spreadsheets using a line-by-line approach for each period or one of the inbuilt formulae. However, care will need to be taken to ensure that appropriate formulae are applied to appropriate inputs.

6.3.3 Expense recognition

After the commencement date, the lessee recognises depreciation and impairment of the right-of-use asset in profit or loss, unless depreciation is permitted to be capitalised (e.g., to inventory) under other sections of FRS 102 (or the lessee applies the fair value model described in 6.3.1.B above).

A lessee also recognises in profit or loss, unless the costs are included in the carrying amount of another asset applying other sections of FRS 102, both:

- Interest on the lease liability.
- And
- Variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs. [FRS 102.20.64].

When a lessee depreciates the right-of-use asset on a straight-line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, interest expense decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the right-of-use asset, results in a front-loaded expense recognition pattern. This can be seen in Illustration 6-5 below.

If a lessee determines that a right-of-use asset is impaired, it recognises an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to 6.6.1 below for additional discussion of impairment of right-of-use assets.

6.3.4 Example - lessee accounting

Illustration 6-5: Lessee accounting

Entity H (lessee) enters into a three-year lease of equipment. Entity H agrees to make the following annual payments at the end of each year: £10,000 in year one, £12,000 in year two and £14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). The initial measurement of the right-of-use asset and lease liability is £33,000 (present value of lease payments using a discount rate of approximately 4.235%). The interest rate implicit in the lease cannot be readily determined, and Entity H chooses to use its incremental borrowing rate rather than its obtainable borrowing rate. Entity H depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis:

At lease commencement, Entity H would recognise the lease-related asset and liability:

Dr	Right-of-use asset	£33,000	
	Cr	Lease liability	£33,000

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

Dr	Interest expense	£1,398	
	Cr	Lease liability	£1,398

To record interest expense and accrete the lease liability using the interest method (£33,000 × 4.235%)

Dr	Depreciation expense	£11,000	
	Cr	Right-of-use asset	£11,000

To record depreciation expense on the right-of-use asset (£33,000 ÷ 3 years)

Dr	Lease liability	£10,000	
	Cr	Cash	£10,000

To record lease payment

A summary of the accounting for the lease contract (assuming no changes due to reassessment) is, as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		£10,000	£12,000	£14,000
<i>Lease expense recognised</i>				
Interest expense		£1,398	£1,033	£569
Depreciation expense		£11,000	£11,000	£11,000
Total periodic expense		£12,398	£12,033	£11,569
<i>Statement of financial position</i>				
Right-of-use asset	£33,000	£22,000	£11,000	-
Lease liability	(£33,000)	(£24,398)	(£13,431)	-

6.4 Remeasurement of lease liabilities

Extract from FRS 102

- 20.65** After the commencement date, a lessee shall apply paragraphs 20.66 to 20.69 to remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.
- 20.66** A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:
- (a) there is a change in the lease term, as described in paragraphs 20.43 to 20.44. A lessee shall determine the revised lease payments on the basis of the revised lease term; or
 - (b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20.43 to 20.44 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.
- 20.67** In applying paragraph 20.66, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term. If that rate cannot be readily determined, the lessee shall use either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate at the date of reassessment. When applicable, a public benefit entity shall apply paragraph PBE20.50.
- 20.68** A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:
- (a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee; or
 - (b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.
- 20.69** In applying paragraph 20.68, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

Section 20 requires lessees to remeasure lease liabilities when there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of the original terms and conditions of the lease) that is not accounted for as a separate contract (refer to 6.5 below). Lessees are also required to remeasure lease payments upon a change in any of the following:

- The lease term (refer to 5.4.2.A above).
- The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to 5.4.2.A above).
- The amounts expected to be payable under residual value guarantees (refer to 5.5.6 above).
- Future lease payments resulting from a change in an index or rate (refer to 5.5.3 above).

Or

- In-substance fixed lease payments (refer to 5.5.1 above).

Lessees use a revised discount rate when lease payments are updated for a change in the lease term or a revised assessment of a purchase option, [FRS 102.20.66], i.e., when there is a change in the underlying economics of the lease¹⁰⁹. The revised discount rate is based on the interest rate implicit in the lease for the remainder of the lease term. If that rate cannot be readily determined, the lessee uses either its incremental borrowing rate or obtainable borrowing rate. A lessee that is a public benefit entity and unable to determine the interest rate implicit in the lease, the lessee's incremental borrowing rate or lessee's obtainable borrowing rate uses the rate of interest obtainable by the public benefit entity on deposits held with financial institutions. [FRS 102.20.67]. Lessees use the original discount rate when lease payments are updated for a change in expected amounts for residual value guarantees, payments dependent on an index or rate and changes to in-substance fixed lease payments, unless changes in the lease payments result from changes in floating interest rate. [FRS 102.20.68, FRS 102.20.69].

How we see it

When a lease includes a market rate adjustment (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (the negotiation period). We believe any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

For example, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5, but are not completed until September in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period in September of year 6 (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6. Under this view, the lessee does not adjust the lease payments at the beginning of year 6 for the expected increase in rent. Instead, the lease payments are adjusted in September of year 6 when they are finalised. The lease liability is remeasured at this date and the additional cost is recognised as an adjustment to the right-of-use asset for the future lease payments.

How we see it

We believe the difference between the original lease payments and the new lease payments for the period when the new lease payments are applied retrospectively (from the beginning of year 6 to September of year 6 in the example above) may be recognised in profit or loss at the date the negotiations are finalised. Alternatively, the difference may be recognised as an adjustment to the right-of-use asset. In this case, it may also be necessary to consider the recoverability of the right-of-use asset.

¹⁰⁹ FRC FRS 102 factsheet 9 Initial application of the Periodic Review 2024 amendments (November 2024)

6.5 Lease modifications

Extract from FRS 102

Appendix I

Glossary

lease modification	A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (eg adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

If a lease is modified (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease), the modified contract is evaluated to determine whether it is or contains a lease (refer to 4.1.7 above). If a lease continues to exist, lease modification can result in:

- A separate lease (refer to 6.5.1 below).
- Or
- A change in the accounting for the existing lease (i.e., not a separate lease) (refer to 6.5.2 below).

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are not lease modifications but can result in the remeasurement of lease liabilities and right-of-use assets (refer to 6.4 above).

6.5.1 Determining whether a lease modification results in a separate lease

A lessee accounts for a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) as a separate lease (i.e., separate from the original lease) when both of the following conditions are met:

- The modification increases the scope of the lease by adding the right to use one or more underlying assets.
- And
- The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract. [FRS 102.20.70].

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original lease and a separate new lease. Lessees account for the separate contract that contains a lease in the same manner as other new leases. The accounting for the unmodified lease is not changed (refer to Scenario A in Illustration 6-7 in 6.5.3 below).

If either of the conditions are not met, the modified lease is not accounted for as a separate lease (refer to 6.5.2 below).

The first condition above, is met if there is an additional right of use that was not included in the original lease. For example, if an existing lease for one floor of a building is modified to add a second floor, the right to use the second floor would meet the first condition as this adds a right of use that was not included in the original contract. Conversely, a modification that grants the lessee the right to use only the existing floor for an additional period of time does not meet the first condition above.

A lessee that terminates an existing lease and at the same time enters into a new lease arrangement with the same landlord evaluates the contract combination guidance discussed in 4.3 above.

Illustration 6-6: Lessee accounting for an immediate termination and new lease with the same landlord

On 1 January 20X4, Retailer entered into a 10-year lease with Landlord for retail store A in a shopping mall. Retail store A is 10,000 square feet. The lease requires Retailer to make fixed monthly payments at the beginning of each month, but the amount increases each year. There are no initial direct costs or incentives associated with the lease, and there are no non-lease components in the contract.

On 1 January 20X6, Retailer and Landlord negotiate a new contract to immediately terminate the lease for retail store A and at the same time enter into a new lease for retail store B (i.e., the termination of retail store A lease is dependent on obtaining retail store B). Retail store B is 5,000 square feet and is located in a more desirable location. The term of the new lease is eight years, consistent with the remaining term of the retail store A lease. There are no lease termination payments for retail store A, and no lease prepayments, initial direct costs or lease incentives associated with the retail store B lease. There are no non-lease components in the contract for the retail store B lease. Retailer determines that the contract combination guidance is met.

On 1 January 20X6, immediately before the parties signed the new lease agreement, Retailer has a remaining right-of-use asset of £115,000 and a lease liability of £120,000. The lease for retail store A is not impaired.

Based on the terms of the retail store B lease agreement, the initial measurement of the lease liability is £70,000, which represents the lease payments in the new lease, discounted using Retailer's incremental borrowing rate at the commencement date of the new lease.

Analysis: Under Section 20, Retailer accounts for the change as a termination of the existing lease of retail store A by removing the right-of-use asset and the lease liability from the balance sheet and including any difference between the right-of-use asset and the lease liability as part of the right-of-use asset it recognises for the new lease of retail store B (which in this case is similar to a lease incentive received to enter into the retail store B lease). Retailer records the following entries:

Dr	Lease liability (existing lease)	£120,000	
	Cr	Right-of-use asset (existing lease)	£115,000
Dr	Right-of-use asset (new lease)	£65,000 ^(a)	
	Cr	Lease liability (new lease)	£70,000

(a) Recognition of the right-of-use asset associated with the new lease of retail store B at the initial measurement of the lease liability of £70,000 less the difference between the lease liability and right-of-use asset from retail store A lease of £5,000 (i.e., which in this case is similar to a lease incentive received to enter into the retail store B lease).

6.5.2 Lessee accounting for a modification that does not result in a separate lease

For those lease modifications that do not result in a separate lease, lessees allocate the consideration in the contract (refer to 4.2.3.B above), determine the lease term of the modified lease (refer to 5.4.1 above), and remeasure the lease liability by discounting the revised lease payments. The lease liability is generally remeasured using a revised discount rate (refer to 5.6.2 above) at the effective date of the modification. [FRS 102.20.71]. However, an unchanged discount rate may be used when:

- The additional consideration from the lease modification is insignificant to the total consideration of the original lease.
- The lease modification decreases the scope of the lease by removing the right to one or more underlying assets, and the consideration for the lease decreases by an amount commensurate with the stand-alone price for the decrease in scope.

Or

- The lease modification decreases the consideration payable for the remaining term of the lease, but does not decrease the scope of the lease by removing the right to use one or more underlying assets.

[FRS 102.20.72].

For a modification that fully or partially decreases the scope of the lease (e.g., reduces the square footage of leased space), Section 20 requires a lessee to recognise a proportionate reduction in the carrying amount of the right-of-use asset, account for any incoming resources from a government grant or non-exchange transaction (refer to 6.2.1 above) in the modified lease, and recognise any resulting gain or loss in profit or loss (refer to Illustration 6-7 at 6.5.3 below). [FRS 102.20.73(a)].

For all other lease modifications which are not accounted for as a separate lease and not a decrease in scope, Section 20 requires the lessee to recognise the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset, net of any adjustment for incoming resources from a government grant or non-exchange transaction (refer to 6.2.1 above) in the modified lease (refer to Illustration 6-7 at 6.5.3 below. [FRS 102.20.73(b)]).

In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). For example, a lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

- If the modification is an increase in the scope that does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).
- If the modification results in a separate lease component, the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and right-of-use asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).
- If the modification is a decrease in the scope, the lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and right-of-use asset at the effective date of the modification (the beginning of year 8).

6.5.3 Examples - lessees' accounting for lease modifications

The following Illustrations are based on IFRS 16, and reflect how lessees may account for lease modifications. [IFRS 16.IE7, IFRS 16.IE Example 15, IFRS 16.IE Example 16, IFRS 16.IE Example 17, IFRS 16.IE Example 18, IFRS 16.IE Example 19]. However, as noted at 6.5.2 above, unlike IFRS 16, Section 20 permits a lessee to use an unchanged discount rate to remeasure the lease liability for certain lease modifications that are not accounted for as a separate lease. [FRS 102.20.72]. Some of the scenarios in the Illustration are therefore updated to provide additional guidance where an FRS 102 optional simplification may apply.

The Illustrations below do not reflect any adjustments for incoming resources from a government grant or non-exchange transaction. As noted at 2.3 above, unlike FRS 102, IFRS 16 does not provide any specific guidance on leases containing a non-exchange component.

Illustration 6-7: Lessee accounting for lease modifications

Scenario A: Modification that is a separate lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification. [IFRS 16.IE Example 15].

Scenario B: Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are £100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum, and Lessee chooses to discount lease payments at Lessee's incremental borrowing rate rather than Lessee's obtainable borrowing rate. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (i.e., £100,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7 per cent per annum.

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on: (a) an eight-year remaining lease term, (b) annual payments of £100,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified lease liability equals £597,130. The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is £346,511. Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (£250,619) as an adjustment to the right-of-use asset. [IFRS 16.IE Example 16].

Scenario C: Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are £50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum and Lessee chooses to discount lease payments at Lessee's incremental borrowing rate rather than Lessee's obtainable borrowing rate. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are £30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5 per cent per annum.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of £30,000 and (c) Lessee's incremental borrowing rate of 5 per cent per annum. This equals £129,884.

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset (i.e., 2,500 square metres corresponding to 50 per cent of the original right-of-use asset).

50 per cent of the pre-modification right-of-use asset (£184,002) is £92,001. Fifty per cent of the pre-modification lease liability (£210,618) is £105,309. Consequently, Lessee reduces the carrying amount of the right-of-use asset by £92,001 and the carrying amount of the lease liability by £105,309. Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (£105,309 - £92,001 = £13,308) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of £105,309 and the modified lease liability of £129,884 (which equals £24,575) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate. [IFRS 16.IE Example 17].

As noted at 6.5.2 above, unlike IFRS 16, Section 20 permits a lessee to use an unchanged discount rate to remeasure the lease liability for certain lease modifications that are not accounted for as a separate lease. [FRS 102.20.72]. Therefore, as an alternative to the treatment outlined above in this scenario, if the lessee determined that the decrease in consideration for the lease was commensurate with the stand-alone price for the decrease in office space leased, the lessee could instead elect to use an unchanged discount rate (i.e., use the lessee's incremental borrowing rate at the commencement date of 6 per cent per annum) to remeasure the lease liability at the effective date of the modification. [FRS 102.20.72(b)].

Scenario D: Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are £100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum and Lessee chooses to discount lease payments at Lessee's incremental borrowing rate rather than Lessee's obtainable borrowing rate. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to (a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and (b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is £150,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee

does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

The pre-modification right-of-use asset and the pre-modification lease liability in relation to the lease are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance £	6% interest expense £	Lease payment £	Ending balance £	Beginning balance £	Depreciation charge £	Ending balance £
1	736,009	44,160	(100,000)	680,169	736,009	(73,601)	662,408
2	680,169	40,810	(100,000)	620,979	662,408	(73,601)	588,807
3	620,979	37,259	(100,000)	558,238	588,807	(73,601)	515,206
4	558,238	33,494	(100,000)	491,732	515,206	(73,601)	441,605
5	491,732	29,504	(100,000)	421,236	441,605	(73,601)	368,004
6	421,236				368,004		

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of: (a) a three-year remaining lease term, (b) annual payments of £150,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified liability equals £393,647, of which (a) £131,216 relates to the increase of £50,000 in the annual lease payments from Year 6 to Year 8 and (b) £262,431 relates to the remaining three annual lease payments of £100,000 from Year 6 to Year 8.

Decrease in the lease term

At the effective date of the modification (at the beginning of Year 6), the pre-modification right-of-use asset is £368,004. Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset for the original 2,000 square metres of office space (i.e., a remaining three-year lease term rather than the original five-year lease term). The remaining right-of-use asset for the original 2,000 square metres of office space is £220,802 (i.e., £368,004 ÷ 5 × 3 years).

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is £421,236. The remaining lease liability for the original 2,000 square metres of office space is £267,301 (i.e., present value of three annual lease payments of £100,000, discounted at the original discount rate of 6 per cent per annum).

Consequently, Lessee reduces the carrying amount of the right-of-use asset by £147,202 (£368,004 - £220,802), and the carrying amount of the lease liability by £153,935 (£421,236 - £267,301). Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (£153,935 - £147,202 = £6,733) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease liability	£153,935
Right-of-use asset	£147,202
Gain	£6,733

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7 per cent per annum, which is £4,870 (£267,301 - £262,431), as an adjustment to the right-of-use asset.

Lease liability	£4,870
Right-of-use asset	£4,870

Increase in the leased space

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in scope of £131,216 (i.e., present value of three annual lease payments of £50,000, discounted at the revised interest rate of 7 per cent per annum) as an adjustment to the right-of-use asset.

Right-of-use asset	£131,216
Lease liability	£131,216

The modified right-of-use asset and the modified lease liability in relation to the modified lease are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance	7% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
	£	£	£	£	£	£	£
6	393,647	27,556	(150,000)	271,203	347,148	(115,716)	231,432
7	271,203	18,984	(150,000)	140,187	231,432	(115,716)	115,716
8	140,187	9,813	(150,000)	-	115,716	(115,716)	-

[IFRS 16.IE Example 18].

Scenario E: Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from £100,000 per year to £95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum and Lessee chooses to discount lease payments at Lessee's incremental borrowing rate rather than Lessee's obtainable borrowing rate. Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum. The annual lease payments are payable at the end of each year.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of £95,000, and (c) Lessee's incremental borrowing rate of 7 per cent per annum. Lessee recognises the difference between the carrying amount of the modified liability (£389,519) and the lease liability immediately before the modification (£421,236) of £31,717 as an adjustment to the right-of-use asset. [IFRS 16.IE Example 19].

As noted at 6.5.2 above, Section 20 permits a lessee to use an unchanged discount rate to remeasure the lease liability for certain lease modifications that are not accounted for as a separate lease. [FRS 102.20.72]. In Scenario E, the lease modification decreases the consideration payable for the remaining term of the lease but does not decrease the scope of the lease by removing the right to use one or more underlying assets.

Therefore, rather than remeasuring the lease liability at a revised discount rate of 7%, the lessee could elect to use an unchanged discount rate (i.e., to use the lessee's incremental borrowing rate at the commencement date of 6 per cent per annum) to remeasure the lease liability at the effective date of the modification.

[FRS 102.20.72(c)].

6.6 Other lessee matters

6.6.1 Impairment of right-of-use assets

Extract from FRS 102

20.59 A lessee shall apply Section 27 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Lessees' right-of-use assets are subject to impairment requirements in Section 27. [FRS 102.20.59].

Section 27 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). [FRS 102.27.7, FRS 102.27.8]. The entity must recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. [FRS 102.27.5]. After an impairment loss is recognised, the adjusted carrying amount of the right-of-use asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. [FRS 102.27.29]. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

[FRS 102.27.30(c), FRS 102.27.31(c)]. Refer to Chapter 29 for further discussion of the requirements of Section 27.

6.6.2 Leases denominated in a foreign currency

Lessees apply Section 30 *Foreign Currency Translation*, to leases denominated in a foreign currency. As they do for other monetary liabilities, lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. [FRS 102.30.9]. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. [FRS 102.30.9]. Because the right-of-use asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate. [FRS 102.30.9]. Refer to Chapter 32 for further discussion of the requirements of Section 30.

6.6.3 Portfolio application

Section 20 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis. The FRC acknowledged the concerns and included a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics (e.g., a similar lease term for a similar class of underlying asset in a similar economic environment). If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio. [FRS 102.20.13].

6.7 Presentation

Extract from FRS 102

Presentation

- 20.74** A lessee shall either present in the statement of financial position, or disclose in the notes:
- (a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
 - (i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
 - (ii) disclose which line items in the statement of financial position include those right-of-use assets.
 - (b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.
- 20.75** The requirement in paragraph 20.74(a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

As discussed in Chapter 6 at 4, UK companies and LLPs may present their statement of financial position and income statement using either statutory formats or adapted formats.

The following table summarises how lease-related amounts and activities are presented in lessees' financial statements if adapted formats are used:

Financial statement	Lessee presentation
Statement of financial position	▪ Right-of-use assets presented either: ▪ Separately from other assets (e.g., owned assets). ▪ Together with other assets as if they were owned, with disclosures of the statement of financial position line items that include right-of-use assets and their amounts. [FRS 102.20.74]. ▪ Right-of-use assets that meet the definition of investment property are presented as investment property. [FRS 102.20.75]. ▪ Lease liabilities presented either: ▪ Separately from other liabilities. ▪ Together with other liabilities with disclosure of the statement of financial position line items that include lease liabilities and their amounts. [FRS 102.20.74].

Income Statement	Lease-related depreciation and lease-related interest expense are presented separately (i.e., lease-related depreciation and lease-related interest expense cannot be combined). Interest expense on the lease liability is a component of finance costs. <i>[IFRS 16.49]</i> .
Statement of cash flows	▪ Cash payments for the principal portion of the lease liability are presented within financing activities. <i>[FRS 102.7.6(e)]</i>. ▪ Cash payments for the interest portion of the lease liability are presented as either operating or financing activities depending on the accounting policy of the entity. <i>[FRS 102.7.15]</i>. ▪ Lease payments for short-term leases and leases of low-value assets not recognised on the statement of financial position and variable lease payments not included in the lease liability are presented within operating activities. <i>[FRS 102.7.4(h)]</i>. ▪ Non-cash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental non-cash item. <i>[FRS 102.7.18]</i>. Cash flows from leasing transactions are discussed further in Chapter 7 at 3.8.

For entities presenting primary statements using statutory formats, the summary presented in the table above will be relevant to the presentation of the income statement and statement of cash flows.

For the statement of financial position (balance sheet), Part 1 of Schedule 1 to the Regulations and Part 1 of Schedule 1 to the LLP Regulations, provide a choice of two balance sheet statutory formats, format 1 and format 2. Format 1 is a vertical format and is adopted by virtually all UK companies and LLPs. Format 2 presents assets separately from capital, reserves and liabilities and is rarely used. The discussion below therefore covers only the format 1 balance sheets applicable to companies (other than banking or insurance companies) and LLPs.

With regards to the presentation of right-of-use assets, format 1 requires fixed assets to be presented on the face of the balance sheet, disaggregated into subheadings for intangible assets, tangible assets and investments. The formats also include sub-headings, denoted with an Arabic number, which can be (and often are in practice), presented in the notes. For tangible assets the subheadings reflected in format 1 are:

- Land and buildings
- Plant and machinery
- Fixtures, fittings, tools and equipment
- Payments on account and assets in the course of construction *[1 Sch]*

As discussed in Chapter 6 at 3.4.2 where statutory formats are used, the General Rules to the formats allow any item to be shown in a company's (or an LLP's) balance sheet in greater detail than required by the particular format used. Entities using statutory balance sheet formats may therefore choose to present right-of-use assets separately from other assets (i.e., as a separate sub-heading of fixed assets on the face of the balance sheet), or within the same line item within which the corresponding underlying asset would be presented if they were owned (i.e., within the tangible or intangible (depending on the nature of the underlying asset) sub-headings on the face of the balance sheet). *[FRS 102.20.74(a)]*.

With regards to the presentation of lease liabilities, the Regulations (and LLP Regulations) distinguish between:

- Creditors: amounts falling due within one year
- And
- Creditors: amounts falling due after more than one year

These two line items are required to be shown on the face of the balance sheet in the format 1 balance sheet.

The format 1 balance sheet includes several sub-headings for both amounts falling due within one year and amounts falling due after more than one year, denoted with an Arabic number, which can be (and often are in practice) presented in the notes to the accounts.

Under the format 1 balance sheet, we would expect lease liabilities to be included within Creditors; amounts falling due within one year and Creditors: amounts falling due after more than one year on the face of the balance sheet, and separately disclosed within the notes to the accounts. However, as noted above, the General Rules to the formats allow any item to be shown in a company's (or an LLP's) balance sheet in greater detail than required by the particular format used. Paragraph 74(b) of Section 20 requires that if the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities. [FRS 102.20.74(b)].

6.8 Lessee disclosures

A lessee is required to disclose a general description of its significant leasing arrangements. [FRS 102.20.76]. If necessary to enable users to understand its significant leasing arrangements, a lessee is required to provide additional qualitative and quantitative information. At a minimum, when relevant, a lessee discloses:

- Information about future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities, including variable lease payments, extension options and termination options, residual value guarantees and leases not yet commenced to which the lessee is committed.
- Information about restrictions or covenants imposed by leases.
- The types of discount rate (interest rate implicit in the lease, lessee's incremental borrowing rate or lessee's obtainable borrowing rate) used in calculating lease liabilities and the proportion of the total lease liability calculated using each of those types of discount rate.
- Information about sale and leaseback transactions, including:
 - The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions.
 - Key terms and conditions of individual sale and leaseback transactions.
 - Payments not included in the measurement of lease liabilities.
 - The cash flow effect of sale and leaseback transactions in the reporting period.
 - When relevant, the entity having made the accounting policy choice to measure the right of use asset arising from the leaseback in accordance with paragraph 46 of Section 20 (i.e., applying the general initial measurement rules for a new lease), as permitted by paragraph 123(a)(ii) of Section 20 in respect of sale and leaseback transactions when the transfer of the asset is a sale (refer to 9.2.1 below). [FRS 102.20.77].

A lessee is also required to disclose the following amounts for the reporting period:

- Interest expense on lease liabilities.
- The expense relating to short-term leases accounted for applying paragraph 6 of Section 20 (refer to 6.1.1 above). This expense need not include the expense relating to leases with a lease term of one month or less.
- The expense relating to leases of low-value assets accounted for applying paragraph 6 of Section 20 (refer to 6.1.2 above). This expense does not include the expense relating to short-term leases of low-value assets disclosed in accordance with the bullet point above.
- The expense relating to variable lease payments not included in the measurement of lease liabilities.
- Income from subleasing right-of-use assets.
- Total cash outflow for leases.
- Gains or losses arising from sale and leaseback transactions. [FRS 102.20.80].

How we see it

Section 20 requires disclosure of the total cash outflow for leases. It does not explicitly state that leases of low-value assets and short-term leases are excluded. Therefore, we believe the cash outflows related to those leases should be included in the disclosure.

A lessee must also disclose the following amounts for the reporting period for right-of-use assets, by class of underlying asset:

- The gross carrying amount and the accumulated depreciation at the beginning and end of the reporting period
- A reconciliation of the carrying amount at the beginning and end of the reporting period showing separately:
 - Additions
 - Disposals
 - Acquisitions through business combinations
 - Revaluations
 - Impairment losses recognised or reversed in profit or loss in accordance with Section 27
 - Depreciation
 - Other changes

This reconciliation is not required to be presented for prior periods *[FRS 102.20.81]*

Section 20 also requires the following:

- An entity that has applied either or both of the practical expedients in paragraphs 13 (portfolio application) and 33 of Section 20 (to not separate non-lease components) must disclose that fact (refer to 6.6.3 above and 4.2.2.B above respectively). *[FRS 102.20.78]*.
- When an entity has remeasured a lease liability as a result of a lease modification (refer to 6.5 above) and has used an unchanged discount rate, it must disclose:
 - That fact.
 - The carrying amount at the end of the reporting period of lease liabilities which have been remeasured in that manner. *[FRS 102.20.79]*.
- A lessee that accounts for short-term leases or leases of low value assets applying paragraph 6 of Section 20 (refer to 6.1.1 and 6.1.2 above) must disclose that fact and disclose separately the amount of its lease commitments for short-term leases and for leases of low-value assets at the end of the reporting period for each of the following periods:
 - Not later than one year.
 - Later than one year and not later than five years.
 - Later than five years. *[FRS 102.20.82]*.
- For right-of-use assets meeting the definition of investment property, a lessee is required to apply the disclosure requirements in Section 16. In that case, a lessee is not required to provide the disclosures in paragraphs 80(e) (income from subleasing right-of-use assets) and 81 (see above) of Section 20 for those right-of-use assets. *[FRS 102.20.83]*.
- For right-of-use assets meeting the definition of heritage assets, a lessee is required to apply the disclosure requirements in paragraphs 55 and 56 of Section 34 (refer to Chapter 36 at 5.4.4). In that case, a lessee is not required to provide the disclosures required by paragraphs 80(e) (income from subleasing right-of-use assets) and 81 (see above) of Section 20 for those right-of-use assets. *[FRS 102.20.84]*.
- If a lessee measures right-of-use assets at revalued amounts applying Section 17, the lessee is required to provide the disclosures required by paragraphs 31(a) and 32A of Section 17 (refer to Chapter 20 at 3.10.1) for those right-of-use assets. *[FRS 102.20.85]*.

In addition to the lessee disclosures required by Section 20, UK Company Law (i.e., the Regulations) and the LLP Regulations require disclosure, for the aggregate of all items shown under 'creditors' in the entity's balance sheet (Statement of Financial Position), of the following:

- The amount of any debts included under creditors which are payable or repayable otherwise than by instalments and fall due for payment or repayment after the end of the period of five years beginning with the day next following the end of the financial year.

And

- In the case of any debts so included which are payable or repayable by instalments, the amount of any instalments which fall due for payment after the end of that period. *[1 Sch 61(1), 1 Sch 59(1)(LLP)]*.

'Creditors', for the requirements above, will include lease liabilities.

7 Requirements of Section 20 for leases: Lessor accounting

7.1 Lease classification

Extract from FRS 102

20.86 A lessor shall classify each of its leases as either an operating lease or a finance lease.

20.87 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

[FRS 102.20.86, FRS 102.20.87]

At inception, lessors classify all leases as finance leases or operating leases. [FRS 102.20.91]. Lease classification determines how and when a lessor recognises lease income and what assets are recorded. The criteria used for lease classification are discussed in detail below.

7.1.1 Criteria for lease classification

The classification of leases in Section 20 is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract. Section 20 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
 - The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised.
 - The lease term is for the major part of the economic life of the asset even if title is not transferred.
 - At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the asset.
 - The asset is of such a specialised nature that only the lessee can use it without major modifications.
- [FRS 102.20.88].

Section 20 does not provide quantitative indicators or thresholds for the assessment of the terms 'major part' and 'substantially all' to determine that a lease should be classified as a finance lease rather than as an operating lease. Under Section 20, entities apply qualitative, rather than quantitative, assessments to determine whether the risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. Accordingly, assessing whether a lease term is for the major part of the economic life of an asset or whether the present value of the lease payments amounts to at least substantially all of the fair value of a leased asset is a matter of judgement.

Similarly, determining whether the exercise price in a lessee's option to purchase the underlying asset is expected to be 'sufficiently lower' than the fair value of the underlying asset at the date the option becomes exercisable, is a matter of judgement and depends on the facts and circumstances of the particular lease.

Paragraph 88 of Section 20 is clear that these are "Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease". [FRS 102.20.88].

Consequently, it is possible that the existence of certain of the situations, on their own, may determine the classification of a lease, whereas other leases may need to be evaluated in combination with other situations or indicators. The overriding consideration is whether the lease transfers from the lessor to the lessee substantially all the risks and rewards incidental to ownership of an underlying asset.

Section 20 also lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a finance lease:

- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease).
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent. [FRS 102.20.89].

Assessing the substance of the transaction involves considering all relevant factors. This includes considering the probability of different gain and loss outcomes relating to the residual accruing to the lessee and is not limited to the maximum possible amount at risk.

Illustration 7-1: Gains and losses from the fluctuation in the fair value of the residual

At the end of a lease, the underlying asset (the item of equipment) of a lease will be disposed of. The lessee is entitled to a rent rebate equalling 100% of the sales proceeds with a cap of £1,000. The distribution of the probability of the sales proceeds is as follows:

Sales proceeds	Probability %
Up to £1,000	95
£1,000 to £2,000	5
Over £2,000	0

Analysis: The sales proceeds could be as high as £2,000 and the rent rebate is capped at £1,000. However, the probability assessment suggests that it would be unlikely for the sales proceeds to exceed the capped amount. Therefore, it would be appropriate to conclude the gains or losses from the fluctuation in the fair value of the residual generally accrue to the lessee.

The examples and indicators in paragraphs 88 and 89 of Section 20 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease. For example, this may be the case if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards. [FRS 102.20.90].

How we see it

In our view, other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

Section 20 contains specific requirements relating to classification of subleases by an intermediate lessor as finance or operating leases (refer to 8.2 below).

7.1.2 Lease classification test for land and buildings

Section 20 does not include any specific guidance in respect of contracts that involve the right to use land and land improvements (e.g., buildings). In contrast, IFRS 16 does include specific guidance which requires a lessor to classify (refer to 7.1 above) and account for the right to use land as a separate lease component, unless the accounting effect of doing so is immaterial to the lease. [IFRS 16.B57]. Despite the absence of an equivalent paragraph in Section 20, the general requirements around identifying and separating lease components are similar to IFRS 16, and we would therefore expect entities applying Section 20 to identify and account for land and building components separately using the guidance in 4.2.1 above.

Separation of the land may not be necessary when the amount that would be recognised for the land lease component is immaterial to the lease.

7.1.3 Residual value guarantees included in the lease classification test

As discussed at 5.5.7 above, for lessors, lease payments are defined to include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. [FRS 102 Appendix I]. Therefore, in evaluating the lease classification criteria in Section 20, lessors are required to include in the 'substantially all' test any (i.e., the maximum obligation) residual value guarantees provided by both lessees and any other third party unrelated to the lessor.

7.1.4 Reassessment of lease classification

Lease classification is made at the inception date and is reassessed only if there is a lease modification (refer to 7.5 below). Changes in estimates (e.g., changes in estimates of the economic life or residual value of the underlying asset), or changes in circumstances (e.g., default by the lessee), do not give rise to a new classification of a lease for accounting purposes. [FRS 102.20.91].

7.2 Key concepts applied by lessor

Extract from FRS 102

Appendix I

gross investment in the lease	The aggregate of: (a) the lease payments receivable by a lessor under a finance lease; and (b) any unguaranteed residual value accruing to the lessor.
Interest rate implicit in the lease	The rate of interest that causes the present value of: (a) the lease payments; and (b) the unguaranteed residual value to equal the sum of: (i) the fair value of the underlying asset; and (ii) any initial direct costs of the lessor.
net investment in the lease	The gross investment in the lease discounted at the interest rate implicit in the lease.
unguaranteed residual value	That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

At lease commencement, lessors apply the key concepts described in 5 above such as determining the initial direct costs, lease term, lease payments, fair value of the underlying asset and the interest rate implicit in the lease. Lessors also apply the following lessor accounting concepts to recognise and measure their leases.

Gross investment in the lease

The lessor's gross investment in a finance lease consists of the following undiscounted amounts:

- Lease payments receivable by the lessor under a finance lease (refer to 5.5 above).
- Any unguaranteed residual value accruing to the lessor - the unguaranteed residual value is the portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

Net investment in the lease

A lessor's net investment in a finance lease consists of the gross investment in the lease discounted at the interest rate implicit in the lease.

7.3 Finance leases

7.3.1 Initial recognition and measurement

Extract from FRS 102

Recognition and measurement

- 20.93** At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Initial measurement

- 20.94** The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease.

- 20.95** Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

Initial measurement of the lease payments included in the net investment in the lease

- 20.96** At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:
- (a) fixed payments (including in-substance fixed payments as described in paragraph 20.52), less any lease incentives payable;
 - (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 20.53);
 - (c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;
 - (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs 20.40 to 20.42); and
 - (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

[FRS 102.20.93, FRS 102.20.94, FRS 102.20.95, FRS 102.20.96]

Illustration 7-2: The lessor's gross and net investment in the lease

Details of a non-cancellable lease are, as follows:

- The asset has a fair value of £10,000
- The lessee is required to make five annual rentals payable in advance of £2,100
- The unguaranteed estimated residual value at the end of five years is £1,000
- There is no guaranteed residual value

The lessor's direct costs have been excluded for simplicity.

The interest rate implicit in the lease is that which gives a present value of £10,000 for the five rentals plus the total estimated unguaranteed residual value at the end of year 5. This rate is 6.62%.

Year	Net investment in the lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods	Net investment in the lease at end of period
	£	£	£	£	£	£
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	-	1,000
		<u>10,500</u>	<u>1,500</u>			

The lessor's gross investment in the lease is the total rents receivable of £10,500 and the unguaranteed residual value of £1,000. The gross earnings are therefore £1,500.

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of £7,300 is three years' rental of £2,100 plus the unguaranteed residual of £1,000. The net investment, which is the amount at which the debtor will be recorded in the statement of financial position, is £7,300 less the earnings allocated to future periods of £558 = £6,742.

At lease commencement, a lessor accounts for a finance lease, as follows:

- Derecognises the carrying amount of the underlying asset.
- Recognises the net investment in the lease.

And

- Recognises, in profit or loss, any selling profit or selling loss.

For finance leases (other than those involving manufacturer and dealer lessors - refer to 7.3.2 below), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the interest rate implicit in the lease and are not added separately. [FRS 102.20.95].

The net investment in the lease is initially measured as the sum of: (1) the present value of both the lease payments (refer to 5.5 above); and (2) the present value of the unguaranteed residual asset, both discounted using the interest rate implicit in the lease (refer to 5.6 above).

7.3.2 Manufacturer or dealer lessors

Extract from FRS 102

- 20.97** At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:
- (a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;
 - (b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value; and
 - (c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which Section 23 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in Section 23.

[FRS 102.20.97]

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts. [FRS 102.20.98].

Manufacturer or dealer lessors sometimes quote artificially low rates of interest to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged. [FRS 102.20.99].

Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

[FRS 102.20.100].

As Section 20 contains no specific requirements to deal with leases that have become onerous after inception but before the commencement date, the requirements in Section 21 apply to those contracts.

Illustration 7-3: Manufacturer or dealer lessors

A company manufactures specialised machinery. The company offers customers the choice of either buying or leasing the machinery. A customer chooses to lease the machinery. Details of the arrangement are, as follows:

- The lease commences on 1 January 20X6 and lasts for three years.
- The lessee is required to make three annual rentals payable in arrears of £57,500.
- The leased machinery is returned to the lessor at the end of the lease.
- The fair value of the machinery is £150,000, which is equivalent to the selling price of the machinery.
- The machinery cost £100,000 to manufacture. The lessor incurred costs of £2,500 to negotiate and arrange the lease.
- The expected useful life of the machinery is 3 years. The machinery has an expected residual value of £10,000 at the end of year three.
- The interest rate implicit in the lease is 10.19%.

The lessor classifies the lease as a finance lease.

The cost to the lessor of providing the machinery for lease consists of the book value of the machinery (£100,000), plus the initial direct costs associated with entering into the lease (£2,500), less the future income expected from disposing of the machinery at the end of the lease (the present value of the unguaranteed residual value of £10,000, being £7,475). This gives a cost of sale of £95,025.

The lessor records the following entries at the commencement of the lease:

Dr	Net investment in the lease	£150,000	
Dr	Cost of sales	£95,025	
	Cr	Inventory	£100,000
	Cr	Revenue	£142,525
	Cr	Creditors/cash (initial direct costs)	£2,500

The sales profit recognised by the lessor at the commencement of the lease is therefore £47,500 (£142,525 - £95,025). This is equal to the fair value of the machinery of £150,000, less the book value of the machinery (£100,000) and the initial direct costs of entering into the lease (£2,500). Revenue is equal to the net investment in the lease (£150,000), less the present value of the unguaranteed residual value (£7,475).

Lease payments received from the lessee will then be allocated over the lease term, as follows:

Year	Net investment in the lease at the start of the year (£)	Lease payments (£)	Interest income (10.19% per annum) (£)	Decrease in net investment in the lease (£)	Net investment in the lease at the end of the year (£)
	(a)	(b)	(c)	(d)=(b)-(c)	(e)=(a)-(d)
1	150,000	57,500	15,280	42,220	107,780
2	107,780	57,500	10,980	46,520	61,260
3	61,260	57,500	6,240	51,260	10,000

The lessor will record the following entries:

Year 1

Dr	Cash	£57,500	
	Cr	Lease receivable	£42,220
	Cr	Interest income	£15,280

Year 2

Dr	Cash	£57,500	
	Cr	Lease receivable	£46,520
	Cr	Interest income	£10,980

Year 3

Dr	Cash	£57,500	
	Cr	Lease receivable	£51,260
	Cr	Interest income	£6,240

At the end of the three-year lease term, the leased machinery will be returned to the lessor, who will record the following entries:

Dr	Inventory	£10,000	
	Cr	Lease receivable	£10,000

7.3.3 Subsequent measurement

Extract from FRS 102

20.101 A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.

20.102 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the gross investment in the lease to reduce both the principal and the unearned finance income.

After lease commencement, a lessor accounts for a finance lease, as follows:

- Recognises finance income (in profit or loss) over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease (i.e., using the interest rate implicit in the lease. [FRS 102.20.101].
- Applies the lease payments relating to the period against the gross investment in the lease to reduce both the principal and the unearned finance income. [FRS 102.20.102]. This means that the lessor reduces the net investment in the lease for lease payments received (net of finance income calculated above).
- Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned. [FRS 102.20.116(a)(iii)].

- Applies the relevant derecognition and impairment requirements, depending on the accounting policy choice made under paragraph 2 of Section 11 and Section 12 of FRS 102 (refer to Chapter 13). [FRS 102.20.103]. A lessor must regularly review estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor revises the income allocation over the lease term and recognises immediately any reduction in respect of amounts accrued (refer to 7.3.4 below). [FRS 102.20.103].

7.3.4 Unguaranteed residual values

Income recognition by lessors can be extremely sensitive to the amount recognised as the asset's residual value. This is because the amount of the residual value directly affects the computation of the amount of finance income earned over the lease term - this is shown in Illustration 7-4 below. Section 20 gives no guidance regarding the estimation of unguaranteed residual values, but it does require them to be reviewed regularly. If there has been a reduction in the estimated value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately. [FRS 102.20.103].

Illustration 7-4: Reduction in residual value

At lease commencement, the lessor accounts for the finance lease, as follows:

Details of a non-cancellable lease are:

- The asset has a fair value of £10,000
- The lessee is required to make five annual rentals payable in advance of £2,100
- The unguaranteed estimated residual value at the end of five years is £1,000

The lessor's direct costs have been excluded for simplicity.

Year	Net investment in lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods	Net investment in lease at end of period
	£	£	£	£	£	£
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	-	1,000
		10,500	1,500			

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of £7,300 is three years' rental of £2,100 plus the unguaranteed residual of £1,000. The net investment, which is the amount that will be recorded in the statement of financial position, is £7,300 less the earnings allocated to future periods of £558 = £6,742. The gross earnings allocated to future periods is the total finance income of £1,500 less the finance income already recognised.

The lessor concludes at the end of year 2 that the residual value of the asset is only £500 and revises the income allocation over the lease term accordingly at the original discount rate of 6.62%.

Year	Net investment in lease at start of period	Rental received	Finance income (6.62% per annum)	Gross investment at end of period*	Gross earnings allocated to future periods	Net investment in lease at end of period
	£	£	£	£	£	£
2	8,423	2,100	419	6,800	471	6,329
3	6,329	2,100	280	4,700	191	4,509
4	4,509	2,100	160	2,600	31	2,569
5	2,569	2,100	31	500	-	500

* The gross investment in the lease now takes account of the revised unguaranteed residual of £500, rather than the original £1,000.

The lessor will have to write off £413, being the difference between the carrying amount of the receivable and the revised balance above (£6,742 - £6,329). This is the present value as at the end of year 2 of £500 and represents the part of the unguaranteed residual written off.

7.3.5 Remeasurement of the net investment in the lease

After lease commencement, the net investment in a lease is remeasured when the following occurs:

- The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of its original terms and conditions), and the modified lease is not accounted for as a separate contract (refer to 7.5 below).
- The lease term is revised when there is a change in the non-cancellable period of the lease (refer to 5.4 above).

Or

- There is a change in the estimated unguaranteed residual value (refer to 7.3.4 above).

A lessor includes in its initial measurement of the net investment in the lease, variable lease payments that depend on an index or rate.

How we see it

Section 20 is silent on the accounting for any subsequent changes in future cash flows resulting from a change in an index or rate or variable lease payments becoming in-substance fixed. In the absence of further guidance, we believe lessors have an accounting policy choice regarding whether variable lease payments that depend on an index or rate are remeasured.

7.4 Operating leases

Under Section 20, lessors continue to recognise the underlying asset and do not recognise a net investment in the lease on the statement of financial position or initial profit (if any) in the income statement. The underlying asset continues to be accounted for in accordance with applicable accounting requirements (e.g., Section 17).

Lessors subsequently recognise lease payments as income over the lease term on a straight-line basis, unless either:

- Another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminishes.
- Or
- The lease payments are structured to increase in line with expected general inflation (based on published indices or statistics) to compensate for the lessor's expected inflationary cost increases. If the lease payments vary according to factors other than general inflation, then this condition is not met. [FRS 102.20.106].

Illustration 7-5: Lease payments containing fixed increments**Scenario A**

A lessor operates in a country in which the consensus forecast by local banks is that the general price level index, as published by the government, will increase by an average of 10% annually over the next five years. The lessor leases some office space to a lessee for five years under an operating lease. The lease payments are structured to reflect the expected 10% annual general inflation (cost and prices index (CPI)) over the five-year term of the lease as follows:

Year	Annual rental £
1	100,000
2	110,000
3	121,000
4	133,000
5	146,000

The lessor recognises annual lease income equal to the amounts charged to the lessee as shown above.

Scenario B

A lessor has entered into a lease under which the payments increase by 10% per annum, in order to correspond to the expected growth in the lessee's retail activity. The lease payments are the same as above. The increases in rental are not compensation for expected annual inflation. The lessor will recognise an annual lease income on a straight-line basis of £122,000 each year (the sum of the amounts payable under the lease divided by five years).

Scenario C

A lessor leases a property at an initial rent of £1,000,000 per annum. The lease has a non-cancellable term of 20 years and rent increases annually in line with the CPI of the country in which the property is situated but with a minimum increase of 2% and a maximum of 5% per annum. The estimated long-term rate of inflation in the country in question is 2.5%. The rental payment charged by the lessor, which will include a minimum increase of 2% per annum whatever the actual rate of inflation, will be recognised as income as incurred. The lessor will not be obliged to make a straight-line adjustment for the 2% minimum increase. The fixed minimum increment is considered to be a proxy for expected general inflation. It is reasonable to have a range rather than a single figure.

This analysis would be the same if the estimated long-term rate of inflation were some other figure within the range, e.g., 2% or 3%, as long as both the long-term rate and minimum and maximum increases were reasonable estimates in the circumstances of the country in question.

If the lessor pays the lessee an incentive to enter the lease, this is accounted for as described in 5.5.2 above. [FRS 102.20.106]. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) as they are earned.

[FRS 102.20.116].

A lessor recognises costs, including depreciation, incurred in earning the lease income as an expense. Section 20 also requires lessors of operating leases to defer initial direct costs at lease commencement and recognise them over the lease term on the same basis as lease income. [FRS 102.20.107, FRS 102.20.108].

The depreciation policy for depreciable underlying assets subject to operating leases must be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with Section 17 or Section 18. [FRS 102.20.109]. A lessor applies Section 27 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified. [FRS 102.20.110].

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale. [FRS 102.20.111].

7.5 Lease modifications

If a finance lease is modified (i.e., there is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and condition of the lease), the modification may result in:

- A separate lease (refer to 7.5.1.A below).

Or

- A change in the accounting for the existing lease (i.e., not a separate lease) (refer to 7.5.1.B below).

If an operating lease is modified, it is treated as a new lease from the effective date of the modification (refer to 7.5.2 below).

7.5.1 Modifications to a finance lease

7.5.1.A Determining whether a lease modification results in a separate lease

Extract from FRS 102

20.104 A lessor shall account for a modification to a finance lease as a separate lease if both:

- (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract. *[FRS 102.20.104].*

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original finance lease and a separate lease. Lessors account for the separate lease in the same manner as other new leases. If either of the conditions is not met, the lease modification does not result in a separate lease.

7.5.1.B Lessor accounting for a modification that does not result in a separate lease

If a finance lease is modified and does not result in a separate lease, lessors account for the modification depending on the classification of the modified lease. If the lease would have been classified as an operating lease had the modification been in effect at the inception date, lessors account for such modifications as the creation of a new lease that commences on the effective date of the modification. The carrying amount of the underlying asset is measured as the net investment in the original lease immediately before the effective date of the modification. Otherwise, the net investment in the lease is accounted for in accordance with the relevant requirements of Section 11 and 12, IAS 39 or IFRS 9 depending on the accounting policy choice made under paragraph 2 of Section 11 and Section 12. *[FRS 102.10.105].*

7.5.2 Modification to an operating lease

If an operating lease is modified and the arrangement continues to be or contains a lease, it is treated as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. *[FRS 102.20.112].* Accounting for the new lease includes identifying and separating the lease and non-lease components of the contract (refer to 4.2 above).

Upon modification, the classification criteria are reassessed (refer to 7.1 above). As a result, the new lease may be an operating lease or a finance lease.

Illustration 7-6 shows how the modification guidance is applied for a concession that involves the forgiveness of future lease payments.

Illustration 7-6: Forgiveness of future lease payments on an operating lease

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of £100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 20X8. The contract does not include any non-lease components, extension, termination or purchase options.

All lease payments due up to 30 June 20X6 have been received in a timely manner. On 30 June 20X6, in compensation for the partial closure of the shopping mall for major refurbishment, Lessor B agrees to forgive Restaurant A's future lease payments for the months of July, August and September 20X6.

Analysis:

The rent concession results in a decrease in the total lease payments. Thus, there has been a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, the rent concession constitutes a lease modification. The modification does not change the classification of the lease as an operating lease.

On the effective date of the modification (i.e., 30 June 20X6), Lessor B accounts for the modification as a new lease, as follows:

- The remaining lease payments under the modified lease comprise £1,700 (lease payments of £100 per month from October 20X6 to February 20X8).
- The remaining lease term is 20 months.
- The monthly operating lease income to be recognised over the remaining lease term is therefore $\text{£1,700} \div 20 \text{ months} = \text{£85}$.

In Illustration 7-6 above, lease payments had been received in a timely manner up until the date at which the lessor agreed to forgive specified future payments. If this had not been the case and the lessor agreed also to legally release the lessee from its obligations in respect of contractually due but not paid lease payments (i.e., those for which an operating lease receivable was recognised by the lessor), the lessor would apply the impairment and derecognition requirements of Section 11 and 12, IAS 39, or IFRS 9 to that operating lease receivable, depending on the accounting policy choice made under paragraph 2 of Section 11 and Section 12. [FRS 102.11.7(c), IAS 39.2, IFRS 9.2.1(b)]. (Refer to Chapter 13 for further discussion of impairment of financial assets). Therefore, in accounting for a rent concession in respect of an operating lease, a lessor applies:

- The derecognition requirements in Section 11 and 12, IAS 39 or IFRS 9 to forgiven lease payments that the lessor has recognised as an operating lease receivable.
- And
- The lease modification requirements in Section 20 to forgiven lease payments that the lessor has not recognised as an operating lease receivable.

This approach is consistent with conclusions reached by the IFRS IC in September 2022 when discussing the application of IFRS 16 and IFRS 9 to a fact pattern in which a rent concession is agreed by a lessor and a lessee, which changes the original terms and conditions of a lease contract that is classified by the lessor as an operating lease.¹¹⁰

7.6 Other lessor matters

7.6.1 Impairment of the net investment in the lease

Extract from FRS 102

20.103 A lessor shall apply the relevant derecognition and impairment requirements, depending on the accounting policy choice made under paragraphs 11.2 and 12.2, to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

¹¹⁰ [IFRS - IFRIC Update September 2022](#)

Lessors evaluate their net investment in the lease for impairment by applying the relevant derecognition and impairment requirements of Section 11, Section 12, IAS 39 or IFRS 9, depending on the accounting policy choice made under paragraph 2 of Section 11 and Section 12. *[FRS 102.20.103]*.

7.6.2 Portfolio application

Section 20 specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply it to a portfolio of leases with similar characteristics (e.g., a similar lease term for a similar class of underlying asset in a similar economic environment). If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio. *[FRS 102.20.13]*.

7.7 Presentation

Lessors recognise assets held under a finance lease in the statements of financial position and present them as a receivable at an amount equal to the net investment in the lease. *[FRS 102.20.93]*. In addition, lessors are required under Section 20 to present underlying assets subject to operating leases according to the nature of that asset in the statement of financial position. *[FRS 102.20.113]*.

The net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in the statement of financial position (refer to Chapter 6).

7.8 Lessor disclosures

Extract from FRS 102

20.114 A lessor shall disclose a general description of its significant leasing arrangements, including, if necessary to enable users to understand those arrangements, information about variable lease payments, renewal or purchase options and escalation clauses, subleases, and restrictions imposed by lease arrangements.

20.115 If necessary to enable users to understand its significant leasing arrangements, a lessor shall disclose additional qualitative and quantitative information.

20.116 A lessor shall disclose the following amounts for the reporting period:

- (a) for finance leases:
 - (i) selling profit or loss;
 - (ii) finance income on the net investment in the lease; and
 - (iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.
- (b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate. *[FRS 102.114, FRS 102.115, FRS 102.116]*

In addition to the disclosure requirements of paragraphs 114 to 116 of Section 20 shown above, Section 20 also requires that:

For finance leases, a lessor must:

- Provide a qualitative and quantitative explanation of the significant changes during the reporting period in the carrying amount of the net investment in finance leases. *[FRS 102.20.117]*.
- Disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor must reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value. A lessor also discloses the accumulated allowance for uncollectible lease payments receivable. *[FRS 102.20.118]*.

For operating leases, a lessor must:

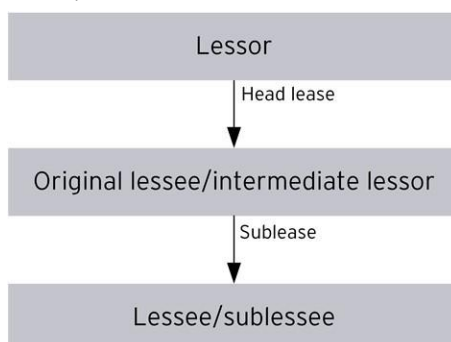
- Apply the disclosure requirements of Section 17 for items of property, plant and equipment subject to an operating lease (refer to Chapter 20 at 3.10.1). In applying the disclosure requirements of Section 17, a lessor must disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases. Accordingly, a lessor provides the disclosures required by Section 17 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor. *[FRS 102.20.119]*.
- Apply the disclosure requirements in Section 16 (refer to Chapter 19 at 4.3), Section 18 (refer to Chapter 21 at 3.4), Section 27 (refer to Chapter 29 at 9), and Section 34 (refer to Chapter 36) for assets subject to operating leases. *[FRS 102.20.120]*.
- Disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. *[FRS 102.20.121]*.

8 Requirements of Section 20 for subleases

8.1 Definition

The term 'sublease' is not defined in Section 20 or in the FRS 102 glossary. However, the term is defined in IFRS 16 as "A transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect", [IFRS 16.Appendix A], and this is consistent with how the term is commonly understood.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor or sublessor, and the ultimate lessee is often referred to as the sublessee.



In some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the original lease, but the original lessee remains the primary obligor under the original lease.

8.2 Intermediate lessor accounting

Extract from FRS 102

- 20.12** If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.
- 20.92** In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:
- (a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 20.6, the sublease shall be classified as an operating lease.
 - (b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (eg the item of property, plant or equipment that is the subject of the lease).

If an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease. That is, the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria in 7.1.1 above by reference to the right-of-use asset in the head lease (and not the underlying asset of the head lease). [FRS 102.20.92].

Illustration 7-1: Classification of a sublease

Entity F (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 30 years. Entity F subleases the building for four years. The sublease is classified with reference to the right-of-use asset in the head lease (and not the underlying building). For example, when assessing the useful life criterion, the sublease term of four years is compared with five year right-of-use asset in the head lease and not with 30-year economic life of the building which may result in the sublease being classified as a finance lease.

The intermediate lessor accounts for the sublease as follows:

- If the sublease is classified as an operating lease, the original lessee continues to account for the lease liability and right-of-use asset on the head lease like any other lease (refer to 6 above). If the total remaining carrying amount of the right-of-use asset on the head lease exceeds the anticipated sublease income, this may indicate that the right-of-use asset associated with the head lease is impaired. A right-of-use asset is assessed for impairment under Section 27.
- If the sublease is classified as a finance lease, the original lessee derecognises the right-of-use asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model (refer to 6 above). The original lessee, as the sublessor, recognises a net investment in the sublease and evaluates it for impairment (refer to 7.6.1 above).

In a sublease, an intermediate lessor may use the discount rate for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined. [FRS 102.20.94].

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for combining contracts (e.g., when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a single combined transaction (refer to 4.3 above).

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset even when the criteria, as discussed in 6.1.2 above, are satisfied.

Section 20 does not provide examples of the application of the subleasing requirements. The following two Illustrations have been based on illustrative examples included in IFRS 16, and provide examples of applying the requirements to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset. [IFRS 16.IE8, IFRS 16.IE Example 20, IFRS 16.IE Example 21].

Illustration 8-1: Accounting for a sublease by an intermediate lessor

Scenario A

An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor). At the beginning of Year 3, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sublessee.

Analysis: The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as a finance lease, having considered the requirements in FRS 102.20.86-91. It is noted in this case that as the sublease is for the entire remaining term of the headlease.

When the intermediate lessor enters into the sublease, the intermediate lessor:

- Derecognises the right-of-use asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease.
- Recognises any difference between the right-of-use asset and the net investment in the sublease in profit or loss.

And

- Retains the lease liability relating to the head lease in its statement of financial position, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both finance income on the sublease and interest expense on the head lease.

Scenario B

An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor). At commencement of the head lease, the intermediate lessor subleases the 5,000 square metres of office space for two years to a sublessee.

Analysis: The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as an operating lease, having considered the requirements in FRS 102.20.86-91. In this case, it is noted that the sublease is entered into at the beginning of the term of the headlease and is for a period of two years. Therefore the term of the sublease is not for the major part of the economic life of the right-of-use asset.

When the intermediate lessor enters into the sublease, the intermediate lessor retains the lease liability and the right-of-use asset relating to the head lease in its statement of financial position.

During the term of the sublease, the intermediate lessor:

- Recognises a depreciation charge for the right-of-use asset and interest on the lease liability.
- And
- Recognises lease income from the sublease.

8.3 Sublessee accounting

A sublessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to Section 20's recognition and measurement provisions) (refer to 6 above).

8.4 Presentation

Following paragraph 96 of Section 2, an entity cannot offset assets and liabilities or income and expenses, unless required or permitted by FRS 102. [FRS 102.2.96]. Therefore, intermediate lessors are not permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirements in FRS 102 for offsetting. Similarly, intermediate lessors are not permitted to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, unless the requirements for offsetting in FRS 102 are met. For example, intermediate lessors apply the principal-versus-agent application guidance in Section 23 to determine whether sublease revenue needs to be presented on a gross or net basis (i.e., reduced for head lease expenses).

How we see it

We believe that intermediate lessors generally will not meet the requirements in Section 23 to present sublease income on a net basis and therefore, will generally present sublease revenue on a gross basis.

8.5 Disclosure

Under Section 20, entities including intermediate lessors are required to disclose a general description of its significant leasing arrangements, which, if necessary to enable users to understand those arrangements must include information about subleases. There are also specific lessor and lessee disclosure requirements which apply equally to intermediate lessors (refer to 6.8 for lessees and 7.8 for lessors, respectively).

9 Requirements of Section 20 for sale and leaseback transactions

Extract from FRS 102

20.122 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease applying paragraphs 20.123 to 20.126.

[FRS 102.20.122]

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Because Section 20 requires lessees to recognise most leases on the statement of financial position, sale and leaseback transactions may no longer provide lessees with a source of off-balance sheet financing. Both the seller-lessee and the buyer-lessor are required to apply Section 23 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

The presentation in the statement of cash flows of sale and leaseback transactions is discussed in Chapter 7 at 3.8.4.

9.1 Determining whether the transfer of an asset is a sale

The accounting for a sale and leaseback transaction by both the buyer-lessor and the seller-lessee depends on whether the transfer of the asset by the seller-lessee satisfies the requirements of Section 23 to be accounted for as a sale of the asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale or purchase of the asset and a lease. If not, both the seller-lessee and the buyer-lessor account for the transaction as a financing transaction (in substance, the 'buyer' has provided finance to the 'seller' with the asset as security). Refer to Chapter 25 at 8 for determining when a performance obligation is satisfied under requirements of Section 23.

Section 23 includes the following to help entities determine whether control of the asset has been transferred. [FRS 102.23.78-FRS 102.23.80, FRS 102.23.85].

Extract from FRS 102

23.78 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service.

23.79 For each performance obligation identified, an entity shall determine at contract inception whether the performance obligation is satisfied over time (in accordance with paragraphs 23.81 to 23.84) or satisfied at a point in time (in accordance with paragraphs 23.85 to 23.89).

23.80 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining economic benefits that may flow from, the asset.

Performance obligations satisfied at a point in time

23.85 If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset, an entity shall consider indicators of the transfer of control, which include but are not limited to, the following:

- (a) the entity has a present right to payment for the asset;
- (b) the customer has legal title to the asset;
- (c) the entity has transferred physical possession of the asset;
- (d) the customer has the significant risks and rewards of ownership of the asset; and
- (e) the customer has accepted the asset (see paragraphs 23.88 to 23.89).

None of the indicators above individually determine whether the buyer-lessor has obtained control of the underlying asset. Both the seller-lessee and the buyer-lessor must consider all relevant facts and circumstances to determine whether control has transferred. Furthermore, not all of the indicators must be present to determine that the buyer-lessor has gained control. Rather, the indicators are factors that are

often present when a customer has obtained control of an asset, and the list is meant to help entities apply the principle of control (refer to Chapter 25).

In considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback.

It should be noted that the existence of a leaseback, in isolation, does not preclude a sale. This is because a lease is different from the sale or purchase of an underlying asset, as a lease does not transfer control of the underlying asset. Instead, it transfers the right to control the use of the underlying asset for the period of the lease.

When assessing whether a customer obtains control of an asset, entities are required to consider any repurchase agreements. [FRS 102.23.90]. Under Section 23, if a selling entity has an obligation or a right to repurchase an asset (a forward or a call option), the selling entity cannot recognise revenue as the customer has not obtained control of the asset. In such a case, the entity is required to account for the contract as either:

- A lease in accordance with Section 20 if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset. As an exception, the entity shall account for the contract in accordance with the general sale and leaseback requirements in paragraph 122 of Section 20 if the contract forms part of a sale and leaseback transaction.
- Or
- A financing arrangement if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset. [FRS 102.23.92].

Since paragraph 92 of Section 23 specifies that where the seller has a forward or call option, the customer does not obtain control of the asset, applying the sale and leaseback requirements under paragraph 122 of Section 20, the entity would account for the transaction as a transfer that does not result in a sale, under paragraph 126 of Section 20 (refer to 9.3 below).

9.2 Transactions in which the transfer of an asset is a sale

Extract from FRS 102

Transfer of the asset is a sale

- 20.123** If the transfer of an asset by the seller-lessee satisfies the requirements of Section 23 to be accounted for as a sale of the asset:
- (a) the seller-lessee shall make an accounting policy choice, which it shall apply consistently, to either:
 - i. measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor; or
 - ii. measure the right-of-use asset arising from the leaseback in accordance with paragraph 20.46, with any excess of the sale proceeds over the previous carrying amount of the asset deferred, and amortised over the lease term, and any shortfall of the sales proceeds under the carrying amount recognised immediately in profit or loss
 - (b) the buyer-lessor shall account for the purchase of the asset applying other sections of this FRS, and for the lease applying the lessor accounting requirements in this section.
- 20.124** If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:
- (a) any below-market terms shall be accounted for as a prepayment of lease payments; and
 - (b) any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.
- 20.125** The entity shall measure any potential adjustment required by paragraph 20.124 on the basis of the more readily determinable of:
- (a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and
 - (b) the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

[FRS 102.20.123, FRS 102.20.124, FRS 102.20.125]

9.2.1 Accounting for the sale

If the transfer of the asset is a sale, the seller-lessee has an accounting policy choice which it must apply consistently, to either:

- Measure the right-of-use asset at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Under this approach the seller-lessee recognises the amount of any gain or loss that relates to the rights transferred to the buyer-lessor in profit or loss (refer to 9.2.1.A below).
- Or
- Measure the right-of-use asset arising from the leaseback at cost in accordance with the general principles of initial measurement in paragraph 46 of Section 20 (refer to 6.2.1 above). Under this approach, any excess of the sale proceeds over the previous carrying amount of the asset is deferred and amortised to profit or loss over the lease term. Any shortfall of the sales proceeds under the carrying amount is recognised immediately in profit or loss (refer to 9.2.1.B below). [FRS 102.20.123(a)].

The first of the two options above is similar to the sale and leaseback requirements under IFRS 16. IFRS 16 does not offer an accounting policy choice, and therefore a GAAP difference arises between UK GAAP and IFRS where a UK GAAP reporter makes the policy choice to apply paragraph 123(a)(ii) of Section 20.

A buyer-lessor accounts for the purchase of the asset in accordance with other standards based on the nature of the asset (e.g., Section 17 for property, plant and equipment).

9.2.1.A Accounting for the sale – policy of measuring the right-of-use asset at the proportion of the previous carrying amount that relates to the right of use retained

If the transfer of the asset is a sale, and the seller-lessee makes the accounting policy choice to apply the requirements of paragraph 123(a)(i) of Section 20 to its sale and leaseback transactions, the seller-lessee will:

- Derecognise the underlying asset.
- Recognise the gain or loss, if any, that relates to the rights transferred to the buyer-lessor and adjust for off-market terms.

How we see it

Where a seller lessee takes the accounting policy choice to apply the requirements of paragraph 123(a)(i) of Section 20, the seller-lessee is required to measure the right-of-use asset from the leaseback at the portion of the previous carrying amount of the asset that relates to the right of use retained, but Section 20 does not prescribe how the portion retained should be measured. Therefore, judgement may be required to measure the portion retained. FRS 102 does not provide any examples of how this approach might be applied, but entities may refer to Examples 24 and 25 in IFRS 16 which show methodologies for determining the gain on sale. Refer to 9.2.4 below.

Frequently asked questions

Question 9-1: When the lease payments relating to a leaseback are totally variable and not based on an index or rate, how is 'the proportion of the previous carrying amount of the asset that relates to right-of-use retained by the lessee' determined?

The IFRS IC issued an agenda decision in June 2020 related to a sale and leaseback transaction with variable payments. Whilst IFRS IC agenda decisions do not apply directly to entities reporting under FRS 102, the following discussion and example may be useful to entities applying FRS 102 who are considering a similar fact pattern and have made the accounting policy choice to apply the requirements of paragraph 123(a)(i) of Section 20 to their sale and leaseback transactions.

In the transaction described in the request, an entity (seller-lessee) enters into a sale and leaseback transaction whereby it transfers an item of property to another entity (buyer-lessor) and leases the asset back for five years. The transfer of the property satisfies the requirements in IFRS 15 (which contains similar principles to Section 23) to be accounted for as a sale of the property. The amount paid by the buyer-lessor to the seller-lessee in exchange for the property equals the property's fair value at the date of the transaction. Payments for the lease (which are at market rates) include variable payments (not based on an index or rate), calculated as a percentage of the seller-lessee's revenue generated using the property during the five-year lease term. The seller-lessee has determined that the variable payments are not in-substance fixed payments as described in IFRS 16 (such payments are similarly not expected to be in-substance fixed payments under Section 20). The request asked how, in the transaction described, the seller-lessee measures the right-of-use asset arising from the leaseback and determines the amount of any gain or loss recognised at the date of the transaction.

The IFRS IC observed that the requirements applicable to the transaction described in the request are in paragraph 100 of IFRS 16. Paragraph 100 states that, "If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset: (a) the seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor." [IFRS 16.100]. This requirement is substantially the same as the requirement set out in paragraph 123(a)(i) of Section 20.

Consequently, to measure the right-of-use asset arising from the leaseback, the seller-lessee determines the proportion of the property transferred to the buyer-lessor that relates to the right of use retained. It does so by comparing, at the date of the transaction, the right of use it retains via the leaseback to the rights comprising the entire property. IFRS 16 (and similarly, Section 20 of FRS 102) does not prescribe a method for determining that proportion. In the transaction described in the request, the seller-lessee could determine the proportion by comparing, for example: (a) the present value of expected lease payments (including those that are variable and not based on an index or rate); with (b) the fair value of the property at the date of the transaction.

The gain or loss the seller-lessee recognises at the date of the transaction is a consequence of its measurement of the right-of-use asset arising from the leaseback. Because the right of use the seller-

lessee retains is not remeasured as a result of the transaction (it is measured as a proportion of the property's previous carrying amount), the amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. Applying paragraph 53(i) of IFRS 16, the seller-lessee discloses gains or losses arising from sale and leaseback transactions. Disclosure of gains or losses arising from sale and leaseback transactions is also required by paragraph 80(g) of Section 20.

The seller-lessee also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the liability is a consequence of how the right-of-use asset is measured - and the gain or loss on the sale and leaseback transaction determined - applying paragraph 100(a) of IFRS 16 (or for a UK GAAP reporter, paragraph 123(a)(i) of Section 20).

The extract below provides an illustrative example included in the June 2020 IFRIC update. Given the similarities between the requirements of paragraph 100(a) of IFRS 16 and paragraph 123(a)(i) of Section 20, this example is expected to be equally informative for entities applying FRS 102.

Illustration 9-1: Sale and leaseback with variable payments - extract from June 2020 IFRIC update

Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset (PPE) to Buyer-lessor, and leases that PPE back for five years. The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.

The carrying amount of the PPE in Seller-lessee's financial statements at the date of the transaction is CU1,000,000, and the amount paid by Buyer-lessor for the PPE is CU1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the PPE during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is CU450,000. There are no initial direct costs.

Seller-lessee determines that it is appropriate to calculate the proportion of the PPE that relates to the right of use retained using the present value of expected payments for the lease. On this basis, the proportion of the PPE that relates to the right of use retained is 25%, calculated as CU450,000 (present value of expected payments for the lease) ÷ CU1,800,000 (fair value of the PPE). Consequently, the proportion of the PPE that relates to the rights transferred to Buyer-lessor is 75%, calculated as (CU1,800,000 – CU450,000) ÷ CU1,800,000.

Applying IFRS 16.100(a), Seller-lessee:

- Measures the right-of-use asset at CU250,000, calculated as CU1,000,000 (previous carrying amount of the PPE) × 25% (proportion of the PPE that relates to the right of use it retains).
- Recognises a gain of CU600,000 at the date of the transaction, which is the gain that relates to the rights transferred to Buyer-lessor. This gain is calculated as CU800,000 (total gain on sale of the PPE (CU1,800,000 - CU1,000,000)) × 75% (proportion of the PPE that relates to rights transferred to Buyer-lessor).

Applying IFRS 16.100(a), the right-of-use asset would not be measured at zero at the date of the transaction because zero would not reflect the proportion of the previous carrying amount of the PPE (CU1,000,000) that relates to the right of use retained by Seller-lessee.

At the date of the transaction, Seller-lessee accounts for the transaction as follows:

Dr	Cash	CU1,800,000	
Dr	Right-of-use asset	CU250,000	
	Cr	PPE	CU1,000,000
	Cr	Liability	CU450,000
	Cr	Gain on rights transferred	CU600,000

The IFRS IC concluded that the principles and requirements in IFRS 16, which are similar to those set out in Section 20, provide an adequate basis for an entity to determine, at the date of the transaction, the accounting for the sale and leaseback transaction described in the request and, therefore, decided not to add the matter to its standard-setting agenda.

How we see it

Although not explicitly stated in Section 20, we believe that if the sale and leaseback transaction is expected to result in a loss to the seller-lessee, that loss will not be deferred. In addition, the seller-lessee may also need to consider whether the underlying asset may have been impaired prior to the sale and leaseback transaction.

9.2.1.B Accounting for the sale – policy of measuring the right-of-use asset in accordance with FRS 102.20.46

If the transfer of the asset is a sale, and the seller-lessee makes the accounting policy choice to apply the requirements of paragraph 123(a)(ii) of Section 20 to its sale and leaseback transactions, the seller-lessee will:

- Derecognise the underlying asset.
And
- Defer any excess of the sales proceeds over the previous carrying amount of the asset, and amortise it to profit or loss over the lease term. Any shortfall of the sales proceeds under the carrying amount recognised immediately in profit or loss.

9.2.2 Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (refer to 6 and 7 above, respectively), with adjustments for any off-market terms. Specifically, a seller-lessee recognises a lease liability and right-of-use asset for the leaseback.

9.2.3 Adjustment for off-market terms

The sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the ensuing lease that are above or below the market rates. These off-market terms could distort the gain or loss on the sale and the recognition of lease expense and lease income for the lease. To ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are neither understated nor overstated, Section 20 requires adjustments for any off-market terms of sale and leaseback transactions, on the more readily determinable basis of the difference between the fair value of the consideration for the sale and the fair value of the asset and the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates. [FRS 102.20.125].

When the sale price is less than the underlying asset's fair value or the present value of the lease payments is less than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as an increase to the sales price and the initial measurement of the right-of-use asset as a lease prepayment. When the sale price is greater than the underlying asset's fair value or the present value of the lease payments is greater than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as a reduction in the sales price and an additional financing received from the buyer-lessor. [FRS 102.20.124].

Buyer-lessors are also required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments are recognised as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee. [FRS 102.20.125].

9.2.4 Illustrative Examples

Section 20 does not provide any examples of the accounting for sale and leaseback transactions. However, IFRS 16 provides two examples, Example 24 and Example 25 which illustrate how the accounting should be applied under IFRS 16. When considering the applicability of these examples to entities applying FRS 102, it is important to remember that IFRS 16 permits only one approach for the seller-lessee to measure the right-of-use asset in a sale and leaseback, which is aligned to the approach under paragraph 123(a)(i) of Section 20. Therefore, entities who have made an accounting policy choice to instead apply paragraph 123(a)(ii) of Section 20 would not follow the approach illustrated in those examples included in IFRS 16.

Illustration 9-2 provides a simple example of the application of the accounting requirements for a sale and leaseback under each of the policy choices available under Section 20:

Illustration 9-2: Sale and leaseback transaction which qualifies as a sale

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of £1,500,000, which is equal to the fair value of the building. Immediately before the transaction, the building is carried at a cost of £1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 10 years, with annual payments of £130,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of Section 23 to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. The interest rate implicit in the lease is 3.5 per cent per annum, which is readily determinable by Seller-lessee.

Scenario A: Seller-lessee has made the accounting policy choice to apply FRS 102.20.123(a)(i) when accounting for sale and leaseback transactions.

The present value of the annual payments (10 payments of £130,000, discounted at 3.5 per cent per annum) is £1,081,159.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 20.123(a)(i), at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee.

Seller-lessee determines the proportion of the asset it retains to be 72.1% by comparing the present value of the lease payments with the fair value of the property at the date of the transaction ($£1,081,159 \div £1,500,000$). Therefore, it calculates the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee as £720,773.

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of £139,614, calculated as follows. The total gain on sale of the building amounts to £500,000 ($£1,500,000 - £1,000,000$), of which:

- £360,386 ($£500,000 \times £1,081,159 \div £1,500,000$) relates to the right to use the building retained by Seller-lessee.

And

- £139,614 ($£500,000 \times (£1,500,000 - £1,081,159) \div £1,500,000$) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	£1,500,000
Right-of-use asset	£720,723
Building	£1,000,000
Lease liability	£1,081,159
Gain on rights transferred	£139,614

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	£1,500,000
Cash	£1,500,000

Scenario B: Seller-lessee has made the accounting policy choice to apply FRS 102.20.123(a)(ii) when accounting for sale and leaseback transactions.

The present value of the annual payments (10 payments of £130,000, discounted at 3.5 per cent per annum) is £1,081,159.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 20.123(a)(ii), at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at cost using the general principles of initial measurement in accordance with paragraph 46 of Section 20. In this example, the cost of the right-of-use asset is equal to the amount of the initial measurement of the lease liability as none of the other components of cost set out in paragraph 20.47(b)-(e) are relevant (i.e., there are no initial direct costs, dismantling costs, lease payments made in advance or lease incentives). As such, the seller-lessee measures the right-of-use asset arising from the leaseback at £1,081,159, an amount equal to the lease liability.

The total excess of the sales proceeds over the previous carrying amount of the asset is £500,000 (£1,500,000 - £1,000,000). This amount is deferred and amortised over the lease term.

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	£1,500,000	
Right-of-use asset	£1,081,159	
Building		£1,000,000
Lease liability		£1,081,159
Deferred income		£500,000

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	£1,500,000	
Cash		£1,500,000

The following Illustration has been based on IFRS 16 Example 24 and illustrates the approach to accounting for a lease at above market terms for an entity applying paragraph 123(a)(i) of Section 20: [IFRS 16.IE11, IFRS 16.IE Example 24]

Illustration 9-3: Sale and leaseback transaction with fixed payments and above-market terms - entity applying FRS 102.20.123(a)(i) (based on IFRS 16.IE Example 24)

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of £2,000,000. Immediately before the transaction, the building is carried at a cost of £1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of £120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of Section 23 to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback.

Seller-lessee has made the accounting policy choice to apply FRS 102.20.123(a)(i) when accounting for sale and leaseback transactions.

Analysis: The fair value of the building at the date of sale is £1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 124(b) of Section 20, the amount of the excess sale price of £200,000 (£2,000,000 - £1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of £120,000, discounted at 4.5 per cent per annum) is £1,459,200, of which £200,000 relates to the additional financing and £1,259,200 relates to the lease-corresponding to 18 annual payments of £16,447 and £103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 123(a)(i) of Section 20, at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee.

Seller-lessee determines the proportion of the asset it retains to be 69.995% by comparing the present value of the lease payments with the fair value of the property at the date of the transaction (£1,259,200 ÷ £1,800,000). Therefore, it calculates the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee as £699,555.

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of £240,355 calculated as follows. The total gain on sale of the building amounts to £800,000 (£1,800,000 - £1,000,000), of which:

- £559,645 (£800,000 × £1,259,200 ÷ £1,800,000) relates to the right to use the building retained by Seller-lessee.
- And
- £240,355 (£800,000 × (£1,800,000 - £1,259,200) ÷ £1,800,000) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	£2,000,000	
Right-of-use asset	£699,555	
Building		£1,000,000
Lease liability		£1,259,200
Financial liability		£200,000
Gain on rights transferred		£240,355

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	£1,800,000	
Financial asset	£200,000 (18 payments of CU16,447, discounted at 4.5 per cent per annum)	
Cash	£2,000,000	

After the commencement date, Buyer-lessor accounts for the lease by treating £103,553 of the annual payments of £120,000 as lease payments. The remaining £16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of £200,000 and (b) interest revenue.

The following Illustration sets out the accounting for the same fact pattern as Illustration 9-3 above for an entity who has instead made the accounting policy choice to apply paragraph 123(a)(ii) of Section 20.

Illustration 9-4: Sale and leaseback transaction with fixed payments and above-market terms - entity applying paragraph 123(a)(ii) of Section 20

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of £2,000,000. Immediately before the transaction, the building is carried at a cost of £1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of £120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of Section 23 to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback.

Seller-lessee has made the accounting policy choice to apply paragraph 123(a)(ii) of Section 20 when accounting for sale and leaseback transactions.

Analysis: The fair value of the building at the date of sale is £1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 124(b) of Section 20, the amount of the excess sale price of £200,000 (£2,000,000 - £1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of £120,000, discounted at 4.5 per cent per annum) is £1,459,200, of which £200,000 relates to the additional financing and £1,259,200 relates to the lease-corresponding to 18 annual payments of £16,447 and £103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 123(a)(ii) of Section 20, at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at cost using the general principles of initial measurement in accordance with paragraph 46 of Section 20. In this example, the cost of the right-of-use asset is equal to the amount of the initial measurement of the lease liability as none of the other components of cost set out in paragraphs 47(b)-(e) of Section 20 are relevant (i.e., there are no initial direct costs, dismantling costs, lease payments made in advance or lease incentives). As such, the seller-lessee measures the right-of-use asset arising from the leaseback at £1,259,200, an amount equal to the lease liability.

The total excess of the sales proceeds over the previous carrying amount of the asset is £800,000 (£1,800,000 - £1,000,000). This amount is deferred and amortised over the lease term.

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	£2,000,000
Right-of-use asset	£1,259,200
Building	£1,000,000
Lease liability	£1,259,200
Financial liability	£200,000
Deferred income	£800,000

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	£1,800,000
Financial asset	£200,000 (18 payments of CU16,447, discounted at 4.5 per cent per annum)
Cash	£2,000,000

After the commencement date, Buyer-lessor accounts for the lease by treating £103,553 of the annual payments of £120,000 as lease payments. The remaining £16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of £200,000 and (b) interest revenue.

FAQ 9-1 above, provides an extract from the June 2020 IFRIC update which includes an illustrative example of how to account for a sale and leaseback transaction in which the payments for the leaseback are variable and do not depend on an index or rate. That Illustration would be relevant for those entities who have made the policy choice to apply paragraph 123(a)(i) of Section 20 in their accounting for sale and leaseback transactions. The following Illustration considers the accounting for a similar fact pattern, but for an entity who has instead made the accounting policy choice to apply paragraph 123(a)(ii) of Section 20.

Illustration 9-5: Sale and leaseback with variable payments - entity applying paragraph 123(a)(ii) of Section 20

Seller-lessee enters into a sale and leaseback transaction whereby it transfers a building to Buyer-lessor, and leases that building back for five years. The transfer of the building satisfies the requirements in Section 23 to be accounted for as a sale of the building.

The carrying amount of the building in Seller-lessee's financial statements at the date of the transaction is £1,000,000, and the amount paid by Buyer-lessor for the building is £1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the building during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is £450,000. There are no initial direct costs.

Seller-lessee has made the accounting policy choice to apply paragraph 123(a)(ii) of Section 20 when accounting for sale and leaseback transactions.

Analysis: Applying paragraph 123(a)(ii) of Section 20, at the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at cost using the general principles of initial measurement in accordance with paragraph 46 of Section 20. In this example, the cost of the right-of-use asset is equal to the amount of the initial measurement of the lease liability as none of the other components of cost set out in paragraphs 47(b)-(e) of Section 20 are relevant (i.e., there are no initial direct costs, dismantling costs, lease payments made in advance or lease incentives).

In this case, although the *expected* lease payments are £450,000, the variable payments are not in-substance fixed payments and nor are they dependent on an index or rate. As such, the initial measurement of the lease liability in such a lease is £nil, and therefore the right-of-use asset arising from the leaseback (measured at an amount equal to the lease liability) is also £nil.

The total excess of the sales proceeds over the previous carrying amount of the asset is £800,000 (£1,800,000 - £1,000,000). This amount is deferred and amortised over the lease term.

At the date of the transaction, Seller-lessee accounts for the transaction as follows:

Dr	Cash	£1,800,000	
	Cr	PPE	£1,000,000
	Cr	Deferred income	£800,000

These Illustrations (together with the example from the June 2020 IFRIC Update (refer to 9.2.1.A above) demonstrate that the accounting policy choice made for sale and leaseback transactions under paragraph 123(a) of Section 20 can significantly impact the accounting for a sale and leaseback under FRS 102.

9.3 Transactions in which the transfer of an asset is not a sale

If the transfer of an asset is not a sale, the seller-lessee accounts for the transaction as a financing transaction. The seller-lessee keeps the transferred asset subject to the sale and leaseback transaction on its statement of financial position and accounts for amounts received as a financial liability in accordance with the accounting policy choice it has made for its financial instruments under paragraph 2 of Section 11 and Section 12. The seller-lessee decreases the financial liability by the payments made less the portion considered interest expense.

If the transfer of an asset is not a sale, the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a receivable in accordance with the accounting policy choice made for its financial instruments under paragraph 2 of Section 11 and Section 12. *[FRS 102.20.126].*

How we see it

A sale and leaseback transaction that includes a repurchase option is not expected to qualify as a sale under Section 23 and therefore is not accounted for as a sale and leaseback under Section 20. However, Section 20 does not explicitly specify whether a buyer and seller would reassess a failed sale when a repurchase option expires unexercised. We believe it is acceptable to reassess whether there is a sale (or purchase) in accordance with Section 23 in this scenario and if so, apply the sale and leaseback guidance in Section 20 at the time the control transfers to the buyer.

9.4 Disclosure

A seller-lessee is required to disclose the following information about sale and leaseback transactions:

- The lessee's reasons for sale and leaseback transactions and the prevalence of those transactions.
- Key terms and conditions of individual sale and leaseback transactions.
- Payments not included in the measurement of lease liabilities.
- The cash flow effect of sale and leaseback transactions in the reporting period.
- When relevant, the entity having made the accounting policy choice to apply paragraph 123(a)(ii) of Section 20 in respect of sale and leaseback transactions when the transfer of the asset is a sale.

[FRS 102.20.77(d)]

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transactions under paragraph 80(g) of Section 20.

10 Requirements of Section 20 for leases: Business combinations

10.1 Acquiree in a business combination is a lessee

Extract from FRS 102

Leases in which the acquiree is the lessee

19.19A The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with Section 20 *Leases* in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

- (a) leases for which the lease term ends within 12 months of the acquisition date; or
- (b) leases for which the underlying asset is of low value (as described in Section 20).

The acquirer shall measure the lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

10.1.1 Initial measurement of a lease

Section 19 *Business Combinations and Goodwill* specifies the initial measurement requirements for leases that are acquired in a business combination.

The acquirer measures the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer applies the initial measurement provisions of Section 20, using the present value of the remaining lease payments at the acquisition date. The acquirer follows the requirements for determining the lease term, lease payments and discount rate as discussed in 5 above. The discount rate is determined from the perspective of the acquiree, as the acquiree is the customer in the lease contract. However, the determination of the lessee's incremental borrowing rate or obtainable borrowing rate will take into account that the acquiree is now part of the new group. This is discussed further in 5.6.1 above.

The right-of-use asset is measured at an amount equal to the recognised liability, adjusted to reflect the favourable or unfavourable terms of the lease, relative to market terms. Because the off-market nature of the lease is captured in the right-of-use asset, the acquirer does not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market.

The acquirer is not required to recognise right-of-use assets and lease liabilities for leases with lease terms which end within 12 months of the acquisition date and leases for low-value assets.

10.1.2 Subsequent measurement of a lease

The subsequent measurement requirements for an acquired lease liability and right-of-use asset are the same as the requirements for any other existing lease arrangement.

10.2 Acquiree in a business combination is a lessor

Section 19 is silent on the accounting where the acquiree in a business combination is a lessor. However, Section 20 requires an acquirer to classify all leases as lessor as either finance or operating leases at the inception of the lease. Classification is only revisited if the terms of the contract have been modified in a manner that would change its classification. [FRS 102.20.91]. Therefore, the classification is not changed as a result of a business combination unless a lease is modified (refer to 6.5 above).

11 Requirements of Section 20 for leases: Periodic review 2024 Transitional Arrangements

The amendments to Section 20 arising from the Periodic Review 2024 apply for accounting periods beginning on or after 1 January 2026. Early application is permitted, provided that all amendments arising from the Periodic Review 2024 (except the new supplier finance arrangements disclosures – refer to Chapter 7 at 2.4) are applied at the same time. *[FRS 102.1.37]*.

11.1 Transition to the revised Section 20

11.1.1 Practical expedient: Definition of a lease on transition to the revised Section 20

As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application of the revised Section 20. Instead, the entity is permitted to apply the requirements of the revised Section 20 to contracts that were previously identified as containing a lease, and not to apply the requirements of the revised Section 20 to contracts that were not previously identified as containing a lease. If an entity chooses this practical expedient, it discloses that fact and applies the practical expedient to all of its contracts. *[FRS 102.1.45]*.

It is important to note that this practical expedient determines which existing contracts the new lease accounting model will apply to, and which will be accounted for under other sections of the standard. It does not allow the entity to continue to apply the old lease accounting model.

As the accounting for operating leases under Section 20 prior to applying the Periodic Review 2024 amendments was similar to the accounting for service contracts, entities may not always have focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under Section 20 prior to applying the Periodic Review 2024 amendments because, under the revised Section 20, most leases are recognised on lessee's balance sheets and the effects of treating an arrangement as a service instead of a lease may be material. The practical expedient in Section 1 Scope allows an entity not to reassess whether a contract contains a lease applied only to arrangements that were properly assessed under Section 20 prior to applying the Periodic Review 2024 amendments.

11.1.2 Disclosure requirements on transition to the revised Section 20

In the reporting period in which an entity first applies the revised Section 20, the entity is not required to disclose the information required by paragraphs 13(b) to (d) of Section 10 in relation to Section 20. The entity must, however, disclose the nature of the changes in accounting policy as required by paragraph 13(a) of Section 10.

In addition, the entity must disclose:

- For the current period, to the extent practicable, the amount of the adjustment to profit or loss for the effect of applying the revised Section 20.
- Or
- An explanation if it is impracticable to determine the amount of the adjustment to profit or loss for the effect of applying the revised Section 20. *[FRS 102.1.44]*.

A requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. *[FRS 102 Appendix I]*.

Refer also to 11.2 and 11.3 below for further disclosures required on transition to the revised Section 20.

11.2 Lessee transition

When a lessee first applies the Periodic Review 2024 amendments, it must apply the revised Section 20 retrospectively, in accordance with paragraphs 47 to 50 of Section 1. *[FRS 102.1.46]*. However, the lessee does not restate comparative information. Instead, the lessee recognises the cumulative effect of initially applying the Periodic Review 2024 amendments to Section 20 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application. *[FRS 102.1.47]*.

A lessee must also disclose a description of the transitional provisions it has applied. *[FRS 102.1.50]*.

11.2.1 IFRS 16 option

If calculations have been prepared for an entity's lease accounting for group reporting purposes under IFRS 16, it may use those carrying amounts of the lease liabilities and right-of-use assets to measure its lease liabilities and right-of-use assets under FRS 102 at the date of initial application of the revised Section 20. This option applies to leases previously classified as finance leases or as operating leases. If an entity chooses this practical expedient, it must disclose that fact and apply the practical expedient to all of its leases. [FRS 102.1.48].

In practice, entities may have intra-group leases for which calculations under IFRS 16 have not been prepared because the intra-group leases would have been eliminated on consolidation. As paragraph 48 of Section 1 requires that an entity choosing the IFRS 16 practical expedient must apply that expedient to all of its leases, it is unclear whether the existence of material intra-group leases for which IFRS 16 calculations have not been prepared would preclude an entity from applying the IFRS 16 option. The FRC has explained that calculations made "for the purposes of including the entity in consolidated financial statements prepared in accordance with IFRS Accounting Standards" would generally include calculations made which are then subsequently eliminated on consolidation, and so the existence of leases which are eliminated on consolidation would not necessarily preclude the use of the IFRS 16 option¹¹¹.

How we see it

The intent of the IFRS 16 option is to promote efficiency within groups, and the FRC has explained that the existence of leases which are eliminated on consolidation would not necessarily preclude the use of the IFRS 16 option. We therefore believe that where the IFRS 16 option is applied, it must be applied to all leases that could be in scope of the option, i.e., it must be applied to all leases for which carrying amounts have been calculated under IFRS 16 for group reporting purposes.

Any leases for which IFRS 16 carrying amounts have not been calculated for group reporting purposes must be measured in accordance with paragraphs 51 to 54 of Section 1 on initial application of the revised Section 20 for leases previously classified as operating leases, and paragraph 55 of Section 1 for leases previously classified as finance leases (see 11.2.2 and 11.2.3 below).

11.2.1.A Government grant or non-exchange transaction on initial application

As discussed at 6.2.1 above, some lease arrangements may contain a government grant or non-exchange transaction for a public benefit entity, for example when lease payments are significantly below market rents. The lessee is required to account for such incoming resources in accordance with the requirements of Section 24 *Government Grants* (when a lease component contains a government grant) or, for a public benefit entity, paragraphs PBE 34.63-PBE 34.74 (when a lease component contains a non-exchange transaction) by recognising the incoming resources as a contribution to the cost of the right-of-use asset. The resulting impact is that the carrying value of the right-of-use asset will be higher than the contractual lease payments would imply. [FRS 102.20.47(e), FRS 102.B20.16]. In the discussion that follows, reference to incoming resources from a government grant or non-exchange transaction for a public benefit entity, is referred to as a 'non-exchange component'. A related situation arises when an entity receives a monetary government grant, say in the form of cash, in respect of entering into a separate lease contract.

IFRS 16 does not provide specific guidance on accounting for leases containing a non-exchange component. In particular, it does not specifically require an entity to account for the incoming resources as a contribution to the right-of-use asset (together with a separate credit) as FRS 102 now does. Further, there are some differences between the recognition and measurement requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and Section 24 when accounting for a government grant, whether that arises from a non-exchange component in a lease contract with the government as lessor or a separate government grant in respect of a lease. The following discussion covers some of the issues that arise on transition when grants have been accounted for under IFRS in a manner that is different from the requirements of FRS 102:

¹¹¹ FRC FRS 102 factsheet 9 Initial application of the Periodic Review 2024 amendments (November 2024)

- Grants recognised under IFRS at nominal amount

Section 24 requires grants to be measured at the fair value of the asset received or receivable, unlike IAS 20 which permits non-monetary government grants to be recorded, alternatively, at a nominal amount. [FRS 102.24.5, IAS 20.23].

Where an entity chooses to apply the IFRS 16 option and has leases that contain a non-monetary non-exchange component (e.g., leases at below-market rates) that had been recognised at nominal amount under IFRS, paragraph 48 of Section 1 is silent as to whether the entity would adjust the right-of-use asset calculated under IFRS 16 to reflect the non-exchange component in the lease. [FRS 102.1.48].

A view that could be taken is that Section 1 does not require the entity to adjust the right-of-use asset calculated under IFRS 16 to reflect the non-exchange component. However, as there is no exemption in Section 1 relating to the recognition of the non-exchange component, an alternative view is that a lessee must comply with the requirements of Section 24 and adjust the right-of-use asset.

How we see it

In our view, lessees have an accounting policy choice when applying the IFRS 16 option of whether or not to adjust the right-of-use asset (that was calculated for the purpose of including the entity in consolidated IFRS financial statements) in the manner required under Section 20 and Section 24 of FRS 102 (as applicable). The policy adopted is applied consistently to all leases containing a non-exchange component.

The discussion above applies similarly to a public benefit entity in receipt of incoming resources from a non-exchange transaction applying Section 20 and Section 34.

- Grants recognised under IFRS which have been deducted from the right-of-use asset

IAS 20 permits government grants to be deducted from the related asset rather than being shown as deferred income. FRS 102 does not permit the deduction of the grant from the related asset. [IAS 20.24, FRS 102.24.5B, FRS 102.24.5G].

Where a lessee has received a monetary grant in respect of a lease contract which, in the consolidated financial statements in which the lessee is included, is deducted from the right-of-use asset as permitted by paragraph 24 of IAS 20, the right-of-use asset would be presented at an amount lower than would have been calculated under IFRS 16.

Where a lessee in these circumstances chooses to apply the IFRS 16 option, Section 1 is silent as to whether the entity would exclude the effect of this netting and present separately the government grant.

How we see it

We believe such an entity must gross up the right-of-use asset for the amount of the grant that was presented net. This is because paragraph 48 of Section 1 requires the lessee to recognise "...the carrying amount...of its lease liabilities and right-of-use assets calculated under IFRS 16 Leases...". The deduction of a government grant from a right-of-use asset in accordance with paragraph 24 of IAS 20 is a presentation matter, and in our view is not a calculation that arose under IFRS 16.

Furthermore, paragraph 96 of Section 2 does not permit the offsetting of assets and liabilities unless required or permitted by FRS 102 nor is this permitted by Sections 20 and 24.

The accounting for any non-exchange component would, therefore, follow the requirements of Section 24 (applying the accruals model or performance model under the lessee's existing accounting policy).

Illustration 11-1 below provides an example of how a lessee accounts for a monetary grant deducted from a right-of-use asset under IFRS.

Illustration 11-1: Monetary grant deducted from a right-of-use asset under IFRS

Entity A, which is an existing FRS 102 reporter, is included in the consolidated financial statements of its parent that is reporting under IFRS. It has been owned by its parent for many years.

On 1 January 2024 (which is also the lease commencement date), Entity A entered into a five-year lease of a property with a lessor. The annual lease payments are £1,000 (paid in advance). Entity A concluded that it cannot readily determine the interest rate implicit in the lease and calculated a right-of-use asset of £4,500* under IFRS 16 as at 1 January 2024, using its incremental borrowing rate of 5.56%. The government provided a cash grant of £2,500 to Entity A in relation to the leased property. The Group accounting policy under IAS 20 followed by Entity A is to deduct the grant in arriving at the carrying amount of the right-of-use asset so that the carrying amount of the right-of-use asset on 1 January 2024 after netting off is £2,000.

Under Section 24, Entity A applies the accruals model to the recognition of government grants and recognised cash and deferred income of £2,500 (released to income on a straight-line basis over the five-year lease term). [FRS 102.24.5G, FRS 102.24.5F].

The date of initial application of the Periodic Review 2024 amendments is 1 January 2026 and Entity A applies the IFRS 16 option. [FRS 102.1.48]. The carrying amount of the right-of-use asset in its parent's IFRS consolidated financial statements immediately before the date of initial application is £1,200[‡] and the lease liability is £2,845.^{††}

As stated above, we believe that the entity must exclude the effect of netting previously made under IFRS. Therefore, on the date of initial application, Entity A would recognise the right-of-use asset at the amount calculated under IFRS 16, being £2,700.^{**}

Because Entity A applies the accruals model under FRS 102, it has already recorded deferred income of £1,500[†] in its FRS 102 financial statements. The same amount of deferred income would continue to be recorded on initial application of the Periodic Review 2024 as the accruals model under Section 24 requires that grants relating to assets, including right-of-use assets, are recognised in income on a systematic basis over the expected useful life of the asset, [FRS 102.24.5F], which is judged to be the full five-year lease term.

The remaining debit entry of £145^{‡‡} would be adjusted in the opening balance of retained earnings, i.e., as of 1 January 2026. [FRS 102.1.47]. The journal entry is as follows:

Dr	Right-of-use asset ^{**}	£2,700	
Dr	Retained earnings ^{‡‡}	£145	
	Cr	Lease liability ^{††}	£2,845

Had Entity A used £1,200 (i.e., the IFRS carrying amount net of the grant element) rather than £2,700 as its right-of-use asset, there would be a reduction in retained earnings of £1,645 which is disproportionate. This is because while both IFRS and FRS 102 amounts debited cash when the grant was received, this was credited to deferred income under FRS 102 but to right-of-use asset under IFRS. Given that Section 24 requires the continued recognition of the deferred income, the right-of-use asset included in the IFRS consolidated financial statements needs to be grossed up by £1,500[†] to avoid double counting of credits.

* This is calculated as the present value of £1,000 annual payments made in advance over 5 years using the lessee's incremental borrowing rate of 5.56%.

** The carrying amount of right-of-use asset before deducting the grant calculated under IFRS 16 is £2,700 (£4,500 less £1,800 for two years of depreciation).

† The amount of grant not yet recognised in profit or loss is £1,500 (£2,500 less £1,000 for amount already recognised in income over the two years).

‡ This is £2,000 of initial amount of right-of-use asset after netting off the grant x 3/5 (based on three years remaining of a 5-year lease term).

†† This is calculated as the present value of £1,000 annual payments made in advance over 3 years (remaining period) using a discount rate of 5.56%.

‡‡ This remaining debit entry represents the cumulative difference between the straight-line recognition of an operating lease under the previous Section 20 and the interest expense and depreciation of right-of-use asset under IFRS 16 for the two years to 1 January 2026 (the initial application of the Periodic Review 2024 Amendments).

11.2.2 Leases previously classified as operating leases

If a lessee does not apply the IFRS 16 option explained in 11.2.1 above, at the date of initial application the lessee:

- Recognises a lease liability, measured at the present value of the remaining lease payments (refer to 5.5 above), discounted using the lessee's incremental borrowing rate or obtainable borrowing rate (refer to 5.6 above) for each lease at the date of initial application. A public benefit entity that is unable readily to determine either the interest rate implicit in the lease, or the lessee's incremental or obtainable borrowing rate for a lease, uses the rate of interest otherwise obtainable by the public benefit entity on deposits held with financial institutions (refer to 5.6.3 above). *[FRS 102.1.51(a)]*
- Recognises a right-of-use asset at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application. The lessee uses the information readily available to it at the date of initial application to determine whether, at the commencement date or the date of the most recent lease modification, the lessor provided the lessee with incoming resources from a government grant or (for a public benefit entity only) a non-exchange transaction as described in paragraph 35 of Section 20 (refer to 6.2.1 above). If so, the lessee measures the non-exchange element at the date of initial application and adjust the right-of-use asset accordingly. *[FRS 102.1.51(b)]*
- Applies Section 27 to right-of-use assets at the date of initial application. Alternatively, a lessee may apply the practical expedient in paragraph 53(b) of Section 1, which allows a lessee to rely on its assessment of whether leases are onerous applying Section 21 immediately before the date of initial application. If a lessee chooses this practical expedient, the lessee adjusts the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application.

A lessee is permitted to apply this practical expedient on a lease-by-lease basis. *[FRS 102.1.51(c), FRS 102.1.53]*

How we see it

We believe that even when the provision for an onerous lease immediately before the date of initial application is nil, a lessee is able to use the practical expedient that allows a lessee to rely on its assessment of whether a lease is onerous applying Section 21 immediately before the date of initial application and not perform an impairment review on that date.

- Derecognises any asset or liability previously recognised relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination and adjusts the carrying amount of the right-of-use asset by a corresponding amount at the date of initial application. *[FRS 102.1.54]*.

Section 20 does not specify whether the lessee's incremental borrowing rate or obtainable borrowing rate at the date of initial application should be determined based on the original lease term or the remaining lease term. We believe that both approaches are acceptable.

How we see it

We believe that a lessee has an accounting policy choice to use either the original lease term or remaining lease term to determine the incremental borrowing rate or obtainable borrowing rate at the date of initial application of revised Section 20.

The policy chosen should be applied consistently and disclosed in the financial statements.

Notwithstanding the requirements of paragraph 51 of Section 1, set out above, for leases previously classified as operating leases, a lessee:

- Is not required to make any adjustments on transition for leases for which the underlying asset is of low value that will be accounted for applying paragraph 6 of Section 20 (refer to 6.1.2 above). The lessee accounts for those leases applying the revised Section 20 from the date of initial application.
- Is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in Section 16 (refer to Chapter 19). This may apply if, for example, an entity generates rental income from a property that it is itself leasing. The lessee accounts for the right-of-use asset and the lease liability arising from those leases applying Section 16 and the revised Section 20 from the date of initial application.
- Measures the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases and that will be accounted for as investment property from the date of initial application. The lessee accounts for the right-of-use asset and the lease liability arising from those leases applying Section 16 and the revised Section 20 from the date of initial application. *[FRS 102.1.52]*.

A lessee may use one or more of the following practical expedients when applying the Periodic Review 2024 amendments to leases previously classified as operating leases. A lessee is permitted to apply these practical expedients on a lease-by-lease basis:

- A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).
- A lessee may rely on its assessment of whether leases are onerous applying Section 21 immediately before the date of initial application as an alternative to applying Section 27 to right-of-use assets at the date of initial application in line with paragraph 51(c) of Section 1 (see above).
- A lessee may choose not to apply the requirements in paragraph 51 of Section 1 (see above) to leases for which the lease term ends within 12 months of the date of initial application. In this case, the lessee shall:
 - Account for those leases in the same way as short-term leases as described in paragraph 6 of Section 20 (refer to 6.1.1 above).

And

 - Include the cost associated with those leases within the disclosure of short-term lease expense in the reporting period starting on the date of initial application.
- A lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. [FRS 102.1.53].

Section 20 does not provide detailed guidance on the use of hindsight. However, as discussed in Chapter 9 at 3.3.2, hindsight cannot be used when applying a new accounting policy, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. Hence, retrospectively applying a new accounting policy requires distinguishing information that provides evidence of circumstances that existed on the prior period date(s) from that information which would have been available when the financial statements for that prior period(s) were authorised for issue. We would expect a similar distinction to apply when a lessee first applies the Periodic Review 2024 amendments, and believe that the use of hindsight does not apply to matters of fact such as changes to an index or rate.

How we see it

We believe that hindsight can be applied only to matters of judgement and estimates and therefore would not apply to matters of fact such as changes to an index or rate.

Having applied the IFRS 16 option in paragraph 48 of Section 1 (refer to 11.2.1 above), or paragraphs 51 to 54 of Section 1 (see above), a lessee subsequently applies the requirements of Section 20, as revised by the Periodic Review 2024 amendments. [FRS 102.1.49].

11.2.3 Leases previously classified as finance leases

Unless the entity applies the IFRS 16 option in paragraph 48 of Section 1 (refer to 11.2.1 above), for each lease previously classified as a finance lease, a lessee recognises a right-of-use asset and lease liability at the date of initial application at the carrying amount of the leased asset and finance lease liability immediately before that date, measured applying FRS 102 prior to the adoption of the Periodic Review 2024 amendments. The lessee subsequently applies the requirements of Section 20, as revised by the Periodic Review 2024 amendments. [FRS 102.1.55]. Depending on the circumstances of the lease, subsequent measurement of leases previously classified as finance leases may differ from how they would have been measured using the old lease accounting model (i.e., Section 20 prior to applying the Periodic Review 2024 amendments), for example if there are lease modifications after the date of initial application. This is because the old lease accounting model contained no specific guidance in respect of lease modifications, and so the accounting that would have been applied may have differed from that required by the revised Section 20.

11.3 Lessor transition

With the exception of subleases (refer to 11.3.1 below), a lessor does not make any adjustments on transition for leases in which it is a lessor, and accounts for those leases applying the revised Section 20 from the date of initial application. [FRS 102.1.56].

11.3.1 Subleases

An intermediate lessor (an entity that is both a lessee and a lessor of the same underlying asset):

- Reassesses subleases that were classified as operating leases prior to adoption of the Periodic Review 2024 amendments and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying the Periodic Review 2024 amendments. The intermediate lessor performs this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date.

And

- For subleases that were classified as operating leases prior to adoption of the Periodic Review 2024 amendments, but are classified as finance leases applying the Periodic Review 2024 amendments, accounts for the sublease as a new finance lease entered into at the date of initial application.

[FRS 102.1.57].

11.4 Sale and leaseback transactions

An entity does not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in Section 23, applying the Periodic Review 2024 amendments, to be accounted for as a sale. [FRS 102.1.58].

If a sale and leaseback transaction was previously accounted for as a sale and finance lease, unless it applies the IFRS 16 option in paragraph 48 of Section 1 (refer to 11.2.1 above), the seller-lessee:

- Accounts for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application.

And

- Continues to amortise any gain or loss on sale over the lease term. [FRS 102.1.59].

If a sale and leaseback transaction was previously accounted for as a sale and operating lease, unless it applies the IFRS 16 option in paragraph 48 of Section 1, the seller-lessee:

- Accounts for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application.

And

- Adjusts the leaseback right-of-use asset for any deferred gains or losses that relate to off-market terms recognised in the statement of financial position immediately before the date of initial application.

[FRS 102.1.60]

12 Summary of differences between Section 20 and IFRS

The differences between FRS 102 and IFRS in accounting for leases are set out below.

	FRS 102	IFRS
Scope - Leases with non-typical contractual terms	Certain leases are excluded from the scope of Section 20 and instead classified as financial instruments within scope of Section 12 if the lease could, as a result of non-typical contractual terms, result in a loss to the lessor or the lessee.	IFRS 16 does not contain a similar scope exemption.
Lessee recognition exemptions - Low value assets	Similar to IFRS 16 with an optional low-value lease exemption available on a lease-by-lease basis, however, FRS 102 provides examples of assets that are not low-value.	Optional low value lease exemption available on a lease-by-lease basis. IFRS 16 does not provide examples of assets that are not low-value, instead only provides examples of low-value assets in the Basis for Conclusions.
Lessee discount rate	An additional option is provided on determining the discount rate when compared to IFRS 16. If the interest rate implicit in the lease, cannot be readily determined, the lessee chooses on a lease-by-lease basis to apply either the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate. If a public benefit entity is unable to readily determine any of the three discount rates mentioned above, they should use the rate of interest on deposits held with financial institutions.	Discount rate applied to measure lease liability is the interest rate implicit in the lease, if the rate can be readily determined. If not, the lessee's incremental borrowing rate is used.
Lessee accounting for leases containing a non-exchange component	A lessee in receipt of incoming resources from a government grant or, for a public benefit entity with a non-exchange component, recognises the incoming resources as part of the right-of-use asset. The incoming resources are measured applying Section 24 or Section 34.	No specific guidance provided on leases containing a non-exchange component.
Lessee accounting - Disclosures	Similar detailed disclosures to IFRS 16. However, lease liability maturity analysis is not a prescribed disclosure in Section 20. Instead, the Regulations require, for an aggregate of all Creditors, disclosure of amounts payable after 5 years. Lease commitment disclosed separately for short-term leases and low value leases. No requirement to present all lease disclosures in a single note or separate section of the financial statements.	IFRS 16 contains a disclosure objective and detailed disclosure requirements including both quantitative and qualitative disclosures. No prescribed time brackets for the maturity analysis of lease liabilities. Lease commitment disclosure is required for short-term leases committed at the reporting date if the portfolio of leases is dissimilar to the portfolio of short-term lease expense incurred in the period. In addition to detailed disclosure requirements, lessees are required

FRS 102		IFRS
		to disclose additional qualitative and quantitative information necessary to meet the disclosure information within the standard. Lessees must present all disclosures required by IFRS 16 in a single note or separate section in the financial statements.
Lessor accounting - Straight-line basis for lease payments	If lease payments increase annually by fixed increments intended to compensate for expected annual inflation over the lease period, the fixed minimum increment that reflects expected general inflation will be recognised as income as incurred. Otherwise, similar to IFRS.	All operating lease receipts are recognised as income on a straight-line basis, unless another systematic basis is more appropriate.
Lessor accounting - Disclosures	Similar to IFRS 16. In addition to specific disclosure requirements, a lessor should disclose additional qualitative and quantitative information to enable users to understand its significant leasing arrangements. There is no specific requirement to include information that helps users to assess the nature of the lessor's leasing activities, and how the lessor manages the risk associated with any rights it retains in underlying assets.	Maturity analysis of lease payments under finance and operating leases showing undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor discloses additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective. This includes information that helps users to assess the nature of the lessor's leasing activities, and how the lessor manages the risk associated with any rights it retains in underlying assets.
Portfolio application	Similar to IFRS 16, except no reference is made to materiality, but instead provides examples of leases with similar characteristics as those with a similar lease term for a similar class of underlying asset in a similar economic environment.	IFRS 16 specifies the accounting for an individual lease, but provides a practical expedient that permits an entity to apply the standard to a portfolio of leases with similar characteristics, only if the accounting would not materially differ. If accounting for a portfolio, an entity uses estimates and assumptions that reflect the size and composition of the portfolio.
Lease modifications	For a lease modification that does not give rise to a separate lease, FRS 102 permits the lessee to use an unchanged discount rate in some circumstances.	When a lease is modified and the modification does not give rise to a new lease, the lessee remeasures the lease liability using a revised discount rate at the effective date of the lease modification.

FRS 102		IFRS
Sale and leaseback accounting	For a seller-lessee in a sale and leaseback transaction, if the transfer of the underlying asset satisfies the requirements of Section 23 to be accounted for as a sale, a policy choice exists in determining the measurement of the resulting right-of-use asset and the treatment of the gains or losses arising from the leaseback - either applying a similar principle to IFRS 16, or measuring the right-of-use asset arising from the leaseback at cost.	If the transfer of the underlying asset satisfies the requirements of IFRS 15 to be accounted for as a sale in a sale and leaseback transaction, the transaction will be accounted for as a sale and leaseback by both the seller-lessee and buyer-lessor. The seller-lessee measures the right-of-use asset from the leaseback at the portion of the previous carrying amount of the asset that relates to the right of use retained.

Appendix A – Defined terms

Extract from FRS 102

Appendix I

Glossary

class of [underlying] assets	A grouping of [underlying] assets of a similar nature and use in an entity's operations.
commencement date (of a lease)	The date on which a lessor makes an underlying asset available for use by a lessee.
contract	An agreement between two or more parties that creates enforceable rights and obligations.
depreciation	The systematic allocation of the depreciable amount of an asset over its useful life.
effective date of the modification	The date when both parties agree to a lease modification.
finance lease	A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred. A lease that is not a finance lease is an operating lease.
government grant	Government assistance in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity.
gross investment in a lease	The aggregate of: (a) the lease payments receivable by the lessor under a finance lease; and (b) any unguaranteed residual value accruing to the lessor
inception date	The earlier of the date of the lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
initial direct costs	Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.
interest rate implicit in the lease	The rate of interest that causes the present value of: (a) the lease payments; and (b) the unguaranteed residual value to equal the sum of: (i) the fair value of the underlying asset; and (ii) any initial direct costs of the lessor.
lease	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
lease incentives	Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.
lease modification	A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (eg adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

lease payment	Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives; (b) variable lease payments that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component. For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.
lease term	The aggregate of: (a) the non-cancellable period of a lease; (b) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and (c) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
lessee's incremental borrowing rate	The rate of interest a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.
lessee's obtainable borrowing rate	The rate of interest a lessee would have to pay to borrow, over a similar term, an amount similar to the total undiscounted value of lease payments to be included in the measurement of the lease liability.
net investment in a lease	The gross investment in a lease discounted at the interest rate implicit in the lease.
non-exchange transaction	A transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.
operating lease	A lease that does not transfer substantially all the risks and rewards incidental to ownership. A lease that is not an operating lease is a finance lease.
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
present value	A current estimate of the present discounted value of the future net cash flows in the normal course of business.
public benefit entity	An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members. ¹¹²
residual value guarantee	A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

right-of-use-asset	An asset that represents a lessee's right to use an underlying asset for the lease term.
short term lease	A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.
underlying asset	An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.
unearned finance income	The difference between: (a) the gross investment in a lease; and (b) the net investment in a lease
unguaranteed residual value	That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

112 The term 'public benefit entity' does not necessarily imply that the purpose of the entity is for the benefit of the public as a whole. For example, many PBEs exist for the direct benefit of a particular group of people, although it is possible that society as a whole also benefits indirectly. The important factor is what the primary purpose of such an entity is, and that it does not exist primarily to provide economic benefit to its investors. Organisations such as mutual insurance companies, other mutual co-operative entities and clubs that provide dividends or other economic benefits directly and proportionately to their owners, members or participants are not PBEs. Some PBEs undertake certain activities that are intended to make a surplus in order to fund their primary activities. Consideration should be given to the primary purpose of an entity's (or group's) activities in assessing whether it meets the definition of a PBE.

PBEs may have received contributions in the form of equity, even though the entity does not have a primary profit motive. However, because of the fundamental nature of public benefit entities, any such contributions are made by the equity holders of the entity primarily to enable the provision of goods or services to beneficiaries rather than with a view to a financial return for themselves. This is different from the position of lenders; loans do not fall into the category of equity.

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Chapter 24 Provisions and contingencies

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Overview

This chapter addresses Section 21 *Provisions and Contingencies*. Section 21 prescribes the recognition criteria, measurement basis and disclosure requirements to be applied to provisions, contingent liabilities and contingent assets. Section 21 does not apply to provisions, contingent liabilities and contingent assets covered by another section of FRS 102. Where those other Sections contain no specific requirements to deal with contracts that have become onerous, Section 21 applies to those contracts. Section 21 does not apply to financial instruments (including loan commitments) that are in scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues* (see Chapter 13), or insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that the entity holds, or financial instruments issued by an entity with a discretionary participation feature that are within the scope of FRS 103 *Insurance Contracts* (see Chapter 38). Section 21 also does not apply to executory contracts (i.e., contracts under which neither party has performed any obligations or both parties have partially performed their obligations to an equal extent), unless they are onerous contracts.

Section 21 requires a provision to be recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the obligation. The amount required to be recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Contingent liabilities and contingent assets are not recognised. Instead, Section 21 requires contingent liabilities to be disclosed, unless the possibility of any outflow is remote, and disclosure of contingent assets where an inflow of economic benefits is probable.

What you need to know

- A provision is recognised by an entity only when the entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits in settlement is required, and the amount of the obligation can be estimated reliably.
- The amount recognised as a provision is required to be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. Where the effect of the time value of money is material, the amount of a provision is the present value of the expenditures expected to be required to settle the obligation.
- Section 21 prohibits the recognition of provisions for future operating losses.
- Contingent liabilities and contingent assets are not recognised. The only exception to this is for certain contingent liabilities assumed in a business combination, which are recognised by applying Section 19 *Business Combinations and Goodwill*.
- Section 21 requires contingent liabilities to be disclosed unless the possibility of any outflow in settlement is remote.
- Contingent assets are disclosed if an inflow of economic benefits is probable.
- Disclosures of provisions, contingent liabilities and contingent assets must be sufficient to enable users to understand their nature, timing and amount.

1 Introduction

Section 21 addresses the recognition, measurement and disclosure of provisions and the disclosure of contingent liabilities and contingent assets.

The principle of Section 21 for the recognition and measurement of provisions is consistent with that applied by IAS 37. A provision must be recognised by an entity if the entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required, and the amount expected to settle the obligation can be measured reliably. [FRS 102.21.4].

The approach to contingent liabilities and contingent assets under Section 21 is also consistent with that taken by IAS 37. These items must not be recognised on balance sheet but disclosed. [FRS 102.21.12, FRS 102.21.13]. The only exception to this is for certain contingent liabilities assumed in a business combination, which must be recognised on the balance sheet of the acquirer. [FRS 102.19.14].

However, IAS 37 provides more guidance than Section 21 in certain areas. In addition, there are some differences between Section 21 and the equivalent guidance under IFRS. These are addressed at 2 below.

2 Comparison between Section 21 and IFRS

As stated at 1 above, Section 21 and IAS 37 apply the same principle to the recognition and measurement of provisions. The approach to the disclosure of provisions, contingent liabilities and contingent assets is also consistent between Section 21 and IAS 37. The key differences between Section 21 and IFRS are set out at 2.1 to 2.2 below.

2.1 Scope - financial guarantee contracts

Financial guarantee contracts are included in the scope of Section 21 when an entity has chosen to apply the requirements of Sections 11 and 12 for the recognition and measurement of financial instruments. Section 21 does not apply to financial guarantee contracts where:

- An entity has chosen to apply IAS 39 *Financial Instruments: Recognition and Measurement* and/or IFRS 9 *Financial Instruments* to its financial instruments.

Or

- An entity has elected under FRS 103 to continue the application of insurance contract accounting. [FRS 102.21.1A]. See 3.1.1.C below.

Under IFRS, issuers of financial guarantee contracts must apply IAS 32 *Financial Instruments: Presentation*, IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*, to financial guarantee contracts even though they meet the definition of an insurance contract in IFRS 17 *Insurance Contracts*, if the risk transferred is significant. However, if an entity has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 17. This election may be made contract by contract, but the election for each contract is irrevocable.

Under IFRS, for the holder, a financial guarantee contract held that is considered to be an integral component of the guaranteed debt instrument will be accounted for as part of the Expected Credit Loss on that debt instrument.

IFRS does not cover the accounting for the holder of a financial guarantee contract which is not considered to be integral to the underlying debt instruments. The holder of such financial guarantee contracts needs to develop an accounting policy in accordance with the hierarchy set out in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In doing so, entities could look to the requirements of IAS 37 dealing with contingent assets or reimbursement assets, at least as far as recoveries under the contract are concerned. In certain situations, it could also be appropriate for the holder of a financial guarantee contract to account for it as an asset at fair value through profit or loss. This might be the case if the guaranteed asset has itself been classified as fair value through profit or loss.

2.2 Disclosures

The disclosures required by Section 21 are discussed at 4 below.

Section 21 does not refer specifically to the following two disclosures required by IAS 37:

- The disclosure of major assumptions concerning future events that may affect the amount required to settle an obligation where this is necessary to provide adequate information. [IAS 37.85(b)].
- A separate line item in the reconciliation of opening and closing provision balances showing the increase during the period in the discounted amount arising from the passage of time and the effect of any change in discount rate. [IAS 37.84(e)]. Section 21 allows the line showing additions to provisions in the period to include adjustments that arise from changes in measuring the discounted amount. [FRS 102.21.14(a)(ii)].

In addition, Section 21 requires an entity to disclose the expected amount and timing of any payments resulting from an obligation. [FRS 102.21.14(b)]. IAS 37 requires disclosure only of the expected timing of payments resulting from an obligation. [IAS 37.85(a)].

Like IAS 37, Section 21 offers an exemption from certain disclosures that would otherwise be required in those extremely rare cases where disclosure of some or all of the information required can be expected to prejudice seriously the position of the entity in a dispute with other parties. [FRS 102.21.17]. Under the seriously prejudicial exemption in IAS 37, entities must disclose the general nature of the dispute, together with the fact that, and the reason, the information otherwise required by the standard has not been disclosed. [IAS 37.92]. Section 21 includes much more fulsome disclosure requirements in the case where information is considered seriously prejudicial. These requirements are set out at 4.4. below and significantly reduce the usefulness of the seriously prejudicial exemption under Section 21.

Section 21 requires an entity to disclose the nature and business purpose of any financial guarantee contracts it has issued, regardless of whether a provision is required or contingent liability disclosed. [FRS 102.21.17A]. In addition, to the extent a provision is recognised, or contingent liability disclosed, for financial guarantee contracts, the general provisions or contingent liabilities disclosures set out at 4.1 and 4.2 below are also required. Under IFRS, the disclosures required for financial guarantee contracts issued will depend on whether they are accounted for under IAS 32, IFRS 7 and IFRS 9, or IFRS 17 (see 2.1 above).

3 Requirements of Section 21 for provisions and contingencies

3.1 Scope

Extract from Section 21

- 21.1 This section applies to provisions (ie liabilities of uncertain timing or amount), contingent liabilities and contingent assets except those provisions covered by other sections of this FRS. Where those other sections contain no specific requirements to deal with contracts that have become onerous, this section applies to those contracts. [FRS 102.21.1].

Section 21 uses the term 'liability' in a way that differs in some respects from the definition of a liability in paragraph 38 of Section 2 *Concepts and Pervasive Principles* and Appendix I *Glossary*. For the purposes of Section 21, a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

[FRS 102.21.4A].

Section 21 applies to all provisions, contingent liabilities and contingent assets other than those covered by other sections of FRS 102. Where those other sections contain no specific requirements to deal with contracts that have become onerous, Section 21 applies to those contracts. [FRS 102.21.1].

Financial guarantee contracts are included in the scope of Section 21 when an entity has chosen to apply the requirements of Sections 11 and 12 for the recognition and measurement of financial instruments. Section 21 does not apply to financial guarantee contracts where:

- The entity has chosen to apply IAS 39 and/or IFRS 9 to its financial instruments (see Chapters 11- 13).
Or
- The entity has elected under FRS 103 to continue the application of insurance contract accounting.
[FRS 102.21.1A]

Where an entity has chosen to apply IAS 39 and/or IFRS 9 to its financial instruments, the issuer of financial guarantee contracts will account for those contracts as financial instruments under those standards. However, financial guarantee contracts held are not within the scope of IAS 39, IFRS 9, or FRS 103 and therefore would fall in scope of Section 21 regardless of whether the elections set out in paragraph 1A of Section 21 are applied.

The requirements of Section 21 relating to financial guarantee contracts are discussed at 3.3.5 below.

The following table lists the specific types of transactions or circumstances that might give rise to a provision, contingent liability or contingent asset. In some cases, the transaction is identified in Section 21 only to prohibit recognition of any liability, such as for future operating losses (see 3.2.4.A below). This chapter does not address those items identified below as falling outside the scope of Section 21.

Types of transactions or circumstances referred to	In scope	Out of scope	Another section
Restructuring costs	•		
Product warranties	•		
Legal claims	•		
Reimbursement rights	•		
Future operating costs (e.g., training)	•		
Future operating losses	•		
Onerous contracts	•		
Financial guarantee contracts	•		
Provisions for depreciation, impairment or doubtful debts		•	Section 17/Section 27/Section 11/Section 12
Executory contracts (unless onerous)		•	

Types of transactions or circumstances referred to	In scope	Out of scope	Another section
Financial Instruments in the scope of Section 11		•	Section 11
Financial Instruments in the scope of Section 12		•	Section 12
Contingent liabilities acquired in a business combination		•	Section 19
Leases		•	Section 20
Employee benefits		•	Section 28
Income taxes		•	Section 29
Insurance contracts		•	FRS 103

3.1.1 Items outside the scope of Section 21

3.1.1.A Executory contracts, except where the contract is onerous

Section 21 does not apply to executory contracts unless they are onerous. Executory contracts are contracts under which neither party to the contract has performed any of their obligations or where both parties have performed their obligations to an equal extent. *[FRS 102.21.1B(c)]*. This means that contracts such as supplier purchase contracts and capital commitments, which would otherwise fall within the scope of Section 21, are exempt unless the contract becomes onerous. Onerous contracts are addressed at 3.3.1.A below.

3.1.1.B Financial instruments

Section 21 does not apply to financial instruments (including loan commitments) that are within the scope of Section 11 or Section 12. *[FRS 102.21.1B(a)]*.

As noted at 3.1 above, an entity must apply Section 21 to financial guarantee contracts unless it has chosen to apply IAS 39 or IFRS 9 to its financial instruments or FRS 103 to continue to account for these guarantees as insurance contracts. *[FRS 102.21.1A]*.

3.1.1.C Insurance contracts

Insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that the entity holds fall within the scope of FRS 103 and not FRS 102. *[FRS 102.21.1B(b)]*. An insurance contract is defined as "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". *[FRS 102 Appendix I]*. A reinsurance contract is "An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant". *[FRS 102 Appendix I]*.

Section 21 also excludes from its scope financial instruments issued by an entity with a discretionary participation feature that are within the scope of FRS 103. *[FRS 102.21.1B(b)]*. These features are most commonly found in life insurance policies and are essentially contractual rights of the holder to receive, as a supplement to guaranteed benefits, significant additional benefits whose amount or timing are contractually at the discretion of the issuer and based on the performance of the insurer, a fund or a specified pool of investments. *[FRS 102 Appendix I]*.

3.1.1.D Areas covered by other Sections of FRS 102

Section 21 does not apply to those provisions covered by other sections of FRS 102. *[FRS 102.21.1]*. However, other than financial instruments and insurance contracts which are explicitly excluded from its scope, Section 21 does not provide any more examples of what transactions or circumstances this exclusion is intended to cover. Examples of other transactions and circumstances which are covered elsewhere and that we would therefore expect to fall outside the scope of Section 21 are included in the table at 3.1 above. However, where those other sections of the FRS do not contain specific requirements on accounting for onerous contracts, Section 21 must be applied. *[FRS 102.21.1]*. This would include, for example:

- Leases that becomes onerous before the commencement date of the lease, and onerous short-term leases and leases for which the underlying asset is of low value, that are accounted for in accordance with paragraph 6 of Section 20 *Leases* (see Chapter 23 at 6.1.1 and Chapter 23 at 6.1.2).
- Revenue from contracts with customers in scope of Section 23 *Revenue from Contracts with Customers* (see Chapter 25) that are or have become onerous.

Unlike Section 21, IAS 37 is explicit that these types of onerous contract are in scope of IAS 37. [IAS 37.5]. See 3.3.1.A below.

Section 21 notes that the word 'provision' is sometimes used in the context of items such as depreciation, impairment of assets and doubtful debts. Such provisions are not covered by Section 21 because they are adjustments to the carrying amount of assets rather than recognition of liabilities. [FRS 102.21.3].

3.1.1.E Provisions compared to other liabilities

The feature distinguishing provisions from other liabilities, such as trade creditors and accruals, is the existence of uncertainty about the timing or amount of the future expenditure required in settlement. This distinction is not explicitly made in FRS 102 but is explained in IAS 37, which compares provisions to:

- Trade payables - liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier.
- Accruals - liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions. [IAS 37.11].

For trade creditors and their associated accruals, there is little uncertainty regarding either the amount of the obligation (which would be determined by the contracted price for the goods and services being provided) or the timing of settlement (which would normally occur within an agreed period following transfer of the goods and services in question and the issue of an invoice). In practice, however, contracts can be more complex and give rise to a wide range of possible outcomes in terms of the amount or timing of payment. In these circumstances, the difference between provisions and other liabilities is less obvious and judgement may be required to determine where the requirement to make an estimate of an obligation indicates a level of uncertainty about timing or amount that is more indicative of a provision. Such judgements, if significant to the amounts recognised in the financial statements, would merit disclosure (see Chapter 6 at 7.3). [FRS 102.8.6].

Some liabilities may initially be classified as provisions due to uncertainty regarding the timing or amount of payment. Subsequently, after negotiation with a counterparty or a decision by a court of law, the exact amount and timing of settlement may be agreed. As the entity now has an obligation to pay a fixed sum at an agreed point in time, the liability no longer meets the definition of a provision and instead is a financial liability in scope of Sections 11 and 12.

One reason why this distinction matters is that provisions are subject to narrative disclosure requirements regarding the nature of the obligation and the uncertainties over timing and amount and to quantitative disclosures of movements arising from their use, remeasurement or release that do not apply to other payables (see 4.1 below). In fact, although questions of recognition and measurement are important, transparency of disclosure is also a very significant matter in relation to accounting for provisions and ensuring that their effect is properly understood by users of the financial statements.

3.2 Determining when a provision must be recognised

Extract from Section 21

- 21.4 An entity shall recognise a provision only when:
- the entity has an obligation at the reporting date as a result of a past event;
 - it is probable (ie more likely than not) that the entity will be required to transfer economic benefits in settlement; and
 - the amount of the obligation can be estimated reliably. [FRS 102.21.4].

Where all of these three conditions are met, a provision must be recognised as a liability in the statement of financial position. In most cases, the recognition of a provision results in an immediate expense in profit or loss. However, in some cases, it may be appropriate to recognise the amount of the provision as part of the cost of an asset such as inventories or property plant and equipment. [FRS 102.21.5]. A common case when a provision is recognised as part of the cost of an asset is in relation to decommissioning costs (see 3.11.1 below).

3.2.1 The entity has an obligation at the reporting date as a result of a past event

An obligation at the reporting date can be either a legal obligation that can be enforced by law, or a constructive obligation. A constructive obligation arises when an entity has created valid expectations in other parties that it will discharge the obligation. [FRS 102.21.6]. This may be as a result of past practice, published policies or a sufficiently specific current statement. [FRS 102 Appendix I]. The entity must have no realistic alternative to settling the obligation, whether legal or constructive, in order to meet condition (a) of the recognition criteria for provisions set out at 3.2 above. [FRS 102.21.6].

The assessment of whether an entity has a constructive obligation may not always be straightforward.

How we see it

In our view, evidence of communication between the entity and other parties is required in order to be able to conclude that other parties have a valid expectation that the entity will honour its obligations and that a constructive obligation exists. In this context, an internal memo or board decision is not sufficient. It is not necessary for the entity to know the identity of the party to whom the obligation is owed.

Restructuring provisions are an example of a case where judgement is often needed to determine whether a valid expectation exists, as discussed at 3.3.2 below.

When assessing whether an entity has a legal obligation, an issue that can arise in practice is determining exactly when a change in law is recognised. Section 21 does not address this. However, IAS 37 states that an obligation arises only when the legislation is virtually certain to be enacted as drafted and suggests that in many cases, this will not be until it is enacted. [IAS 37.22]. Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, this guidance may be relevant for an FRS 102 reporter to consider in developing an accounting policy for proposed new laws yet to be finalised.

In addition to an entity having an obligation at the reporting date, the obligation must arise as a result of a past event. Obligations that will arise from an entity's future actions do not satisfy condition (a) of the recognition criteria set out at 3.2 above, regardless of how likely the future actions are to occur, and even if they are contractual. [FRS 102.21.6]. This is illustrated in the following scenarios. [FRS 102.21.6, FRS 102.21A.8].

Illustration 3-1 No provision without a past obligating event

Scenario 1: Requirement to fit smoke filters

An entity may intend or need to carry out expenditure to fit smoke filters in a particular type of factory in the future, as a result of either legal requirements or commercial pressures.

In this scenario, the entity can avoid the expenditure required to fit smoke filters by its future actions, for example by changing its method of operation or selling the factory. It therefore has no obligation at the reporting date arising as a result of a past event and no provision is recognised.

Scenario 2: Staff retraining as a result of changes to the income tax system

The government introduces changes to the income tax system. As a result of those changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with tax regulations. At the end of the reporting period, no retraining of staff has taken place.

In this scenario, the change in tax law does not impose an obligation on the entity to do any retraining. An obligating event for recognising a provision (the retraining itself) has not taken place at the reporting date to create a present obligation.

Sometimes it is not always clear whether a present obligation exists as a result of a past event, in which case judgement is required. A common example is a lawsuit, in which the responsibility of the defendant has not yet been established. IAS 37, which shares consistent principles with Section 21 regarding the recognition of provisions, suggests that entities would recognise an obligation if, taking account of all available evidence, it is 'more likely than not' that a present obligation exists at the end of the reporting period. [IAS 37.15]. In this context, 'all available evidence' would include the opinion of experts together with any additional evidence provided by events after the reporting period. [IAS 37.16]. Indeed, Section 32 *Events after the End of the Reporting Period* cites the settlement of a court case as such an example of facts that might indicate the existence of an obligation at the reporting date. [FRS 102.32.5(a)].

3.2.2 A transfer of economic benefits is probable

A transfer of economic benefits is considered probable if it is more likely than not to occur. [FRS 102.21.4]. In practice this is taken as meaning a probability of greater than 50%.

Where an entity has a number of similar obligations, the probability that a transfer of economic benefits will occur is based on the class of obligations as a whole. Whilst this is not explicitly stated in Section 21, it is implied in an example in the Appendix to the Section, where a manufacturer recognises a provision for warranties given at the time of sale to purchasers of its product. The obligating event is the sale of a product with a warranty and an outflow of resources in settlement is determined to be probable for the warranties as a whole (i.e., it is more likely than not that the entity will have to honour some warranties claims). [FRS 102.21A.4]. Warranty provisions are discussed further at 3.3.3 below.

3.2.3 The amount of the obligation can be measured reliably

Section 21 provides no guidance on how this condition is to be applied. However, reliability is defined in FRS 102, Appendix I as “The quality of information that makes it free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.” [FRS 102 Appendix I]. Free from error means there are no errors or omissions in the description of the events, and the process used to produce the reported information has been selected and applied with no errors. In this context, free from error does not mean perfectly accurate in all respects. [FRS 102.2.18]. Combined with the requirement that a provision is measured at the best estimate of the amount required to settle the obligation at the reporting date, [FRS 102.21.7], it could be argued that only in rare cases would a lack of a reliable measure prohibit recognition of an obligation. Under the hierarchy set out in Section 10 *Accounting Policies, Estimates and Errors* entities may consider the requirements of IAS 37, which takes the view that a sufficiently reliable estimate can almost always be made for a provision where an entity can determine a range of possible outcomes. Hence IAS 37 contends that it will only be in extremely rare cases that a range of outcomes cannot be determined. [IAS 37.25]. Whether such a situation is as rare as IAS 37 asserts may be open to question, especially for entities trying to determine estimates relating to potential obligations that arise from litigation and other legal claims. However, given the consistent principles applied by Section 21 and IAS 37 to the recognition of provisions, we would expect entities applying FRS 102 to apply a similar approach in assessing whether a reliable estimate can be made of the amount of an obligation.

In the event that a present obligation cannot be measured reliably, it is regarded as a contingent liability, [FRS 102 Appendix I] (see 3.4 below).

3.2.4 Cases where recognition of a provision is prohibited

Section 21 sets out two cases in which the recognition of a provision is prohibited. They are future operating losses and staff training costs. The common theme in these cases is that the potential obligation does not exist independently of an entity's future actions. Obligations that will arise from the entity's future actions (i.e., the future conduct of its business) do not satisfy the condition in paragraph 21.4(a) of Section 21, no matter how likely they are to occur. [FRS 102.21.6]. This principle is also relevant to determining the timing of recognition of a provision, whereby no liability is recognised until the obligation cannot otherwise be avoided by the entity.

3.2.4.A Future operating losses

Section 21 prohibits the recognition of provisions for future operating losses. [FRS 102.21.11B]. This is illustrated by Example 1 in the Appendix to Section 21, which is reproduced below. [FRS 102.21A.1].

Illustration 3-2: Future operating losses

An entity determines that it is probable that a segment of its operations will incur future operating losses for several years.

In this situation, no provision is recognised. There is no past event that obliges the entity to pay out resources and expected future losses do not meet the definition of a liability. However, the expectation of future losses may be an indicator that one or more assets are impaired.

As alluded to in Illustration 3-2 it would be wrong to assume that the prohibition of provisions for future operating losses in Section 21 has effectively prevented the effect of future operating losses from being anticipated. They may sometimes be recognised as a result of requirements in another Section of FRS 102. For example:

- Under Section 27 *Impairment of Assets* the carrying amount of an asset is compared with its recoverable amount when there is an indicator of impairment. If the recoverable amount is lower than the carrying amount then the asset must be impaired to its recoverable amount. The calculation of the recoverable amount includes the effect of any future operating losses (or sub-standard operating profits) on the value of the asset. See Chapter 29.
- Under Section 27, inventories are written down to selling price less costs to complete and sell to the extent that they will not be recovered from future revenues, rather than leaving the difference between carrying amount and selling prices less costs to complete and sell to show up as a future operating loss. See Chapter 16 at 3.3.

This is therefore a rather more complex issue than Section 21 acknowledges. Indeed, Section 21 itself has to navigate closely the dividing line between the general prohibition of the recognition of future losses and the recognition of contractual or constructive obligations that are expected to give rise to losses in future periods.

3.2.4.B Staff training costs

Illustration 3-2, scenario 2, at 3.2.1 above reproduces an example from Section 21 where the government introduces changes to the income tax system. An entity needs to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with tax regulations. Section 21 argues that there is no present obligation until the actual training has taken place and so no provision is recognised. In many cases the need to incur training costs could also be avoided by the entity by its future actions. For example, the cost could be avoided by hiring new staff who were already appropriately trained.

3.3. Examples of provisions in the scope of Section 21

3.3.1 Onerous contracts

Although future operating losses in general cannot be provided for, Section 21 requires that “If an entity has an onerous contract, the present obligation under the contract shall be recognised and measured as a provision”. [FRS 102.21.11A].

FRS 102 defines an onerous contract as a “...contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.”

[FRS 102 Appendix I]. This requires that the contract is onerous to the point of being directly loss-making, not simply uneconomic by reference to current prices. For example, a change to more environmentally friendly materials or processes because of increased stakeholder interest in climate change could mean that contracts previously expected to be profitable are now expected to be loss making.

The unavoidable costs under a contract reflect the least net cost of exiting from the contract. This is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

The cost of fulfilling the contract comprises:

- The incremental costs of fulfilling that contract
And
- An allocation of other costs that relate directly to fulfilling contracts [FRS 102.21A.2]

The requirement that the cost of fulfilling a contract comprises the incremental costs of fulfilling that contract, and an allocation of costs that relate directly to fulfilling contracts is consistent with IAS 37. IAS 37 also states that examples of the cost of fulfilling the contract may include direct labour and materials. Examples of other costs that relate directly to fulfilling the contract may include an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others. [IAS 37.68A]. In addition, the Basis for Conclusions to IAS 37 notes that several IFRS accounting standards, such as IAS 2 *Inventories*, specify the costs to include in measuring a non-monetary asset. Although the detailed requirements differ, they all require an entity to include both the incremental costs of purchasing or constructing the asset, and an allocation of other directly related or directly attributable costs, such as production overheads. The Board concluded that, in assessing whether a contract to deliver goods is onerous, the way in which an entity determines the cost of fulfilling the contract should be broadly consistent with the way it measures the costs of the goods when it holds them. [IAS 37.BC7]. Given the similarities between the requirements of paragraph A.2 of Section 21 and paragraph 68A of IAS 37 we expect this additional guidance from IAS 37 and its Basis for Conclusions to be equally informative for

entities applying FRS 102. Therefore, entities could look to other Sections of FRS 102, such as Section 13 *Inventories*, Section 17 *Property, Plant and Equipment* and Section 18 *Intangible Assets other than Goodwill* when considering which costs are included or excluded when assessing whether an onerous contract provision is recognised.

As noted above, Section 21 defines an onerous contract a contract “...in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.” [FRS 102 Appendix I]. Neither Section 21 nor IAS 37 provide any further guidance on how ‘economic benefits expected to be received’ should be determined and there is some diversity in practice. In particular, whether the ‘economic benefit expected to be received’ should be interpreted narrowly (to include only the economic benefits to which the entity becomes directly entitled under the contract) or more broadly (to include other expected indirect benefits, such as access to future profitable contracts).

The evaluation of whether a contract is onerous does not require an intention by the entity to fulfil or to exit the contract. It does not even require there to be specific terms in the contract that apply in the event of its termination or breach. Its purpose is to recognise only the unavoidable costs to the entity. In the absence of specific clauses in the contract relating to termination or breach the unavoidable cost could include an estimation of the cost of walking away from the contract and having the other party go to court for compensation for the resultant breach.

There is a subtle yet important distinction between making a provision in respect of the unavoidable costs under a contract (reflecting the least net cost of what the entity has to do) compared to making an estimate of the cost of what the entity ‘intends’ to do. The first is an obligation, which merits the recognition as a provision. The second is a choice of the entity, which fails the recognition criteria because it does not exist independently of the entity’s future actions, [FRS 102.21.6], and is therefore akin to a future operating loss.

Illustration 3-3: Onerous supply contract

Entity P negotiated a contract in 20X3 for the supply of components when availability in the market was scarce. It agreed to purchase 100,000 units per annum for 5 years commencing 1 January 20X4 at a price of £20 per unit. Since then, new suppliers have entered the market and the typical price of a component is now £5 per unit. Whilst its activities are still profitable (Entity P makes a margin of £6 per unit of finished product sold) changes to the entity’s own business means that it will not use all of the components it is contracted to purchase. As at 31 December 20X6, Entity P expects to use 150,000 units in future and has 55,000 units in inventory. The contract requires 200,000 units to be purchased before the agreement expires in 20X8. If the entity terminates the contract before 20X8, compensation of £1 million per year is payable to the supplier. Each finished product contains one unit of the component.

Therefore, the entity expects to achieve a margin of £900,000 ($150,000 \times £6$) on the units it will produce and sell; but will make a loss of £15 ($£20 - £5$) per unit on each of the 105,000 components ($55,000 + 200,000 - 150,000$) it expects to be left with at the end of 20X8 and now expects to sell in the components market.

In considering the extent to which the contract is onerous, Entity P in the example above must compare the net cost of the excess units purchased of £1,575,000 ($105,000 \times £15$) with the related benefits, which includes the profits earned as a result of having a secure source of supply. Therefore, the supply contract is onerous (directly loss making) only to the extent of the costs not covered by related revenues, justifying a provision of £675,000 ($£1,575,000 - £900,000$).

3.3.1.A Onerous leases

As discussed in 3.1.1.D above, where other sections of FRS 102 do not contain specific requirements on accounting for contracts that have become onerous, Section 21 must be applied. [FRS 102.21.1].

Section 20 does not specify any particular requirements for onerous leases. For leases that have already commenced, an entity will reflect an onerous lease contract by applying the requirements of Section 20, which require a lessee to apply Section 27 to determine whether a right-of-use asset is impaired and to account for any impairment loss identified. [FRS 102.20.59]. For leases that have not yet commenced, short-term leases and leases of low-value assets to which paragraph 6 of Section 20 is applied, no right-of-use asset is recognised. As Section 20 does not specify any particular requirements for these types of onerous leases, Section 21 applies to:

- Leases that become onerous before the commencement date of the lease
- Short-term leases (as defined in Appendix I to FRS 102) that are accounted for in accordance with paragraph 6 of Section 20 and that have become onerous
- And
- Leases for which the underlying asset is of low value that are accounted for in accordance with paragraph 6 of Section 20 and that have become onerous.

Unlike Section 21, IAS 37 is explicit that these types of onerous leases are in scope of IAS 37. [IAS 37.5].

If a lease contract includes non-lease components that have been accounted for separately from the lease components as per paragraph 28 of Section 20, these non-lease components fall under the scope of Section 21. This is because Section 20 mandates that, unless the practical expedient in paragraph 33 is used, a lessee must account for non-lease components under other sections of FRS 102. [FRS 102.20.34].

In practice, a lease contract may sometimes require the lessee to pay costs related to the leased property to third parties during the lease term. For instance, the lessee, as the legal occupier of the property, may be required by law to pay quarterly business rates or other levies to local authorities or the government. Such levies are statutory obligations, and under IFRS, fall in scope of IFRIC 21. [IFRIC 21.4]. As discussed at 3.11.5 below, IFRIC 21 notes that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. [IFRIC 21.8]. Applying the requirements of IFRIC 21, the lessee recognises the levy when the event that triggers the payment of the levy occurs, which would be on a quarterly basis over the period in which the lessee remains legal occupier in this case. In the event that the lessee vacates the property before the lease term ends, it would not be appropriate for the lessee to recognise an onerous contract provision for these payments over the remaining lease term. While signing the lease contract is necessary, it is not sufficient to create a present obligation for business rates for the entire lease term. Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, it would be appropriate for entities to consider the guidance in IFRIC 21 in developing an accounting policy for the recognition of liabilities for levies under FRS 102 in accordance with the hierarchy in Section 10 (see Chapter 9 at 3.1).

A lease agreement may also obligate the lessee to bear additional costs payable to third parties, which are not statutory requirements. For instance, a lease might mandate that the lessee ensures the leased property is properly insured throughout the lease term. If the lessee vacates the property before the lease ends but is bound by the lease contract to maintain insurance coverage until the lease expires, this constitutes a 'past obligating event'. Consequently, the lessee must recognise an onerous contract provision for the insurance costs. [FRS 102.21.4]. Conversely, if the lease does not impose such an obligation and the lessee voluntarily continues to insure the property for the duration of the lease, there is no past obligating event concerning insurance costs. In this scenario, the insurance expenses would be considered future operating costs and expensed as incurred, without recognising an onerous contract provision.

3.3.1.B Contracts with customers that are, or have become, onerous

As Section 23 contains no specific requirements to address contracts with customers that are, or have become, onerous, Section 21 applies to such contracts. [FRS 102.21.1].

In assessing whether a contract with a customer is onerous, an entity is required to compare the unavoidable costs of meeting the obligations under the contract to the economic benefits expected to be received under it. The unavoidable costs under the contract are the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil the contract. [FRS 102.21A.2].

One question that may arise, is how an entity must account for an onerous contract with a customer when the contract includes several 'over time' performance obligations that are satisfied consecutively. Since the requirements for onerous contracts are outside the scope of Section 23, an entity's accounting for onerous contracts does not affect the accounting for its revenue from contracts with customers in accordance with Section 23.

How we see it

To account for an onerous contract with a customer when the contract includes several 'over time' performance obligations that are satisfied consecutively, we believe that an entity must use an 'overlay' approach, which consists of two steps:

- Apply the requirements of Section 23 to measure progress in satisfying each performance obligation, and account for the related costs when incurred in accordance with the applicable standards.
- At the end of each reporting period, apply Section 21 to determine if the remaining contract as a whole is onerous. If the entity concludes that the remaining contract as a whole is onerous, it recognises a provision only to the extent that the amount of the remaining unavoidable costs under the contract exceed the remaining economic benefits to be received under it.

This approach is shown in Illustration 3-4 below.

Illustration 3-4: Onerous contract with several 'over time' performance obligations that are satisfied consecutively

Entity A enters into a contract that consists of two distinct performance obligations, which are satisfied consecutively. Revenue is recognised over time for both performance obligations. Entity A expects to satisfy the first performance obligation (PO1) during Years 1-4 and the second performance obligation (PO2) in Years 5-6. Entity A measures progress towards the satisfaction of both performance obligations based on costs incurred compared to the total expected costs (i.e., it applies an input method under Section 23).

If Entity A terminates the contract, a penalty of £100,000 is payable.

The expected revenues and costs at the inception of the contract and the updated expectations at the beginning of Year 2 are as follows:

	At contract inception		Update in Year 2		
	<i>Expected costs (£)</i>	<i>Expected revenue (£)</i>	<i>Expected costs (£)</i>	<i>Expected revenue (£)</i>	<i>Expected progress (£)</i>
PO1					
Year 1	24,000	30,000	24,000	30,000	25%
Year 2	24,000	30,000	24,000	30,000	25%
Year 3	24,000	30,000	24,000	30,000	25%
Year 4	24,000	30,000	24,000	30,000	25%
Total PO1	96,000	120,000	96,000	120,000	
PO2					
Year 5	10,000	15,000	32,000	15,000	50%
Year 6	10,000	15,000	32,000	15,000	50%
Total PO2	20,000	30,000	64,000	30,000	
Total contract	116,000	150,000	160,000	150,000	
Gross profit/(loss)		34,000		(10,000)	

At contract inception, Entity A expects a positive margin for both performance obligations. At the beginning of Year 2, its estimates of the cost to fulfil the second performance obligation are increased by £44,000. Therefore, Entity A now expects to incur a loss of £34,000 for the second performance obligation, resulting in a negative margin for the entire contract of £10,000.

The contract as a whole is only onerous to the extent that the remaining costs to be incurred exceed the remaining benefits to be recognised. This is not the £34,000 loss relating to the second performance obligation, because at the beginning of Year 2, Entity A has yet to recognise profits of £18,000 for the completion of the first performance obligation. As a result, the net cost of fulfilling the contract at Year 2 is £16,000. This cost is less than the termination penalty of £100,000 and therefore, applying the 'overlay' approach explained above, Entity A recognises a provision under Section 21 of £16,000 in Year 2.

In Years 2 to 4, as the first performance obligation is being completed, the provision increases to reflect the higher net cost of satisfying the remaining performance obligations in the contract. As at the end of Year 4, only the revenues and costs relating to the second performance obligation remain, such that the provision now stands at £34,000 and is utilised in Years 5 and 6 as the related losses are incurred.

The table below illustrates the effect of this accounting treatment (assuming that the actual outcome of the contract is the same as the updated estimates). This example ignores the time value of money for simplicity reasons.

	<i>Costs</i>	<i>Revenue</i>	Provision		<i>Profit or loss for the period</i>
			<i>Additions/ Utilisations</i>	<i>Balance</i>	
Year 1	24,000	30,000	-	-	6,000
Year 2 (change in estimated total costs)	-	-	16,000	16,000	(16,000)
Year 2	24,000	30,000	6,000	22,000	-
Year 3	24,000	30,000	6,000	28,000	-
Year 4	24,000	30,000	6,000	34,000	-
Year 5	32,000	15,000	(17,000)	17,000	-
Year 6	32,000	15,000	(17,000)	-	-
Total	160,000	150,000	-	-	(10,000)

The effect of an onerous contract provision, or a change in the provision, is recognised as an expense in profit or loss and not as an adjustment to revenue.

As provisions for onerous contracts with customers are in the scope of Section 21, they are classified as provisions in the balance sheet and disclosed in accordance with Section 21 (see 4.1 below). Onerous contract provisions are outside the scope of Section 23 and are not included within contract liabilities.

Since the definition of an onerous contract in Section 21 refers only to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather than the performance obligations identified in accordance with Section 23. [FRS 102.21A.2]. As a result, the entity must consider the entire remaining contract, including remaining revenue to be recognised for unsatisfied, or partially unsatisfied, performance obligations and the remaining costs to fulfil those performance obligations.

As discussed at 3.3.1 above, there is diversity in practice in how entities determine the economic benefits expected to be received under a contract for the purposes of assessing whether a contract is onerous. Where a contract with a customer contains an element of variable consideration, it is likely that judgement will be required in assessing the economic benefits expected to be received under a contract. This may particularly be the case where an entity is required to constrain the estimate of variable consideration to be included in the transaction price for revenue recognition purposes under Section 23. Variable consideration under Section 23 is discussed further in Chapter 25 at 6.2.

3.3.2 Restructuring provisions

A restructuring is a programme that is planned and controlled by management and materially changes either:

- The scope of a business undertaken by an entity.
Or
- The manner in which that business is conducted. [FRS 102 Appendix I].
- In practice, a restructuring may include changes such as the sale or termination of a line of business, the closure of business locations in a country or region, changes in management structure or fundamental reorganisations that have a material effect on the nature and focus of the entity's operations. Whilst the definition of a restructuring may be widely interpreted, there must be a material change to either the scope of the business or the way in which it is conducted. This may be a subjective judgement. However, this distinction is essential to prevent entities from presenting routine operating expenses as restructuring costs, which could mislead users of the financial statements by portraying such costs as something other than the normal expenditures of running a dynamic business.

An entity recognises a provision for restructuring costs only when it has a legal or constructive obligation at the reporting date to carry out the restructuring. [FRS 102.21.11D].

The specific requirements within Section 21 for the recognition of a restructuring provision seek to define the circumstances that give rise to a constructive obligation to restructure.

Extract from Section 21

21.11C A restructuring gives rise to a constructive obligation only when an entity:

- (a) has a detailed formal plan for the restructuring identifying at least:
 - (i) the business or part of a business concerned;
 - (ii) the principal locations affected;
 - (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
 - (iv) the expenditures that will be undertaken; and
 - (v) when the plan will be implemented; and
- (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

[FRS 102.21.11C]

The following examples based on the Appendix to Section 21 illustrate how a constructive obligation for a restructuring may or may not be created. [FRS 102.21A.6, FRS 102.21A.7].

Illustration 3-5: The effect of timing of the creation of a constructive obligation on the recognition of a restructuring provision

Scenario 1: Closure of a division - no implementation before the end of the reporting period

On 12 December 20X6 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X6) the decision was not communicated to any of those affected and no other steps had been taken to implement the decision.

In these circumstances, no provision is recognised at 31 December 20X6 because the actions of management prior to this date are insufficient to create a constructive obligation.

Scenario 2: Closure of a division - Communication and implementation before the end of the reporting period

On 12 December 20X6, the board of an entity decided to close a division making a particular product. On 20 December 20X6 a detailed plan for closing the division was agreed by the board, letters were sent to customers warning them to seek an alternative source of supply, and redundancy notices were sent to the staff of the division.

The communication of management's decision to customers and employees on 20 December 20X6 creates a valid expectation that the division will be closed, thereby giving rise to a constructive obligation from that date. Accordingly, a provision is recognised at 31 December 20X6 for the best estimate of the costs that would be incurred to close the division.

In practice it can be very difficult to determine whether it is appropriate to recognise a provision for the future costs of a restructuring programme. The determination of whether an organisational change is a material change or just part of a process of continuous improvement is a subjective judgement. Once it has been established that the activities in question constitute a restructuring rather than an ongoing operating cost, it can be difficult to determine whether management's actions before the reporting date have been sufficient to have 'raised a valid expectation in those affected'. [FRS 102.21.11C(b)]. Even if a trigger point is easily identifiable, such as the date of an appropriately detailed public announcement, it might not necessarily commit management to the whole restructuring, but only to specific items of expenditure such as redundancy costs. When the announcement is less clear, referring for example to consultations, negotiations or voluntary arrangements, particularly with employees, judgement is required. Furthermore, taken on its own, the 'valid expectation' test is at least as open to manipulation as one based on the timing of a board decision. Entities anxious to accelerate or postpone recognition of a liability could do so by advancing or deferring an event that signals such a commitment, such as a public announcement, without any change to the substance of their position.

In these situations, it is important to consider all the related facts and circumstances and not to focus on a single recognition criterion. The objective of the analysis is to determine whether there is a past obligating event at the reporting date. The guidance in Section 21 about restructuring, referring as it does to constructive obligations and valid expectations is ultimately aimed at properly applying the principle in Section 21 that only those obligations arising from past events and existing independently of an entity's future actions are recognised as provisions. [FRS 102.21.6]. In essence, a restructuring provision qualifies for recognition if, as at the reporting date, it relates to a detailed plan of action from which management cannot realistically withdraw.

3.3.2.A Costs that can (and cannot) be included in a restructuring provision

Section 21 does not address which costs can or cannot be included within a restructuring provision. IAS 37, which contains consistent principles to Section 21 on the recognition and measurement of provisions, imposes criteria to restrict the types of cost that can be provided for. They specify that a restructuring provision must include only the direct expenditures arising from the restructuring, which are those that are both:

- Necessarily entailed by the restructuring.
- And
- Not associated with the ongoing activities of the entity. [IAS 37.80].

IAS 37 gives specific examples of costs that may not be included within the provision, because they relate to the future conduct of the business. Such costs include:

- Retraining or relocating continuing staff.
- Marketing.
- Investing in new systems and distribution networks. [IAS 37.81].

Given the consistent principles of Section 21 with IAS 37 in respect of the recognition of provisions, including restructuring provisions, we expect this additional guidance from IAS 37 to also be relevant for FRS 102 reporters. The application of these criteria would ensure that entities do not contravene the general prohibition in Section 21 against provisions for future operating losses. [FRS 102.21.11B].

Illustration 3-6: Distinguishing restructuring costs from ongoing expenses

On 15 November 20X6, management announced its intention to close down its operation in the North of the country and relocate to a new site in the South, primarily to be closer to its key customers. Before the end of the reporting period (31 December 20X6), the principal elements of the plan were agreed with employee representatives, a lease signed for a building at the new location, and a decision was made to market the existing facility for sale; all on the basis that production would start at the new location on 31 March 20X7 and the existing site would be vacated on 30 April 20X7. Production would cease at the existing site on 28 February 20X7 to allow plant and equipment to be relocated. Inventory levels would be increased up to that date so that customers could be supplied with goods sent from the Northern facility until 31 March 20X7.

Whilst the majority of the 600 existing staff was expected to take redundancy on 28 February 20X7, 50 had agreed to accept the entity's offer of relocation, including an incentive of £3,000 each towards relocation costs. Of those employees taking redundancy, 20 had agreed to continue to work for the entity until 30 June 20X7, to dismantle plant and equipment at the Northern site; install it at the new facility in the South; and train new staff on its operation. A bonus of £4,500 per employee would be payable if they remained until 30 June. A further 60 had agreed to stay with the entity until 31 March 20X7, to ensure that inventory was sent out to customers before the new site was operational, of which 10 would remain until 30 April 20X7 to complete the decommissioning of the Northern facility. These employees would also receive a bonus for staying until the promised date.

The announcement of management's decision on 15 November 20X6 and the fact that the key elements of the plan were understood by employees and customers of the Northern site before the end of the reporting period give rise to a constructive obligation that requires a provision to be recognised at 31 December 20X6 for the best estimate of the costs of the reorganisation.

However, only those direct costs of the restructuring not associated with ongoing activities can be included in the provision. For example, as follows:

Type of expense	Direct cost of restructuring	Associated with ongoing activities
Redundancy payments to 550 staff	•	
Payroll costs to 28 February 20X7 (all 600 staff)		•
Relocation incentive of £3,000 per employee (50 staff)		•
Payroll costs - to 31 March 20X7 (60 staff dispatching goods)		•
Payroll costs - March to June 20X7 (20 staff relocating plant) ^{Note 1}	•	•
Payroll costs - April 20X7 (10 staff decommissioning site)	•	
Costs of dismantling plant and equipment ^{Note 1}	•	•
Cost of transporting PP&E and inventory to the new site		•
Costs of recruiting and training staff for the Southern site		•
Rent of new site to 31 March 20X7 (pre-production)		•
Cost of invoices, forms and stationery showing new address		•
Note 1: Costs relating to dismantling plant and equipment that is no longer intended for use in the business could be regarded as a direct cost restructuring. However, costs relating to the dismantling and installation of equipment at the new site and training staff to operate it are costs associated with ongoing operations and, therefore, ineligible for inclusion in the restructuring provision.		

This example shows that individual classes of expenditure must be disaggregated into components that distinguish those elements associated with ongoing activities. Even if expenditure would not have been incurred without the restructuring activity, its association with ongoing activities means that it should not be included in a provision. In order to not contravene the general prohibition in Section 21 against provisions for future operating losses, the amounts to be included in a restructuring provision must be restricted to the direct expenditures arising from the restructuring, i.e., those that are both necessarily entailed by the restructuring; and not associated with the ongoing activities of the reporting entity.

[FRS 102.21.11B].

For that reason, whilst the cost of making employees redundant is an eligible restructuring cost, any incremental amounts paid to retain staff to ensure a smooth transition of operations from one location to another are not eligible because they are incurred to facilitate ongoing activities. Section 28 *Employee Benefits* requires these to be treated as short-term employee benefits to the extent that they are expected to be settled within 12 months after the end of the reporting period. [FRS 102.28.4]. Similarly, whilst the costs of dismantling plant and equipment intended to be scrapped is an eligible restructuring cost, the costs of dismantling plant and equipment intended to be relocated and installed at the new site is ineligible, because it is associated with ongoing activities.

The provision must not include identifiable future operating losses up to the date of the restructuring, unless they relate to an onerous contract. This means that even if the operation being reorganised is loss-making, its ongoing costs are not provided for. This is consistent with the general prohibition against the recognition of provisions for future operating losses. [FRS 102.21.11B].

The general requirement in Section 21 that gains from the expected disposal of assets cannot be taken into account in the measurement of provisions is also relevant to the measurement of restructuring provisions, even if the sale of the asset is envisaged as part of the restructuring. [FRS 102.21.8]. Whilst the expected disposal proceeds from asset sales might have been a significant element of the economic case for a restructuring, the income from disposal is not anticipated just because it is part of a restructuring plan.

3.3.3 Warranty provisions

Warranty provisions are specifically addressed by Example 4 in the Appendix to Section 21, which is reproduced in Illustration 3-8 and Illustration 3-9 at 3.8.1 and 3.8.2 below.

In Illustration 3-8 and Illustration 3-9 the assessment of the probability of an outflow of economic resources is made across the population of warranties as a whole and not using each potential claim as the unit of account. This makes it more likely that a provision will be recognised, because the probability criterion is considered in terms of whether at least one item in the population will give rise to a payment. Recognition then becomes a matter of reliable estimation and entities calculate an expected value of the estimated warranty costs.

An entity would apply Section 23 to warranties that provide the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. If the entity provides the customer with the option to purchase the warranty separately, the warranty provides the customer with an additional service. If the warranty cannot be purchased separately, the entity assesses whether the warranty provides the customer with an additional service, considering whether the warranty is required by law, the length of the warranty coverage, and the nature of tasks that the entity promises to perform. [FRS 102.23.27]. If the warranty provides the customer with an additional service, that additional service is a separate performance obligation and is accounted for in accordance with Section 23. Only if the warranty, or part of the warranty, does not provide the customer with an additional service would the warranty be accounted for in accordance with Section 21. Warranties are discussed further in Chapter 25 at 10.1.

3.3.4 Litigation and other legal costs

The Appendix to Section 21 includes an example of a court case to illustrate how the principles of Section 21 distinguish between a contingent liability and a provision in such situations. This example is reproduced in Illustration 3-7 at 3.4 below. However, the assessment of the particular case in the example is clear-cut. In most situations, assessing the need to provide for legal claims is one of the most difficult tasks in the field of provisioning. This is due mainly to the inherent uncertainty in the judicial process itself, which may be very long and drawn out. Furthermore, this is an area where either provision or disclosure might risk prejudicing the outcome of the case, because they give an insight into the entity's own view on the strength of its defence that can assist the claimant.

Whether an entity makes provision for the costs of settling a case or to meet any award given by a court will depend on a reasoned assessment of the particular circumstances, based on appropriate legal advice. The evidence to be considered must also include any additional evidence occurring after the end of the reporting period that confirms whether the entity had a present obligation at the reporting date. This is relevant if, for example, the court case is settled in the period between the reporting date and the date on which the financial statements are authorised for issue. [FRS 102.32.5(a)].

3.3.5 Financial guarantee contracts

A financial guarantee contract is a "...contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the original or modified terms of a debt instrument." [FRS 102 Appendix I].

As discussed at 3.1 above, in some cases, financial guarantee contracts may be excluded from the scope of Section 21. For financial guarantee contracts in the scope of Section 21, a provision is recognised if the general recognition criteria for provisions are met. This would include it being probable that the issuer would be required to make a payment under the guarantee.

3.4 Contingent liabilities

Extract from FRS 102 Appendix I

A contingent liability is either:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognised because:
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.

The term 'possible' is not defined in FRS 102. Literally, it could mean any probability greater than 0% and less than 100%. However, since 'probable' is defined as 'more likely than not', [FRS 102 Appendix I], it would be reasonable to use the term 'possible' in the context of contingent liabilities as meaning a probability of 50% or less. Accordingly, the above definition restricts contingent liabilities to those where either the existence of an obligation or an outflow of economic resources is less than 50% probable, or in those rare cases when a probable obligation cannot be measured with sufficient reliability.

Section 21 requires that contingent liabilities must not be recognised as liabilities on the balance sheet. The only exception to this is certain contingent liabilities assumed in a business combination. [FRS 102.21.12]. Such contingent liabilities are covered by the requirements of Section 19 (see Chapter 22).

Information about contingent liabilities must be disclosed unless the probability of an outflow of resources is remote (see 4.2 below). [FRS 102.21.12]. When an entity is jointly and severally liable for an obligation (see 3.8.6 below), the part of the obligation that is expected to be met by other parties is treated as a contingent liability and disclosed. [FRS 102.21.12].

Although it is not explicitly required by Section 21, we would expect contingent liabilities to be assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. Where this becomes the case, then the provision must be recognised in the period in which the change in probability occurs, except in the circumstances where no reliable estimate can be made. This is illustrated by Example 9 to Section 21, which is reproduced below. [FRS 102.21A.9].

Illustration 3-7: When the likelihood of an outflow of economic benefits becomes probable

A customer has sued Entity X, seeking damages for injury the customer allegedly sustained from using a product sold by Entity X. Entity X disputes liability on grounds that the customer did not follow directions in using the product. Up to the date the board authorised the financial statements for the year to 31 December 20X5 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 December 20X6, its lawyers advise that, owing to developments in the case, it is now probable that the entity will be found liable.

At 31 December 20X5, no provision is recognised and the matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote. On the basis of evidence available when the financial statements were approved, there is no obligation as a result of a past event.

At 31 December 20X6, a provision is recognised for the best estimate of the amount required to settle the obligation as at that date. The fact that an outflow of economic benefits is now believed to be probable means that there is a present obligation. The expense is recognised in profit or loss. It is not a correction of an error in 20X5 because, on the basis of the evidence available when the 20X5 financial statements were approved, a provision must not have been recognised at that time.

The requirement to recognise the effect of changing circumstances in the period in which the change occurs extends to the analysis of information available after the end of the reporting period and before the date of approval of the financial statements. Section 32 includes as a specific example of an adjusting event "...The settlement after the reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period...". It notes that the entity adjusts any previously recognised provision related to this court case in accordance with Section 21 or recognises a new provision and does not merely disclose a contingent liability. [FRS 102.32.5(a)].

3.5 Contingent assets

A contingent asset is defined as a "...possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity". [FRS 102 Appendix I]. In contrast to the case of contingent liabilities (see 3.4 above), the word 'possible' in the context of contingent assets is not confined to a probability level of 50% or less because Section 21 states that a contingent asset must never be recognised. [FRS 102.21.13].

Extract from Section 21

21.13 An entity shall not recognise a contingent asset as an asset. Disclosure of a contingent asset is required by paragraph 21.16 when an inflow of economic benefits is probable. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate. [FRS 102.21.13].

Only when the flow of economic benefits to the entity is virtually certain is the related asset not contingent and capable of recognition. [FRS 102.21.13]. 'Virtually certain' is not defined in FRS 102, but it is certainly a much higher hurdle than 'probable' and indeed more challenging than the term 'highly probable', defined in FRS 102 as "Significantly more likely than probable". [FRS 102 Appendix I]. We believe it's reasonable that virtual certainty is interpreted as being as close to 100% as to make any remaining uncertainty insignificant.

Contingent assets are disclosed when an inflow of economic benefits is probable, [FRS 102.21.13], with 'probable' meaning 'more likely than not'. [FRS 102 Appendix I]. The disclosure requirements for contingent assets are discussed at 4.3 below.

As with contingent liabilities, we would expect contingent assets to be assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income must be recognised in the period in which the change occurs. If a previously unlikely inflow becomes probable, then the contingent asset must be disclosed. [FRS 102.21.16].

The requirement to recognise the effect of changing circumstances in the period in which the change occurs extends to the analysis of information available after the end of the reporting period and before the date of approval of the financial statements. However, in contrast to contingent liabilities, no adjustment is made to reflect the subsequent settlement of a legal claim in favour of the entity. In this instance, the period in which the change occurs is subsequent to the reporting period. There is no suggestion that the example in paragraph 5(a) of Section 32 is referring to anything but liabilities. Paragraph 7 of Section 32 notes that an amount that becomes receivable due to a favourable judgement or settlement of a court case

after the reporting date but before the financial statements are authorised for issue is a contingent asset at the reporting date, and that disclosure may be required by paragraph 16 of Section 21. However, agreement on the amount of damages for a judgement that was reached before the reporting date, but was not previously recognised because the amount could not be measured reliably, may constitute an adjusting event. [FRS 102.32.7(b)].

3.5.1 Obligations contingent on the successful recovery of a contingent asset

Entities may sometimes be required to pay contingent fees to a third-party dependent upon the successful recovery of a contingent asset. For example, the payment of fees to a legal advisor in a contract agreed on a 'no win, no fee' basis will depend upon the successful outcome of a legal claim.

How we see it

Where entities are required to pay contingent fees to a third party, dependent upon the successful recovery of a contingent asset, the obligation for the success fee arises from an executory contract that must be evaluated separately from the legal claim. The liability for the success fee would therefore only be recognised by the entity upon winning the claim.

Section 21 uses the term executory contracts to mean "contracts under which neither party has performed any obligations or both parties have partially performed their obligations to an equal extent".

[FRS 102.21.1B(c)]. When payment for a contract for services is wholly contingent on recovering a contingent asset, no service requiring payment is deemed to be provided until or unless the matter is resolved successfully. Unless the contract also required payment to be made in the event of failure, the amount of work put in by the lawyer to prepare a case and argue for recovery of the contingent asset is irrelevant to the existence of a liability to pay fees.

If the entity has deemed it appropriate to recognise an asset in respect of the claim, it would be appropriate to take account of any such fees in the measurement of that asset (in determining the net amount recoverable); but no accrual is made for the legal fees themselves unless a successful outcome is confirmed.

This analysis is specific to a no win-no fee arrangement related to a contingent asset and may not be appropriate in other circumstances.

3.6 How probability determines whether to recognise or disclose

The following matrix summarises the treatment of contingencies under Section 21:

Likelihood of outcome	Accounting treatment: contingent liability	Accounting treatment: contingent asset
Virtually certain	Recognise	Recognise
Probable	Recognise	Disclose
Possible, but not probable	Disclose	No disclosure permitted
Remote	No disclosure required	No disclosure permitted

FRS 102 does not put a numerical measure of probability on either 'virtually certain' or 'remote'. In our view, the use of such measures would downgrade a process requiring the exercise of judgement into a mechanical exercise. It is difficult to imagine circumstances when an entity could reliably determine an obligation to be, for example, 92%, 95% or 99% likely, let alone be able to compare those probabilities objectively.

How we see it

We think it is reasonable to regard 'virtually certain' as describing a likelihood that is as close to 100% as to make any remaining uncertainty insignificant; to see 'remote' as meaning a likelihood of an outflow of resources that is not significant; and for significance to be a matter for judgement and determined according to the merits of each case.

3.7 Recognising an asset when recognising a provision

In most cases, the recognition of a provision results in an immediate expense in profit or loss. Nevertheless, in some cases it will be appropriate to recognise an asset. These issues are not discussed in Section 21, which neither prohibits nor requires capitalisation of the costs recognised when a provision is made. It states that the amount of the provision is expense, unless another Section of FRS 102 requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment.

[FRS 102.21.5].

Section 17 states that the cost of an item of property, plant and equipment includes the initial estimate of the costs, recognised and measured in accordance with Section 21, of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. [FRS 102.17.10].

The treatment of decommissioning costs is discussed further in 3.11.1 below.

3.8 Initial measurement

3.8.1 Best estimate of provision

Except in the case of an onerous contract, the amount required to be recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. [FRS 102.21.7]. In the case of an onerous contract, the amount required to be recognised as a provision is not based on an estimate of an expected outcome. Instead, the provision reflects the lower of the costs of fulfilling the contract and any compensation or penalties from a failure to fulfil it [FRS 102.21A.2], regardless of what the entity expects to do. Onerous contracts are discussed in 3.3.1 above.

The best estimate of the amount required to settle the obligation at the reporting date is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. [FRS 102.21.7].

Extract from Section 21

- 21.7** An entity shall measure a provision at the best estimate of the amount required to settle the obligation at the reporting date. The best estimate is the amount an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.
- (a) When the provision involves a large population of items, the estimate of the amount reflects the weighting of all possible outcomes by their associated probabilities. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.
 - (b) When the provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, even in such a case, the entity considers other possible outcomes. When other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.

When the effect of the time value of money is material, the amount of a provision shall be the present value of the amount expected to be required to settle the obligation. The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and risks specific to the liability. The risks specific to the liability shall be reflected either in the discount rate or in the estimation of the amounts required to settle the obligation, but not both.

As can be seen above, paragraph 7 of Section 21 states that the best estimate of the amount required to settle the obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period (implying a 'fulfilment value' measurement basis), or transfer it to a third party (suggesting a 'transfer value' measurement basis). The assumptions that an entity makes regarding derecognition of the liability could influence how the entity determines the best estimate of the expenditure required to settle the obligation. In practice, there are several ways in which an obligation recognised in accordance with Section 21 could be derecognised. For example:

- The obligation is settled by the entity performing the obligation itself (for example, the entity uses its own personnel to clean up a site to satisfy an environmental clean-up obligation).

- The entity employs a third party to perform the work required to settle the obligation (for example, the entity hires a third-party company to clean up the site).
- The entity transfers the obligation to a third party (for example, another entity takes on the obligation to clean up the site, the entity pays the transferee and is relieved of the obligation).

Or

- The obligation is cash settled by negotiation with the party to whom the obligation is owed (for example, the entity negotiates a cash settlement with the local municipality in order to be relieved of the obligation).

In our view, any of the assumptions above are acceptable basis for measurement provided that they appropriately reflect the facts and circumstances of the situation. If an entity exercises significant judgement in determining the most appropriate approach, consideration must be given to the disclosure requirements in paragraph 6 of Section 8 *Notes to the Financial Statements*. See Chapter 6 at 7.3.

How we see it

The assumptions that an entity makes regarding how an obligation recognised in accordance with Section 21 will be derecognised could influence how the entity determines the best estimate of the expenditure required to settle the obligation. We believe that this is acceptable, provided that the measurement basis appropriately reflects the facts and circumstances of the situation.

It is implicit in the definition of a provision that there are often uncertainties around the amount of the outflow required by an entity. Section 21 sets out different approaches to dealing with these uncertainties in arriving at an estimate of the provision, depending upon whether it arises from a single obligation or from a large population of items.

Where a provision arises from a single obligation, the individual most likely outcome may be the best estimate of the amount required to settle the obligation. However, even in such a case, the other possible outcomes must be considered. When the other possible outcomes are mostly higher than the most likely outcome, the best estimate will be higher than the individual most likely amount. Conversely, when other possible outcomes are mostly lower, the best estimate will be lower than the individual most likely amount. [FRS 102.21.7(b)]. In effect, this adjustment builds into the measure of the provision an allowance to reflect the risk that the actual outcome is an amount other than the individual most likely outcome.

When the provision involves a large population of items, the best estimate of the amount required to settle the obligation reflects the weighting of all possible outcomes by their associated probabilities, i.e., a probability-weighted expected value calculation is performed. [FRS 102.21.7(a)]. This method is illustrated by Example 4 in the Appendix to Section 21, which considers the estimation of a provision for product warranties, as set out below. [FRS 102.21A.4].

Illustration 3-8: Calculation of expected value: warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale, the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On the basis of experience, it is probable that there will be some claims under the warranties. Accordingly, it is determined that the obligating event is the sale of a product with a warranty and an outflow of resources in settlement is probable for the warranties as a whole (i.e., it is more likely than not that the manufacturer will have to settle some warranties given on past sales). The entity therefore recognises a provision for the best estimate of the costs of making good under the warranty products sold before the reporting date.

In 2026, goods are sold for £1,000,000. Experience indicates that 90 per cent of products sold require no warranty repairs; 6 per cent of products require minor repairs costing 30 per cent of the sale price; and 4 per cent of products require major repairs or replacement costing 70 per cent of sale price. Therefore, estimated warranty costs are:

Possible outcome	Probability weighted cost	Expected value (£)
No repair required	$£1,000,000 \times 90\% \times 0$	0
Minor repairs	$£1,000,000 \times 6\% \times 30\%$	18,000
Major repairs	$£1,000,000 \times 4\% \times 70\%$	28,000
Expected value		46,000

Where the provision involves a large population of items and there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used as the best estimate of the amount required to settle the obligation. [FRS 102.21.7(a)].

3.8.2 Discounting the estimated cash flows to a present value

When the effect of the time value of money is material, the amount of a provision is the present value of the amount expected to be required to settle the obligation. The discount rate (or rates) must be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The risks specific to the liability must be reflected either in the discount rate or in the estimation of the amounts required to settle the obligation, but not both. [FRS 102.21.7].

This requirement is illustrated in the following example taken from the Appendix to Section 21.

[FRS 102.21A.4].

Illustration 3-9: Discounting the estimated cash flows to a present value

The fact pattern is the same as Illustration 3-8 above, with the probability-weighted estimate of total warranty costs for goods sold in 20X6 expected to be £46,000. In this case, the expenditures for warranty repairs and replacements are expected to be made 60% per cent in 20X7, 30% per cent in 20X8 and 10 per cent in 20X9, in each case at the end of the period. Because the estimated cash flows already reflect the probabilities of the cash outflows, and assuming there are no other risks or uncertainties that must be reflected, to determine the present value of those cash flows the entity uses a 'risk-free' discount rate based on national government bonds with the same term as the expected cash outflows (6 per cent for one-year bonds and 7 per-cent for two-year and three-year bonds). Calculation of the present value, at the end of 20X6, of the estimated cash flows related to the warranties for products sold in 20X6 is as follows:

Year		Expected cash payments (£)	Discount rate	Discount factor	Present value (£)
1	60% × £46,000	27,600	6%	0.9434 (at 6% for 1 year)	26,038
2	30% × £46,000	13,800	7%	0.8734 (at 7% for 2 years)	12,053
3	10% × £46,000	4,600	7%	0.8163 (at 7% for 3 years)	3,755
Present value					41,846

The entity will recognise a warranty obligation of £41,846 at the end of 20X6 for products sold in 20X6.

FRS 102 gives no further guidance on how an entity determines the appropriate discount rate to use. However, the example above refers to a government bond rate with a similar term as the related obligation. This is consistent with the application of similar requirements in IAS 37.

The main types of provision where the impact of discounting will be significant are those relating to decommissioning and other environmental restoration liabilities, which are discussed at 3.11.1 and 3.11.2 below.

3.8.2.A Real or nominal rate

Section 21 does not indicate whether the discount rate must be a real discount rate or a nominal discount rate. The discount rate to be used depends on whether:

- The future cash flows are expressed in current prices, in which case a real discount rate (which excludes the effects of general inflation) is used.
- Or
- The future cash flows are expressed in expected future prices, in which case a nominal discount rate (which includes a return to cover expected inflation) is used.

Either alternative is acceptable, and these methods may produce the same amount for the initial present value of the provision. However, the effect of the unwinding of the discount will be different in each case (see 3.9.1 below).

3.8.2.B Adjusting for risk and using a government bond rate

Section 21 requires that risk is taken into account in the calculation of a provision but gives little guidance as to how this is done. It merely states that the risks specific to the liability is reflected in either the discount rate or in the estimate of the amounts required to settle the obligation, but not in both.

[FRS 102.21.7]. One may use a discount rate that reflects the risk associated with the liability (a risk-adjusted rate). The following example shows how an entity might calculate such a risk adjusted rate.

Illustration 3-10: Calculation of a risk-adjusted rate

A company has a provision for which the expected value of the cash outflow in three years time is £250, and the risk-free rate (i.e., the nominal rate unadjusted for risk) is 5%. However, the possible outcomes lie within a range between £200 and £300. As the company is risk averse, management would settle instead for a certain payment of £270 in three years time rather than be exposed to the risk of the actual outcome being as high as £300. The effect of risk in calculating the present value can be expressed as either:

- Discounting the risk-adjusted cash flow of £270 at the risk-free (unadjusted) rate of 5%, giving a present value of £233.
- Or
- Discounting the expected cash flow (which is unadjusted for risk) of £250 at a risk-adjusted rate that will give the present value of £233, i.e., a rate of 2.35%.

As can be seen from this example, the risk-adjusted discount rate is a 'lower' rate than the unadjusted (risk-free) discount rate. This may seem counter-intuitive initially, because the experience of most borrowers is that banks and other lenders will charge a higher rate of interest on loans that are assessed to be higher risk to the lender. However, in the case of a provision a risk premium is being suffered to eliminate the possibility of the actual cost being higher (thereby capping a liability), whereas in the case of a loan receivable a premium is required to compensate the lender for taking on the risk of not recovering its full value (setting a floor for the value of the lenders financial asset). In both cases the actual cash flows incurred by the paying entity are higher to reflect a premium for risk. In other words, the discount rate for an asset is increased to reflect the risk of recovering less and the discount rate for a liability is reduced to reflect the risk of paying more.

A problem with changing the discount rate to account for risk is that this adjusted rate is a theoretical rate, as it is unlikely that there would be a market assessment of the risks specific to the liability alone.

[FRS 102.21.7]. However, the lower discount rate in the above example is consistent with the premise that a risk-adjusted liability is higher than a liability without accounting for the risk that the actual settlement amount is different to the estimate. It is also difficult to see how a risk-adjusted rate could be obtained in practice. In the above Illustration, it was obtained only by reverse-engineering; it was already known that the net present value of a risk-adjusted liability was £233, so the risk-adjusted rate was just the discount rate applied to unadjusted cash flow of £250 to give that result.

The alternative approach, to adjust the cash flows instead of using a risk-adjusted discount rate, [FRS 102.21.7], is conceptually more straightforward, but still presents the problem of how to adjust the cash flows for risk. It could be inferred from Illustration 3-8 at 3.8.1 above that estimated cash flows which reflect the probabilities of cash outflows represent risk adjusted cash flows. However, whilst a best estimate based solely on the expected value approach or the mid-point of a range addresses the uncertainties relating to there being a variety of possible outcomes, it does not fully reflect risk, because the actual outcome could still be higher or lower than the estimate. Nevertheless, adjusting estimated cash flows to reflect risk may be easier than attempting to risk-adjust the discount rate.

Where the risks specific to the liability are reflected in the estimated cash flows, they must not also be included in the discount rate. [FRS 102.21.7]. The discount rate to be applied in this case must therefore be a risk-free rate. As suggested in Illustration 3-9 at 3.8.2 above, it would be appropriate to apply a national government bond rate with a similar currency and remaining term as the provision. It follows that because a risk-adjusted rate is always lower than the risk-free rate, an entity cannot justify the discounting of a provision at a rate higher than a government bond rate with a similar currency and term as the provision.

In recent years, government bond rates have been more volatile as markets have changed rates to reflect (among other factors) heightened perceptions of sovereign debt risk. Several years ago, it was not uncommon for government debt to offer negative yields. It is now much less common. The question has therefore arisen whether government bond rates, at least in certain jurisdictions, should continue to be regarded as the default measure of a risk-free discount rate. Whilst the current volatility in rates has highlighted the fact that no debt (even government debt) is totally risk free, the challenge is to find a more

reliable measure as an alternative. Any adjustment to the government bond rate to 'remove' the estimate of sovereign debt risk is conceptually flawed, as it not possible to isolate one component of risk from all the other variables that influence the setting of an interest rate. Another approach might be to apply some form of average bond rate over a period of 3, 6 or 12 months to mitigate the volatility inherent in applying the spot rate at the period end. However, this is clearly inappropriate given the requirements in Section 21 to determine the best estimate of an obligation by reference to the expenditure required to settle it 'at the reporting date' [FRS 102.21.7] and to determine the discount rate on the basis of 'current market assessments' of the time value of money. [FRS 102.21.7].

With 'risk' being a measure of potential variability in returns, it remains the case that in most countries a government bond will be subject to the lowest level of variability in that jurisdiction. As such, it normally remains the most suitable of all the observable measures of the time value of money in a particular country. When government bond rates are negative or, more likely, result in a negative discount rate once adjusted for risk, we believe that it is not appropriate to apply a floor of zero to the discount rate as this would result in an understatement of the liability. As discussed above, and at 3.8.2.A above, there are various approaches to determining an appropriate discount rate. It may sometimes be the case that one or more of the acceptable approaches result in a negative discount rate whereas the application of an alternative permitted approach would not. In order to avoid some of the presentational difficulties associated with a negative discount rate, entities faced with a negative real discount rate before risk adjustment may wish to consider the alternative approach of discounting expected future cash flows expressed in future prices, at a nominal discount rate (see 3.8.2.A above), if the nominal rate is not negative. Similarly, entities that are faced with a negative risk-adjusted discount rate only because of risk adjustment (i.e., where risk free rates themselves are not negative) may wish to adopt the alternative approach of adjusting the estimated future cash flows to reflect the risks associated with the liability, rather than risk-adjusting the discount rate.

How we see it

Even as government bond rates have become more volatile in recent years, in most countries a government bond remains the most suitable of all the observable measures of the time value of money in a particular country. It follows that because a risk-adjusted rate is always lower than the risk-free rate, an entity cannot justify the discounting of a provision at a rate that is higher than a government bond rate with a similar currency and term to the provision.

Where government bond rates are negative or, more likely, result in a negative discount rate once adjusted for risk, we believe that it is not appropriate to apply a floor of zero to the discount rate as this would result in an understatement of the liability.

3.8.2.C Own credit risk

Section 21 does not address whether an entity's own credit risk is a risk-specific to a liability when determining a risk-adjusted discount rate. However, predominant practice is to exclude it for the reason that credit risk is generally viewed as a risk of the entity rather than a risk specific to the liability.

[FRS 102.21.7].

How we see it

Whether own credit risk is considered a risk specific to a liability could depend, at least in part, on the way in which an entity measures a provision (i.e., how an entity determines the best estimate of the expenditure required to settle the obligation).

As discussed in 3.8.1 above, the measurement objective in Section 21 is not precise, and the term 'best estimate' can be interpreted in different ways. For example, an entity could determine the best estimate by assuming that the obligation will be cash settled by negotiation with the party to whom the obligation is owed. In this case, own credit risk could be considered relevant if the party to whom the obligation is owed would be willing to negotiate a lower settlement amount if the entity risks defaulting in the future. If an entity has exercised significant judgement in determining the best estimate of the expenditure required to settle an obligation, and whether own credit risk is taken into account, consideration must be given to the disclosure requirements in paragraph 6 of Section 8. See Chapter 6 at 7.3.

3.8.3 Anticipating future events that may affect the estimate of cash flows

The amount that an entity expects will be required to settle an obligation in future may depend upon expectations and assumptions concerning future events, such as changes in legislation or technological advances. Section 21 does not address the extent to which such expectations are built into an entity's best estimate of the amount required to settle the obligation. IAS 37 provides guidance in this area. Given the consistent principles of Section 21 and IAS 37 regarding the measurement of provisions, entities may look to IAS 37 for further guidance based on the hierarchy set out in Section 10 (See Chapter 9 at 3.1). IAS 37 states that "Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur". [IAS 37.48].

The requirement for objective evidence means that it is not appropriate to reduce the best estimate of future cash flows simply by assuming that a completely new technology will be developed before the liability is required to be settled. There will need to be sufficient objective evidence that such future developments are likely. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised must reflect a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. It would be appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology. [IAS 37.49].

Similarly, if new legislation is to be anticipated, IAS 37 requires that there needs to be evidence both of what the legislation will demand and whether it is virtually certain to be enacted and implemented. In many cases sufficient objective evidence will not exist until the new legislation is enacted. [IAS 37.50].

These requirements are most likely to impact provisions for liabilities that will be settled some distance in the future, such as decommissioning costs (see 3.11.1 below).

3.8.4 Provisions must exclude gains on expected disposal of assets

An entity excludes gains from the expected disposal of assets from the measurement of a provision. [FRS 102.21.8]. Such gains are instead recognised at the time specified by the relevant Section of FRS 102 dealing with the assets concerned. This is likely to be of particular relevance in relation to restructuring provisions which are discussed at 3.3.2 above.

3.8.5 Reimbursement of amounts required to settle a provision

An entity may sometimes be reimbursed all or part of an amount required to settle a provision, for example through an insurance claim. The reimbursement must be recognised only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. [FRS 102.21.9]. It must be recognised as an asset in the statement of financial position and must not be offset against the provision. [FRS 102.21.9]. However, the expense relating to a provision can be presented net of reimbursement in the income statement or statement of comprehensive income. [FRS 102.21.9]. The amount recognised for the reimbursement must not exceed the amount of the provision. [FRS 102.21.9].

Except when an obligation is determined to be joint and several (see 3.8.6 below), any form of net presentation in the balance sheet is prohibited. This is because the entity would remain liable for the whole cost if the third party failed to pay for any reason, for example as a result of the third party's insolvency.

3.8.6 Joint and several liability

When an entity is jointly and severally liable for an obligation, it recognises only its own share of the obligation, based on the amount that it is probable that the entity will pay. The remainder that is expected to be met by other parties is treated as a contingent liability. [FRS 102.21.12].

Arguably, the economic position in the case of joint and several liability is no different than if the entity was liable for the whole obligation but expected to be reimbursed part of the amount required to settle the provision under the terms of an insurance contract. In both cases, the entity is exposed to further loss in the event that the other parties are unable or unwilling to pay. However, in the case of joint and several liability, the entity and the parties with whom it shares liability each have a direct (albeit shared) obligation for the past event. This contrasts with the case where the entity expects to be reimbursed part of the amount required to settle a provision by an insurance company. In this case, the insurance company from whom the reimbursement is expected has a contractual relationship only with the entity and has no direct obligation for the past event itself. Accordingly, any disclosed liability is not reduced on the basis that the entity holds valid insurance against the obligation.

3.9 Subsequent measurement of provisions

After initial recognition, provisions must be reviewed at each reporting date and adjusted to reflect the current best estimate of the amount required to settle the obligation. [FRS 102.21.11]. Any adjustments to the amounts previously recognised are recognised in profit or loss unless the provision was originally recognised as part of the cost of an asset. [FRS 102.21.11].

An entity must charge against a provision only those expenditures for which the provision was originally recognised. [FRS 102.21.10]. Therefore, if a provision is no longer required, the amount of the provision must be reversed. Provisions may not be redesignated or used for expenses for which the provision was not originally recognised.

When a provision is measured at the present value of the amount required to settle the obligation, the unwinding of the discount is recognised as a finance cost in profit or loss in the period it arises. [FRS 102.21.11]. However, the amount of finance cost recognised as an unwinding of the discount depends upon whether the provision has been discounted at a real or a nominal rate, and also whether the entity has used a risk-free or risk-adjusted discount rate. This is not addressed by Section 21 but is discussed at 3.9.1 and 3.9.2 below. In addition, Section 21 provides no guidance on the effect of changes in interest rates on the discount rates applied. This is discussed at 3.9.3 below.

3.9.1 Unwinding of the discount: impact of using real or nominal discount rates

As discussed at 3.8.2.A above, Section 21 provides no guidance on whether a real or nominal discount rate must be used to discount a provision. Whilst both methods may produce the same figure for the initial present value of the provision, the effect of the unwinding of the discount will be different in each case. This is best illustrated by way of an example.

Illustration 3-11: Effect on future profits of choosing a real or nominal discount rate

A provision is required to be set up for an expected cash outflow of £100,000 (estimated at current prices), payable in three years' time. The appropriate nominal discount rate is 7.5%, and inflation is estimated at 5%. If the provision is discounted using the nominal rate, the expected cash outflow must reflect future prices. Accordingly, if prices increase at the rate of inflation, the cash outflow will be £115,762 ($£100,000 \times 1.05^3$). The net present value of £115,762, discounted at 7.5%, is £93,184 ($£115,762 \times 1 \div (1.075)^3$). If all assumptions remain valid throughout the three-year period, the movement in the provision would be as follows:

	Undiscounted cash flows	Provision
	£	£
Year 0	115,762	93,184
Unwinding of discount ($£93,184 \times 0.075$)		6,989
Revision to estimate		-
Year 1	115,762	100,173
Unwinding of discount ($£100,173 \times 0.075$)		7,513
Revision to estimate		-
Year 2	115,762	107,686
Unwinding of discount ($£107,686 \times 0.075$)		8,076
Revision to estimate		-
Year 3	115,762	115,762

If the provision is calculated based on the expected cash outflow of £100,000 (estimated at current prices), then it needs to be discounted using a real discount rate. This may be thought to be 2.5%, being the difference between the nominal rate of 7.5% and the inflation rate of 5%. However, it is more accurately calculated as 2.381%, being $(1.075 \div 1.05) - 1$. Accordingly, the net present value of £100,000, discounted at 2.381%, is £93,184 ($£100,000 \times 1 \div (1.02381)^3$), the same as the calculation using future prices discounted at the nominal rate.

If all assumptions remain valid throughout the three-year period, the movement in the provision would be as follows:

	Undiscounted cash flows	Provision
	£	£
Year 0	100,000	93,184
Unwinding of discount ($£93,184 \times 0.02381$)		2,219
Revision to estimate ($£100,000 \times 0.05$)	5,000	4,770
Year 1	105,000	100,173
Unwinding of discount ($£100,173 \times 0.02381$)		2,385
Revision to estimate ($£105,000 \times 0.05$)	5,250	5,128
Year 2	110,250	107,686
Unwinding of discount ($£107,686 \times 0.02381$)		2,564
Revision to estimate ($£110,250 \times 0.05$)	5,512	5,512
Year 3	115,762	115,762

Although the total expense in each year is the same under either method, what will be different is the allocation of the change in provision between operating costs (assuming the original provision was treated as an operating expense) and finance charges. It can be seen from the second table in the above example that using the real discount rate will give rise to a much lower finance charge each year. However, this does not lead to a lower provision in the balance sheet at the end of each year. Provisions must be revised annually to reflect the current best estimate of the amount required to settle the obligation. [FRS 102.21.11]. Thus, the provision in the above example at the end of each year needs to be adjusted to reflect current prices at that time (and any other adjustments that arise from changes in the estimate of the provision), as well as being adjusted for the unwinding of the discount. For example, the revised provision at the end of Year 1 is £100,173, being £105,000 discounted for two years at 2.381%. After allowing for the unwinding of the discount, this required an additional provision of £4,770.

A more significant difference will arise where the recognition of the original provision is included as part of the cost of property, plant or equipment, rather than as an expense, such as when a decommissioning provision is recognised. In that case, using a real discount rate will result initially in a lower charge to the income statement, since Section 21 requires any revision to the estimate of the provision is not taken to the income statement when the provision was originally recognised as part of the cost of an asset [FRS 102.21.11].

3.9.2 Unwinding of the discount: impact of using risk-free or risk-adjusted discount rates

The decision made by an entity to use a risk-free or risk-adjusted discount rate impacts on the unwinding of the discount and the amount recognised in finance costs in respect of the unwind. This is illustrated in the following Illustration:

Illustration 3-12: Effect on future profits of choosing a risk-free or risk-adjusted discount rate

A company is required to make a provision for which the expected value of the cash outflow in three years' time is £150, when the risk-free rate (i.e., the rate unadjusted for risk) is 5%. However, the possible outcomes from which the expected value has been determined lie within a range between £100 and £200. The reporting entity is risk averse and would settle instead for a certain payment of, say, £160 in three years' time rather than be exposed to the risk of the actual outcome being as high as £200. The measurement options to account for risk can be expressed as either:

- Discounting the risk-adjusted cash flow of £160 at the risk-free (unadjusted) rate of 5%, giving a present value of £138
- Or
- Discounting the expected cash flow (which is unadjusted for risk) of £150 at a risk-adjusted rate that will give the present value of £138, i.e., a rate of 2.8%

If no changes in estimate were made to the provision during the three-year period, the first alternative above will unwind to give an overall finance charge of £22 and a final provision of £160. The second alternative will unwind to give an overall finance charge of £12 and a final provision of £150.

In Illustration 3-12 above, the unwinding of different discount rates gives rise to different provisions. The difference of £10 (£22 - £12) relates to the risk adjustment that has been made to the provision. As the actual date of settlement comes closer, the estimates of the range of possible outcomes (and accordingly the expected value of the outflow) and the premium the entity would accept for certainty will converge. As such, the effect of any initial difference related to the decision to apply a risk-free or risk-adjusted rate will be lost in the other estimation adjustments that would be made over time.

3.9.3 The effect of changes in interest rates on the discount rate applied

Section 21 requires the discount rate to reflect current market assessments of the time value of money. [FRS 102.21.7]. It follows that where interest rates change, the provision must be recalculated on the basis of revised interest rates. This will give rise to an adjustment to the carrying value of the provision, but Section 21 does not address how this is classified in the income statement. We believe that the adjustment to the provision is a change in accounting estimate, as defined in Section 10 and discussed in Chapter 9 at 3.1. Accordingly, it will be reflected in the line item of the income statement (or statement of comprehensive income if presented) in which the expense establishing the provision was originally recorded. Where the original provision was recorded as part of the cost of an asset such as inventory or property, plant and equipment, the effect of any subsequent adjustment to discount rates is added to or deducted from the cost of the asset to which the provision relates.

Calculating this adjustment is not straightforward either, because Section 21 gives no guidance on how it must be done. For example, must the new discount rate be applied during the year or just at the year-end and must the rate be applied to the new estimate of the provision or the old estimate? Because Section 21 requires the value of a provision to reflect the best estimate of the expenditure required to settle the obligation to be assessed as at the end of the reporting period, [FRS 102.21.7], a change in the discount rate is applied prospectively from the end of the reporting period. This is illustrated in the following example:

Illustration 3-13: Accounting for the effect of changes in the discount rate

A provision is required to be set up for an expected cash outflow of £100,000 (estimated at current prices), payable in three years' time. The appropriate nominal discount rate is 7.5%, and inflation is estimated at 5%. At future prices the cash outflow will be £115,762 (£100,000 × 1.05³). The net present value of £115,762, discounted at 7.5%, is £93,184 (£115,762 × 1 ÷ (1.075)³).

At the end of Year 2, all assumptions remain valid, except it is determined that a current market assessment of the time value of money and the risks specific to the liability would require a decrease in the discount rate to 6.5%. Accordingly, at the end of Year 2, the revised net present value of £115,762, discounted at 6.5%, is £108,697 (£115,762 ÷ 1.065).

The movement in the provision would be reflected as follows:

	Undiscounted cash flows	Provision
	£	£
Year 0	115,762	93,184
Unwinding of discount (£93,184 × 0.075)		6,989
Revision to estimate		-
Year 1	115,762	100,173
Unwinding of discount (£100,173 × 0.075)		7,513
	115,762	107,686
Revision to estimate (£108,697 - £107,686)		1,011
Year 2	115,762	108,697
Unwinding of discount (£108,697 × 0.065)		7,065
Revision to estimate		-
Year 3	115,762	115,762

In Year 2, the finance charge is based on the previous estimate of the discount rate and the revision to the estimate of the provision would be charged to the same line item in the income statement that was used to establish the provision of £93,184 at the start of Year 1.

3.10 Funding commitments (other than loan commitments)

The requirements of FRS 102 regarding funding commitments are set out in Section 34 *Specialised Activities*, rather than in Section 21. Nevertheless, an entity is required to consider the requirements of both Section 21 and Section 2 when accounting for funding commitments. [FRS 102.34.58]. This does not apply to financial instruments, including loan commitments, which fall within the scope of Section 11 and Section 12. [FRS 102.34.57].

3.10.1 Recognition of a funding commitment as a liability

Section 34 requires that an entity recognises a liability and, usually, a corresponding expense, when it has made a commitment that it will provide resources to another party, if, and only if:

- The definition and recognition criteria for a liability have been satisfied.
- The obligation (which may be a constructive obligation) is such that the entity cannot realistically withdraw from it.

And

- The entitlement of the other party to the resources does not depend on the satisfaction of performance-related conditions. [FRS 102.34.59].

The definition of a liability requires that there be a present obligation, and not merely an expectation of a future outflow. [FRS 102.34A.1]. A general statement that the entity intends to provide resources to certain classes of potential beneficiaries in accordance with its objectives does not in itself give rise to a liability, as the entity may amend or withdraw its policy, and potential beneficiaries do not have the ability to insist on their fulfilment. Similarly, a promise to provide cash conditional on the receipt of future income in itself may not give rise to a liability where the entity cannot be required to fulfil it if the future income is not received and it is probable that the economic benefits will not be transferred. [FRS 102.34A.2].

A liability is recognised only for a commitment that gives the recipient a valid expectation that payment will be made and from which the grantor cannot realistically withdraw. One of the implications of this is that a liability only exists where the commitment has been communicated to the recipient. [FRS 102.34A.3].

Commitments that are performance-related will be recognised when those performance-related conditions are met. [FRS 102.34.60]. Performance-related conditions are defined in FRS 102 as conditions under which entitlement to resources is conditional on the performance of a specified activity or a particular level of service or units of output to be delivered. [FRS 102 Appendix I]. Commitments are not recognised if they are subject to performance-related conditions. In such a case, the entity is required to fulfil its commitment only when the performance-related conditions are met and no liability exists until that time. [FRS 102.34A.4].

A commitment may contain conditions that are not performance-related conditions. For example, a requirement to provide an annual financial report to the grantor may serve mainly as an administrative tool because failure to comply would not release the grantor from its commitment. This may be distinguished from a requirement to submit a detailed report for review and consideration by the grantor of how funds will be utilised in order to secure payment. A mere restriction on the specific purpose for which the funds are to be used does not in itself constitute a performance-related condition. [FRS 102.34A.5].

Whether an arrangement gives rise to a funding commitment and when such commitments are recognised is a matter of judgement based on the facts and circumstances of the case, as illustrated in Illustration 3-14 below.

Illustration 3-14: Accounting for donations to non-profit organisations

An entity decides to enter into an arrangement to 'donate' £1m in cash to a university. A number of different options are available for the arrangement and the entity's management want to determine whether the terms of these options make any difference to the timing, measurement or presentation of the £1m expenditure, as follows:

Option 1:

The entity enters into an unenforceable contract to contribute £1m for general purposes. The benefits to the entity are deemed only to relate to its reputation as a 'good corporate citizen'; the entity does not receive any consideration or significant benefit from the university in return for the donation.

Option 2:

As per Option 1 except the entity publishes a press release in relation to the donation and announcing that payment is to be made in equal instalments of £200,000 over 5 years.

Option 3:

As per Option 2, except that the contract is legally enforceable in the event that the entity does not pay all the instalments under the contract.

Option 4:

As per Option 2, except that the entity is only required to make the donation if the university raises £4m from other sources.

Option 5:

As per Option 2, except that the contract is legally enforceable and the funds will be used for research and development activities specified by the entity. The entity will retain proprietary rights over the results of the research.

Applying the requirements in respect of funding commitments discussed above:

- In Option 1, the contract is unenforceable, there is no announcement or conditions preceding payment and there is no exchange of benefits. Accordingly, an expense would be recognised only when the entity transfers cash to the university.
- For Option 2, it could be appropriate for the entity to conclude that the entity's announcement of the donation to be paid by instalments indicates that there is a constructive obligation because the entity has created a valid expectation that it will make all of the payments promised. Alternatively, it could determine that once the first instalment is paid, the entity has created a valid expectation that it will make the remaining payments. This is a matter of judgement. In this case the entity would recognise an expense and a liability, measured at the net present value of the 5 instalments of £200,000, at the point when it is determined that a constructive obligation exists.
- Option 3 involves an enforceable contract with no exchange of benefits. Therefore, a liability and an expense are recognised on signing the enforceable contract, measured at the present value of the 5 instalments of £200,000.
- Under Option 4, the contract is unenforceable and the donation is subject to a performance condition. In these circumstances, no liability exists until the performance condition is met (i.e., when the additional funds have been raised). [FRS 102.34.60]. Only then would a liability and expense be recognised, measured at the net present value of the £1m promised.
- Option 5 involves an enforceable contract which could give rise to a liability recognised when the contract is signed. However, there is an exchange of benefits relating to the research and development activities performed on behalf of the entity. Whether these benefits have a value close to the present value of the 5 instalments of £200,000 is a matter of judgement. If it is determined that this is an exchange transaction that is not onerous, the entity could regard the signing of the contract as executory and apply the criteria in Section 18 to determine whether an asset or expense could be recognised for the related research and development costs as incurred (see Chapter 21).

Where the arrangement gives rise to an exchange transaction rather than a donation, the expenditure incurred by the donor is recorded in accordance with the relevant Section of FRS 102. An exchange transaction is a reciprocal transfer in which each party receives and sacrifices approximately equal value. Assets and liabilities are not recognised until each party performs their obligations under the arrangement.

3.11 Other examples of provisions

Section 21 provides specific guidance in respect of a limited number of situations, which are discussed at 3.2.4. and 3.3 above. This Section considers other common provisions not addressed specifically by Section 21. As there is no specific guidance on accounting for these provisions within FRS 102, entities may, under the hierarchy set out in Section 10 (see Chapter 9 at 3.1) refer to the requirements and guidance of IFRS in formulating an appropriate accounting policy for these obligations.

3.11.1 Decommissioning provisions

Decommissioning costs arise when an entity is required to dismantle or remove an asset at the end of its useful life and to restore the site on which it has been located, for example, when an oil rig or nuclear power station reaches the end of its economic life.

Section 17 observes that the cost of an item of property, plant and equipment includes the initial estimate of the costs, recognised and measured in accordance with Section 21, of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. [FRS 102.17.10(c)]. See Chapter 20 at 3.4.3. However, Section 21 provides no specific guidance on decommissioning provisions.

In IAS 37, the accounting for decommissioning costs is dealt with by way of an example relating to an oil rig in an offshore oilfield. A provision is recognised at the time of constructing the oil rig in relation to the eventual costs that relate to its removal and the restoration of damage caused by building it. This is because the construction of the asset (and the environmental damage caused by it) creates the past obliging event requiring restoration in the future. Additional provisions are recognised over the life of the oil field to reflect the need to reverse damage caused during the extraction of oil. The total decommissioning cost is estimated, discounted to its present value and it is this amount which forms the initial provision. This 'initial estimate of the costs of dismantling and removing the item and restoring the site' is added to the corresponding asset's cost. Thereafter, the asset is depreciated over its useful life, while the discounted provision is progressively unwound, with the unwinding charge shown as a finance cost.

How we see it

Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, we believe that this approach is also appropriate for entities reporting under FRS 102

Neither Section 21 nor Section 17 give guidance on accounting for changes in the decommissioning provision. Under IFRS, guidance is provided by IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

IFRIC 1 applies to any decommissioning, restoration or similar liability that has been both included as part of the cost of an asset measured in accordance with IAS 16 or as part of the cost of a right-of-use asset in accordance with IFRS 16 and recognised as a liability in accordance with IAS 37. [IFRIC 1.2]. IFRIC 1 requires an increase that reflects the passage of time (also referred to as the unwinding of the discount) to be recognised in profit or loss as a finance cost as it occurs. [IFRIC 1.8]. The IFRS IC concluded that the unwinding of the discount is not a borrowing cost as defined in IAS 23 *Borrowing Costs*, and thus cannot be capitalised under that standard. [IFRIC 1.BC26, IFRIC 1.BC27].

For a change in either: (a) the estimated outflow of resources embodying economic benefits (e.g., cash flows) required to settle the obligation; or (b) change in the current market-based discount rate (this includes changes in the time value of money and the risks specific to the liability) the adjustment is taken to the income statement only in specific circumstances. Any revision to the provision (other than to reflect the passage of time) is first recognised in the carrying value of the related asset or in other comprehensive income, depending on whether the asset is measured at cost or using the revaluation model. [IFRIC 1.4, IFRIC 1.5, IFRIC 1.6, IFRIC 1.7].

If the related asset is measured using the cost model, the change in the liability is added to or deducted from the cost of the asset to which it relates. Where the change gives rise to an addition to cost, the entity must consider the need to test the new carrying value for impairment. This is particularly relevant for assets approaching the end of their useful life, as their remaining economic benefits are often small compared to the potential changes in the related decommissioning liability. Reductions over and above the remaining carrying value of the asset are recognised immediately in profit or loss. [IFRIC 1.5]. The adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. [IFRIC 1.7].

If the related asset is measured using the revaluation model, changes in the liability alter the revaluation surplus or deficit previously recognised for that asset. Decreases in the provision are recognised in other comprehensive income and increase the value of the revaluation surplus in respect of the asset, except that:

- A decrease in the provision is required to be recognised in profit or loss to the extent that it reverses a previous revaluation deficit on that asset that was recognised in profit or loss.
- If a decrease in the provision exceeds the carrying amount of the asset that would have been recognised under the cost model, the excess is required to be recognised in profit or loss. [IFRIC 1.6].

Increases in the provision are recognised in profit or loss, except that they must be recognised in other comprehensive income, and reduce the revaluation surplus, to the extent of any credit balance existing in the revaluation surplus in respect of that asset. Changes in the provision might also indicate the need for the asset (and therefore all assets in the same class) to be revalued. [IFRIC 1.6].

Some entities may participate in a decommissioning, restoration or environmental rehabilitation fund, the purpose of which is to segregate assets to fund some, or all, of the costs of decommissioning for which the entity must make a provision under Section 21. There is no specific guidance on such funds within FRS 102. Under IFRS, IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds* was issued to address the accounting for these funds, referring to decommissioning to mean not only the dismantling of plant and equipment but also the costs of undertaking environmental rehabilitation, such as rectifying pollution of water or restoring mined land. [IFRIC 5.1].

IFRIC 1 and IFRIC 5 are discussed further in the EY publication, International GAAP®. Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, IFRIC 1 and IFRIC 5 may be relevant for an FRS 102 reporter to consider in developing an accounting policy for decommissioning provisions and related funds under the hierarchy in Section 10 (see Chapter 9 at 3.1).

3.11.2 Environmental provisions

IAS 37 sets out two examples of circumstances where environmental provisions would be required, both in relation to contaminated land. The examples illustrate that an entity can have an obligation to clean up contaminated land either as a result of legislation or as a result of a widely publicised environmental policy. The accounting applied in these examples is consistent with the principles of Section 21.

The first example deals with the situation where it is virtually certain that legislation will be enacted which will require the clean-up of land already contaminated. In these circumstances, the virtual certainty of new legislation being enacted means that the entity has a present legal obligation as a result of the past event (contamination of the land), requiring a provision to be recognised. [IAS 37.IE Example 2A]. Although Section 21 does not contain equivalent guidance on virtual enactment of legislation (see 3.2.1 above), given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, this example may be relevant for an FRS 102 reporter to consider in developing an accounting policy for proposed new laws yet to be finalised.

The second example deals with a similar situation, except that the entity is not expected to be legally required to clean it up. Nevertheless, the entity has a widely publicised environmental policy undertaking to clean up all contamination that it causes and has a record of honouring this policy. In these circumstances, a provision is still required because the entity has created a valid expectation that it will clean up the land, meaning that the entity has a present constructive obligation as a result of past contamination.

[IAS 37.IE Example 2B].

It is therefore clear that where an entity causes environmental damage and has a present legal or constructive obligation to make it good; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the amount, a provision will be required. [IAS 37.14] [FRS 102.21.4].

3.11.3 Liabilities associated with emissions trading schemes

A number of countries around the world either have, or are developing, schemes to encourage reduced emissions of pollutants, in particular greenhouse gases. Schemes commonly involve a 'cap and trade' model whereby participants are allocated emission rights or allowances equal to a cap (i.e., a maximum level of allowable emissions) and are permitted to trade those allowances.

In 'cap and trade' schemes every tonne of emissions made creates an obligation. In such schemes, allowances received from the government represent economic resources of the entity (because they can be used for an alternative purpose, for example, sale to a third party) and, therefore, as the entity emits greenhouse gases it is probable there will be an outflow of economic resources (i.e., the allowances) to settle the obligation. In this situation, a liability is recognised as the entity emits, from the first tonne.

Neither Section 21 nor IFRS provide any specific requirements for 'cap and trade' schemes. In practice, three approaches have gained acceptance for accounting for 'cap and trade' emission schemes under IFRS:

- The IFRIC 3 *Emission Rights* approach, which despite having been withdrawn, is considered to be an appropriate interpretation of existing IFRS. This approach leads to the recognition of an asset for the credits or allowances; a government grant; and a liability in respect of emissions. However, this approach can result in accounting mismatches because the liability for the obligation to deliver allowances is measured at the current market price.

- The net liability approach where, in practice, two approaches have gained acceptance:
 - The 'net liability/carrying value' approach - under this approach, the allowances (or emission rights) received by way of a grant are recorded at a nominal amount (in most cases, nil) and purchased rights are initially recognised at cost. The liability component is measured at the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held (both granted and purchased). The measurement of the emissions liability can be estimated on a FIFO or on a weighted average basis. Using FIFO basis, an entity measures the liability taking into account the allowances held at the end of the (interim or annual) reporting period first, and then includes the expected cost per unit, using the current market price, for the actual shortfall at the end of the reporting period. Using a weighted average basis, an entity measures the liability by calculating the weighted average cost per unit of expected emissions over the entire compliance period (i.e., including the estimated shortfall).
 - The 'net liability/reimbursement rights' approach - under this approach, the allowances (or emission rights) received by way of a grant are recorded initially at a nominal amount (in most cases, nil) and purchased rights are initially recognised at cost, but the entity remeasures (to fair value) the emission rights (or allowances) that it holds and can use to settle the liability up the amount of emission made in the period. The liability component is measured at the best estimate of the cost to settle the liability taking into account the cost of any allowances currently held (and remeasured to fair value).
- The government grant approach leads to the recognition of an asset for the credits or allowances; a government grant; and a liability in respect of emissions. Therefore, it is similar to the IFRIC 3 approach, except that the liability is measured by reference to the carrying value of the credits or allowances to the extent they will be used to settle the liability.

FRS 102 reporters will need to develop their own accounting policy, in accordance with Section 10 (see Chapter 9 at 3.1).

3.11.4 EU Directive on Waste Electrical and Electronic Equipment

This Directive regulates the collection, treatment, recovery and environmentally sound disposal of waste electrical or electronic equipment (WE&EE). It applies to entities involved in the manufacture and resale of electrical or electronic equipment, including entities (both European and Non-European) that import such equipment into the EU.

The Directive states that the cost of waste management for historical household equipment must be borne by producers of that type of equipment that are in the market during a period to be specified in the applicable legislation of each Member State (the measurement period). The Directive states that each Member State must establish a mechanism to have producers contribute to costs proportionately e.g., in proportion to their respective share of the market by type of equipment.

IFRIC 6 *Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment* clarifies that the obligation under the Directive is linked to participation in the market during the measurement period, with there being no obligation unless and until a market share exists during the measurement period. The obligation is not linked to the production or sale of the items to be disposed of. Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, it would be appropriate to consider the guidance in IFRIC 6 in developing an accounting policy for the identification of an obligation arising from the Directive under FRS 102, in accordance with the hierarchy in Section 10 (see Chapter 9 at 3.1).

3.11.5 Levies charged on entities operating in a specific market

When governments or other public authorities impose levies on entities in relation to their activities, it is not always clear when the liability to pay a levy arises and when a provision is recognised.

Under IFRS, IFRIC 21 *Levies* addresses this question. It requires that, for levies within its scope, an entity must recognise a liability only when the activity that triggers payment, as identified by the relevant legislation, occurs. [IFRIC 21.8].

IFRIC 21 defines a levy as "...an outflow of resources embodying economic benefits that is imposed by governments on entities in accordance with legislation (i.e., laws and/or regulations), other than:

- (a) those outflows of resources that are within the scope of other Standards (such as income taxes that are within the scope of IAS 12 *Income Taxes*); and
- (b) fines or other penalties that are imposed for breaches of the legislation.

'Government' refers to government, government agencies and similar bodies whether local, national or international." [IFRIC 21.4].

In addition to income taxes and fines, IFRIC 21 does not apply to contractual arrangements with government in which the entity acquires an asset or receives services. [IFRIC21.4, IFRIC 21.5].

For levies within the scope of IFRIC 21, the activity that creates the obligation under the relevant legislation to pay the levy is the obligating event for recognition purposes. [IFRIC 21.8]. In many cases this activity is related to the entity's participation in a relevant market at a specific date or dates. The Interpretation states that neither a constructive nor a present obligation arises as a result of being economically compelled to continue operating; or from any implication of continuing operations in the future arising from the use of the going concern assumption in the preparation of financial statements. [IFRIC 21.9, IFRIC 21.10].

When a levy is payable progressively, for example, as the entity generates revenues, the entity recognises a liability over a period of time on that basis. This is because the obligating event is the activity that generates revenues. [IFRIC 21.11]. If an obligation to pay a levy is triggered in full as soon as a minimum threshold is reached, such as when the entity commences generating sales or achieves a certain level of revenue, the liability is recognised in full on the first day that the entity reaches that threshold. [IFRIC 21.12]. If an entity pays over amounts to government before it is determined that an obligation to pay that levy exists, it recognises an asset. [IFRIC 21.14].

The table below summarises the illustrative examples that accompany IFRIC 21, which provide guidelines on how to account for the timing of the recognition for the various types of levies: [IFRIC 21.IE1]

Illustrative examples	Obligating event	Recognition of liability
Levy triggered progressively as revenue is generated in a specified period.	Generation of revenue in the specified period.	Recognise progressively. A liability must be recognised progressively because, at any point in time during the specified period, the entity has a present obligation to pay a levy on revenues generated to date.
Levy triggered in full as soon as revenue is generated in one period, based on revenues from a previous period.	First generation of revenue in subsequent period.	Full recognition at that point in time. Where an entity generates revenue in one period, which serves as the basis for measuring the amount of the levy, the entity does not become liable for the levy, and therefore cannot recognise a liability, until it first starts generating revenue in the subsequent period.
Levy triggered in full if the entity operates as a bank at the end of the annual reporting period.	Operating as a bank at the end of the reporting period.	Full recognition at the end of the annual reporting period. Before the end of the annual reporting period, the entity has no present obligation to pay a levy, even if it is economically compelled to continue operating as a bank in the future. The liability is recognised only at the end of the annual reporting period.
Levy triggered if revenues are above a minimum specified threshold (e.g., when a certain level of revenue has been achieved)	Reaching the specified minimum threshold.	Recognise an amount consistent with the obligation at that point of time. A liability is recognised only at the point that the specified minimum threshold is reached. For example, a levy is triggered when an entity generates revenues above specified thresholds: 0% for the first CU50 million and 2% above CU50 million. In this example, no liability is accrued until the entity's revenues reach the revenue threshold of CU50 million.

We discuss the accounting for two levies that may be relevant to entities in the UK, the Bank of England Levy and the Apprenticeship Levy, at 3.11.5.A and 3.11.5.B below.

IFRIC 21 does not address the accounting for the costs that arise from recognising a liability to pay a levy. It requires entities to apply other IFRS accounting standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense. [IFRIC 21.3].

Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, it would be appropriate to consider the guidance in IFRIC 21 in developing an accounting policy for the recognition of liabilities for levies under FRS 102, in accordance with the hierarchy in Section 10 (see Chapter 9 at 3.1). IFRIC 21 is discussed further in the EY publication, International GAAP®.

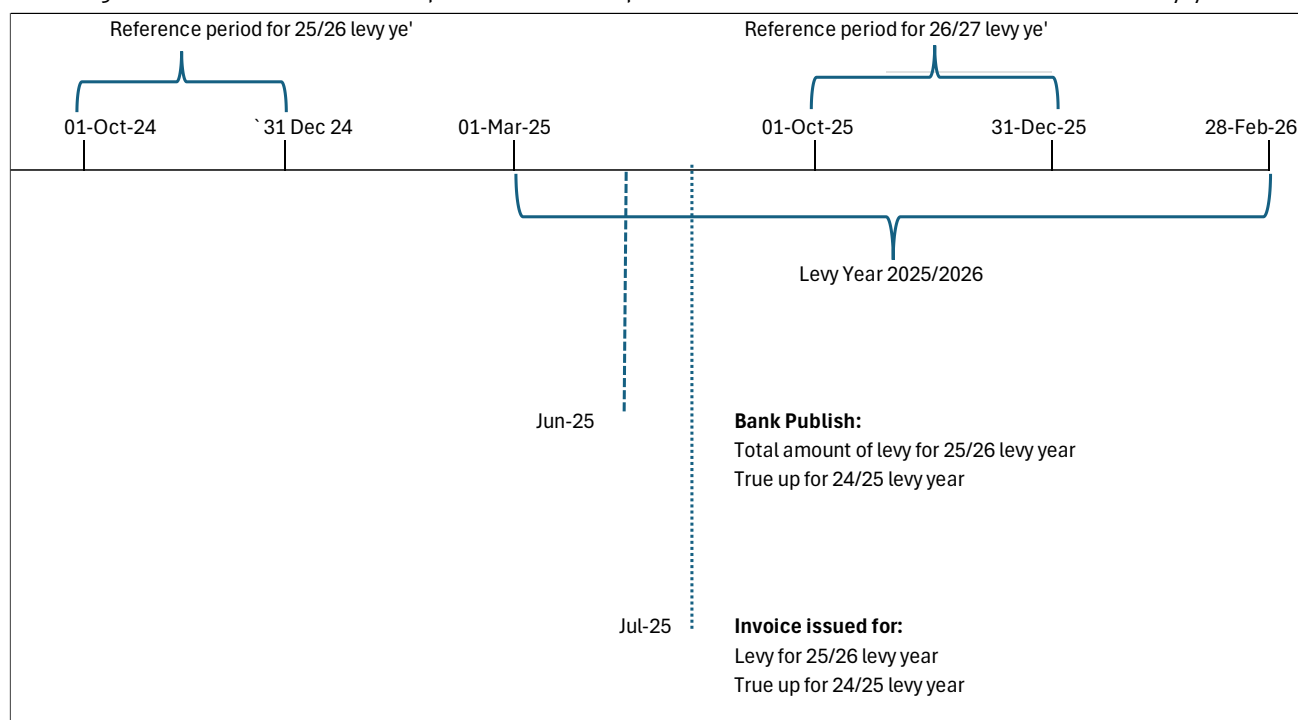
3.11.5.A UK Bank of England Levy

The UK Bank of England Levy is levied by the Bank of England on 'Eligible Institutions' to fund the costs of the Bank's monetary policy and financial stability operations. An Eligible Institution is defined in the Bank of England 1998 Act as an institution who, at any time during a Levy Year, is an authorised deposit taker under the Financial Services and Markets Act 2000.¹¹³

The Levy is charged to Eligible Institutions that have eligible liabilities greater than £600 million average in the period from 1st October to 31st December prior to the start of the Levy Year ('the Reference Period'). The Levy Year is the 12-month period beginning on 1st March in one calendar year to the last day of February in the following calendar year.

The Levy is charged annually for the year ahead, based on the Bank's projection for its annual policy costs and subject to any adjustments. In June of each year, the Bank publishes the total amount of the Levy for the current Levy Year, and any true up in respect of the previous Levy Year. An invoice for the Levy Year is issued to Eligible Institutions in July each year, reflecting the Levy amount payable by that entity for the current Levy Year, and any true-up for the previous Levy Year. The amount of levy payable by each payer is proportionate to the average size of the eligible liabilities in their deposit book during the Reference Period. Ceasing to be an Eligible Institution during a Levy Year does not discharge an entity from the obligation to pay the Levy in full for that year.

The diagram below shows an example of reference periods and other relevant dates within a Levy year.



¹¹³ The Financial Services and Markets Act 2000, Section 359(4) defines an authorised deposit taker as a person with a permission to accept deposits (but not a person who has a permission to accept deposits only for the purpose of carrying on another regulated activity in accordance with that permission).

For simplicity, the discussion below refers only to the liability in respect of each annual Levy Year, and not for any true-up adjustments in respect of the previous Levy Year.

As discussed above, IFRIC 21 provides specific guidance on accounting for levies under IFRS. Whilst there is no equivalent guidance in Section 21, entities may wish to apply it to the recognition of liabilities for levies under FRS 102, since Section 21 is consistent with the principles of IAS 37.

In considering when a levy is recognised, IFRIC 21 states “The obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation.” [IFRIC 21.8].

Based on the relevant Legislation,¹¹⁴ for an entity that is an Eligible Institution, there two conditions that trigger payment of the levy:

- The institution needs to meet the threshold of having an average amount of eligible liabilities of at least £600 million during a Reference Period, being 1st October to 31st December of the calendar year prior to a Levy Year (the 12-month period beginning on 1st March in one calendar year and ending on the last day of February in the following calendar year).

And

- The institution needs to be an authorised deposit taker at any time during the Levy Year.

The first condition could be met during the Reference Period (i.e., as soon as the average deposits meet £600 million). However, the second condition could be met only during the current Levy Year. Therefore, we believe that the obligating event that gives rise to a liability to pay a levy does not occur before 1st March. Assuming the first condition is met, an Eligible Institution will become liable to pay the levy on the first day of any given Levy Year that it is an authorised deposit-taker, typically on 1st March.

In addition, as noted above, ceasing to be an Eligible Institution during a Levy Year does not discharge an entity from the obligation to pay the levy in full for that year. Therefore, we believe that full liability for the Levy Year ending on the last day of February in the following calendar year would be recognised at the point the obligating event occurs, typically at the start of the Levy Year (1st March). As the total amount of the levy for the current Levy Year is not published until June of each year, and is invoiced to Eligible Institutions in July each year, entities recognising a liability at the start of the Levy Year will typically have to estimate the amount of the levy for that Levy Year, including the impact of any true-ups.

How we see it

In our view, the activity that triggers the payment for the levy in respect of a Levy Year would typically be met on the 1st March (i.e., at the start of the Levy Year) of any given year. The amount recognised on this date would be the full liability for the Levy Year.

3.11.5.B UK Apprenticeship levy

Since 6 April 2017, UK employers with an annual pay bill in excess of £3 million are required to pay a levy of 0.5% of that bill. Payments are made via the PAYE system, along with payroll taxes. Amounts paid by the employer are recorded in the employer’s account on the government controlled ‘Digital Apprenticeship System’ (DAS). Payments made under the levy are credited to the employer’s DAS account and are immediately available to fund certain approved apprenticeship training for, or assessment of, new hires or existing employees. Payments to the training provider are made directly by the government, with a corresponding reduction made to the employer’s DAS balance. The employer cannot recover cash directly from the DAS account, and amounts paid into the DAS expire after 24 months, i.e., they cannot be applied against training costs incurred after that time.

Government also contributes to apprenticeship costs, through a ‘top-up’ of £1 for every £10 paid in through the levy system, and through, in some cases, co-investment funding.

As discussed above, IFRIC 21 provides specific guidance on accounting for levies under IFRS. Whilst there is no equivalent guidance in Section 21, entities may wish to apply it to the recognition of liabilities for levies under FRS 102, since Section 21 is consistent with the principles of IAS 37. However, whilst IFRIC 21 addresses the recognition of liabilities to pay levies, entities are required to apply other Standards to decide whether recognition of a liability to pay a levy gives rise to an asset or expense. [IFRIC 21.3].

¹¹⁴ Bank of England Framework Document (paragraph 1.29), and the Bank of England Act (Schedule 2ZA)

How we see it

In our view, for employers that expect to enter into apprenticeships that meet the requirements for utilisation of funds in their DAS account within the 24-month life of those funds, the payment under the levy represents a prepayment for approved training services expected to be received and must be recognised an asset until the approved training occurs. An expense will be recognised when the training is delivered. Employers that do not expect to incur qualifying training costs before their entitlement to the funds expire must recognise the payment of the levy as an expense.

Both the government 'top-up' element of funding, and any benefit received under co-investment funding would meet the definition of government grants within FRS 102 and are therefore accounted for in accordance with Section 24 *Government Grants* (see Chapter 26).

3.11.6 Repairs and maintenance of owned assets

IAS 37 includes an example, reproduced in Illustration 3-15 below, within the appendices illustrating how the principles for the recognition of a provision are applied strictly in the case of an obligation to incur repairs and maintenance costs in the future on owned assets. This is the case even when this expenditure is substantial, distinct from what may be regarded as routine maintenance and essential to the continuing operations of the entity, such as major refit or refurbishment of the asset.

Repairs and maintenance provisions for owned assets are generally prohibited under IAS 37. Given that Section 21 and IAS 37 apply the same principles to the recognition and measurement of provisions, we would also not expect provisions for repairs and maintenance of owned assets to be recognised under FRS 102.

Entities might argue that a repairs and maintenance provision should be recognised due to a clear intention to incur the expenditure at a specified time, making it likely that an outflow of resources will occur by the end of the reporting period. However, a liability is only recognised when an entity has an obligation at the reporting date resulting from past event. Therefore, an entity's intentions do not create an obligation, and no liability is recognised. Paragraph 6 of Section 21 explains that obligations that will arise from an entity's future actions (i.e., the future conduct of its business) do not give rise to an obligation at the reporting date as a result of a past event, no matter how likely they are to occur. [FRS 102.21.6].

Illustration 3-15: Prohibition on maintenance provisions relating to owned assets

Scenario 1: Re-lining costs of a furnace

An entity operates a furnace, the lining of which needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. In these circumstances, a provision for the cost of replacing the lining is not recognised because, at the end of the reporting period, no obligation to replace the lining exists independently of the entity's future actions. Even the intention to incur the expenditure depends upon the entity deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the initial cost of the lining is treated as a significant part of the furnace asset and depreciated over a period of five years. The re-lining costs are then capitalised when incurred and depreciated over the next five years.

[IAS 37.IE Example 11A, FRS 102.17.16].

Scenario 2: Overhaul costs of an aircraft

An airline is required by law to overhaul its aircraft once every three years. Even with the legal requirement to perform the overhaul, there is no obligating event until the three-year period has elapsed. As with Scenario 1, no obligation exists independently of the entity's future actions. The entity could avoid the cost of the overhaul by selling the aircraft before the three-year period has elapsed. Instead of a provision being recognised, the overhaul cost is identified as a separate part of the aircraft asset under IAS 16 and is depreciated over three years. [IAS 37.IE Example 11B, FRS 102.17.16].

In the Illustration above, recognition of a provision was not appropriate because the entity could do all manner of things to avoid the obligation, including selling the asset, however unlikely that might be in the context of the entity's business or in terms of the relative cost of replacement as compared to repair.

The effect of the IAS 37 prohibition on setting up provisions for repairs obviously has an impact on presentation in the statement of financial position. It may not always, however, have as much impact on the statement of comprehensive income. This is because it is stated in the Illustration above that depreciation would be adjusted to take account of the repairs. For example, in the case of the furnace lining, the lining is depreciated over five years in advance of its expected repair. Similarly, in the case of the aircraft overhaul, the example in the standard states that an amount equivalent to the expected maintenance costs is depreciated over three years. The result of this is that the depreciation charge recognised in profit or loss over the life of the component of the asset requiring regular repair may be equivalent to what would previously have arisen from the combination of depreciation and a provision for repair. This is the way Section 17 requires entities to account for significant parts of an item of property, plant and equipment which have different useful lives. [FRS 102.17.16].

3.11.7 Dilapidations and other provisions relating to leased assets

Whilst it is not generally appropriate to recognise provisions that relate to repairs and maintenance of owned assets, the position can be different in the case of obligations relating to assets held under leases.

Leases often contain clauses which specify that the lessee must incur periodic charges for maintenance, make good dilapidations or other damage occurring during the rental period or return the asset to the configuration that existed as at inception of the lease. These contractual provisions may restrict the entity's ability to change its future conduct to avoid the expenditure. For example, the entity might not be able to transfer the asset in its existing condition. Alternatively, the entity could return the asset to avoid the risk of incurring costs relating to any future damage, but would have to make a payment in relation of dilapidations incurred to date. The contractual obligations in a lease could therefore create an environment in which a present obligation could exist as at the reporting date from which the entity cannot realistically withdraw.

Any provision must reflect only the conditions as at the reporting date. [FRS 102.21.4]. This means that a provision for specific damage done to the leased asset would merit recognition, as the event giving rise to the obligation under the lease has certainly occurred. For example, if an entity has erected partitioning or internal walls in a leasehold property and under the lease these must be removed at the end of the term, then provision is made for this cost (on a discounted basis, if material) at the time of putting up the partitioning or the walls. In this case, an equivalent asset would be recognised and depreciated over the term of the lease. [FRS 102.17.10].

How we see it

Leases often contain clauses which specify that the lessee is required to make good dilapidations or other damage occurring during the rental period or return the asset to the configuration that existed as at inception of the lease. However, there must be specific evidence of dilapidation before any provision can be made. It cannot be assumed that the condition of a leased asset has deteriorated simply because time has passed.

The fact that a provision for repairs can be made at all for leased assets might appear inconsistent with the case where the asset is owned by the entity. In that case, as discussed in 3.11.6 above, no provision for repairs could be made. There is, however, a difference between the two situations. Where the entity owns the asset, it has the choice of selling it rather than repairing it, and so the obligation is not independent of the entity's future actions. However, in the case of an entity leasing the asset, it can have a contractual obligation to repair any damage from which it cannot walk away.

3.11.8 Self-insurance

Another situation where entities sometimes make provisions is self-insurance which arises when an entity decides not to take out external insurance in respect of a certain category of risk because it would be uneconomic to do so. The same position may arise when a group insures its risks with a captive insurance subsidiary, the effects of which have to be eliminated on consolidation. In fact, the term 'self-insurance' is potentially misleading, since it really means that the entity is not insured at all and will settle claims from third parties from its own resources in the event that it is found to be liable. Accordingly, the recognition criteria in Section 21 must be applied, with a provision being justified only if there is a present obligation as a result of a past event; if it is probable that an outflow of resources will occur; and a reliable estimate can be determined. [FRS 102.21.4]. FRS 103 also clarifies that self-insurance is not insurance as there is no insurance contract because there is no agreement with another party. [FRS 103.A2.19(c)].

Therefore, losses are recognised based on their actual incidence and any provisions that appear in the balance sheet must reflect only the amounts expected to be paid in respect of those incidents that have occurred by the end of the reporting period.

In certain circumstances, a provision will often be needed not simply for known incidents, but also for those which insurance companies call IBNR - Incurred But Not Reported - representing an estimate of claims that have occurred at the end of the reporting period, but which have not yet been notified to the reporting entity.

How we see it

In our view, this approach is less likely to be appropriate when assessing a small number of distinct claims but could be needed when estimating the amount of a provision for a larger population of claims with common characteristics. We believe that it is appropriate that provision for such expected claims is made to the extent that such items can be measured reliably.

3.11.9 Parent company guarantees given in connection with audit exemption

The Companies Act 2006 exempts some subsidiary companies from the requirement to be audited, subject to a number of conditions. One of the conditions requires that the parent company files with the registrar a statutory guarantee of all of the outstanding financial liabilities of the subsidiary at the end of the financial year for which the subsidiary seeks an exemption from audit. [s394A, s479A].

How we see it

In our view, the statutory guarantee is not a contract. It therefore does not meet the definition of a financial guarantee contract within FRS 102 and must be accounted for under Section 21.

If it is only a remote possibility that the guarantee will be called upon by the subsidiary's creditors, the parent does not recognise a provision nor disclose the guarantee in their separate financial statement. If it is possible (but not probable) that the guarantee will be called upon, the parent must disclose a contingent liability in their separate financial statements. If it is probable that the guarantee will be called upon, the parent must recognise a provision for the best estimate of the amount required to settle the obligation under the guarantee at the reporting date.

3.11.10 Net zero commitments and liabilities

In recent years, many entities have declared that they intend to reduce and/or offset their greenhouse gas emissions with the aim of achieving net zero emissions. The financial reporting consequences of such net zero commitments will vary depending on the nature of the declarations. In some cases, an entity may declare an intention to be net zero by a certain date without committing itself to any particular actions. In other cases, entities may declare an intention to be net zero by a certain date and commit to certain actions to support that intention. Entities will need to assess whether they have a legal or constructive obligation that requires recognition of a provision.

In many cases, it may be difficult to conclude that there is a legal or constructive obligation that requires recognition of a provision. Net zero declarations often represent declarations of intentions to be met over the long term, such as by 2050, and could be changed over the course of time, for example, as a result of developments in technology related to carbon emissions. The long-term nature of such commitments may mean that an entity can still realistically withdraw from the commitment, and a declaration of intention may not raise a valid expectation in other parties regarding the entity's future actions. [FRS 102.21.6].

In addition, some actions committed to be taken towards achieving net zero may be within the scope of other Sections of FRS 102, rather than Section 21. For example, a contractual commitment to purchase low-emission plant and equipment would usually be in scope of Section 17 rather than Section 21 and would require disclosure. [FRS 102.17.32(b)]. Executory contracts, such as contractual commitments for the acquisition of plant and equipment, are within the scope of Section 21 only if they are onerous. [FRS 102.21.1B].

Under Section 21, obligations that will arise from an entity's future actions cannot be recognised as a provision. [FRS 102.21.6]. A legal requirement or public commitment to offset future greenhouse gas emissions does not, in itself, give rise to a present obligation requiring recognition of a provision. Instead, an entity could have a present obligation for the costs of offsetting emissions only when it has emitted the gas it is required, or has promised, to offset.

It is worth noting that, determining whether an entity has created a valid expectation will depend on the facts of the commitment and the circumstances surrounding it. Therefore, management needs to apply judgement to reach a conclusion. If those facts or circumstances change over time, the conclusion could do so as well. Factors that may be relevant for management to consider in their analysis include:

- The language is used in the statement. If statements describe the actions the entity 'will take', 'is committed to taking' or 'pledges to take', they are more likely to indicate that the entity will fulfil the commitment than statements that describe the entity's 'ambitions', 'targets' or 'aspirations'.
- The specificity and status of plans supporting the statement. Statements are more likely to raise a valid expectation that the entity will achieve its target to reduce its greenhouse gas emissions if they are supported by formally approved plans detailing, for example:
 - The nature and timing of the actions the entity will take to achieve the reductions.
 - Milestones the entity has committed to achieve on the path to longer term goals.
 - How management will measure progress towards the milestones and longer-term goals (for example, the metrics an entity will use).
- The expected timing of the actions required to fulfil the commitment. Plans for short- and medium-term actions are less likely to be changed than those for longer-term actions.
- Whether there is publicly available evidence of progress to date. Evidence that the entity has achieved milestones it committed to in previous statements may enhance expectations that it will achieve milestones and longer-term goals it commits to in its current statement. Conversely, evidence that an entity has failed to achieve previous milestones may reduce those expectations.

If the entity's statement has not created a constructive obligation, the entity does not recognise a provision. If the entity's statement has created a constructive obligation, consideration must then be given to whether that obligation satisfies the criteria for recognising a provision. Section 21 requires an entity to recognise a provision when the following criteria are met:

- The entity has a present obligation (legal or constructive) as a result of a past event.
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

And

- A reliable estimate can be made of the obligation. *[FRS 102.21.4]*.

With regards to first criterion, the publication of a policy or statement is not sufficient to give an entity a present constructive obligation. An entity has a present legal or constructive obligation only when the event to which the law, policy or statement applies has occurred.

When an entity publishes a climate-related (net-zero) commitment that requires future action (e.g., modifying its manufacturing methods, purchasing and retiring carbon credits in the future), the related costs need to be incurred to operate in the future. The obligations to incur those costs do not exist independently of the entity's future actions. Accordingly, there is no present obligation for those costs when the entity publishes its commitment. *[FRS 102.21.6]*. An entity will have a present obligation for the modifications to its manufacturing methods once it must pay for resources it purchases to modify its methods - for example, to pay for new plant or equipment or for renewable energy - but only when it receives those resources. Similarly, in the case of a commitment to offset greenhouse gas emissions, the entity will have a present obligation only when the entity emits the gases it has committed to offset.

In considering second criterion above, whether a constructive obligation satisfies the probable outflows criterion depends on the nature of the actions required to settle it. Even if an entity will incur expenditure to settle an obligation, it will not suffer a net outflow of resources if it receives resources of equal value in exchange for that expenditure. For example, an entity may expect to incur expenditure on low-emission plant and equipment in order to modify its manufacturing methods to meet net zero commitments. In that case, the entity will receive resources (plant and equipment) of equal value in exchange for the cash outflow, and no net outflow of resources embodying economic benefits will be required to settle the obligation.

If a provision is recognised, the corresponding amount is recognised as an expense, rather than as an asset, unless it gives rise to, or forms part of the cost of, an item that qualifies for recognition as an asset in accordance with another Section of FRS 102.

Illustration 3-16: Recognising a provision for a net zero commitment

In March 20X6, a manufacturer publicly announces its commitment to becoming 'net zero' by 20X9. It announces it will:

- Immediately start to change the way it manufactures its products with the aim of gradually reducing its greenhouse gas emissions, so they are no more than 40% of their current level by 20X9.

And

- In 20X9 and thereafter, offset the remaining emissions by paying the forestry commissions of the countries in which it manufactures to plant trees.

Present obligation as a result of a past event

The manufacturer's public announcement indicates to the public that it has accepted a responsibility to eliminate or offset its greenhouse gas emissions from 20X9 onwards. This announcement is judged to create a constructive obligation for the manufacturer if it creates a valid expectation among members of the public that it will discharge this responsibility. Whether the announcement creates such an expectation is a matter of judgement, determined by management taking into account the facts and circumstances.

An announcement that fulfils the criteria for creating a constructive obligation is not sufficient in itself to recognise a provision. A present constructive obligation arises only when the manufacturer has taken actions that will require it to transfer an economic resource - that is, when it has emitted greenhouse gases it has committed to offset. It then has an obligation to pay for the amount of tree planting required to offset the past emissions. The manufacturer's commitment to change aspects of the way in which it manufactures its goods is not an obligation to transfer an economic resource.

Conclusion - The manufacturer recognises a provision as a result of its net zero commitment:

- When it has emitted the greenhouse gases it has committed to offset.
- And
- If at that time, management judges that its announcement has given rise to a constructive obligation to meet the net zero commitments.

The manufacturer would recognise a provision for the best estimate of the amounts payable to forestry commission in respect of past emissions.

Since an entity's specific plans are key to appropriately accounting for net-zero commitments, entities will need to provide sufficient disclosure to allow users of financial statements to understand the nature of their net-zero commitments and the impact on the financial statements, together with any key estimates and critical judgements required to be disclosed. [FRS 102.8.6]. Furthermore, entities should be careful to ensure that clear language is used in describing their aspirations, targets and intended actions in response to the climate change challenge. Without clear disclosure, a reader may have difficulty understanding the extent to which the entity can realistically withdraw from a course of action described in its transition plan.

How we see it

Climate-related matters potentially have a significant impact on the recognition and measurement of provisions, and the need for disclosure of contingent liabilities. However, under Section 21, only those obligations arising from past events and the settlement of which is expected to result in an outflow from the entity of resources will result in the recognition of a provision.

Given the significant uncertainties involved in assessing the extent and impact of climate change, entities need to ensure that sufficient information is disclosed to allow users of financial statements to understand those uncertainties, how planned climate transition has been taken into account in the measurement of a provision or disclosure of a contingent liability, and the assumptions and judgements made by management in recognising and measuring provisions.

4. Presentation and disclosure

For UK companies and LLPs preparing financial statements using statutory formats rather than 'adapted formats' as allowed by Section B of Part 1 of Schedule 1 to the Regulations (and Section B of Part 1 of Schedule 1 to the LLP Regulations), provisions within the scope of Section 21 would fall within the statutory caption 'Other provisions' within the heading 'Provisions for liabilities'. 'Other provisions' can be shown either on the face of the balance sheet or in the notes to the accounts. See Chapter 6 at 4.3.11.

Companies and LLPs using 'adapted formats' must present current and non-current provisions separately on the face of the balance sheet. [FRS 102.4.2A, FRS 102.4.2D]. See Chapter 6 at 4.1.10.

4.1 Disclosures about provisions

Extract from Section 21

21.14 For each class of provision, an entity shall disclose the following:

- (a) a reconciliation showing:
 - (i) the carrying amount at the beginning and end of the period;
 - (ii) additions during the period, including adjustments that result from changes in measuring the discounted amount;
 - (iii) amounts charged against the provision during the period; and
 - (iv) unused amounts reversed during the period;
- (b) a brief description of the nature of the obligation and the expected amount and timing of any resulting payments;
- (c) an indication of the uncertainties about the amount or timing of those outflows; and
- (d) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Comparative information for prior periods is not required. [FRS 102.21.14]

Disclosure (b) above requires disclosure of the expected amount and timing of any resulting payments. In many cases, the expected amount of the payments will be the same as the carrying amount of the provision at the end of the period. However, where a provision has been discounted to its present value it is unclear from Section 21 whether the disclosure of the expected amount of payments is expressed based on current prices or expected future prices.

Comparative information is not required for any of the disclosures about provisions. [FRS 102.21.14].

Where a transfer has been made to any provision for liabilities, or from any provision for liabilities other than for the purpose for which the provision was established, UK Company Law (i.e., the Regulations) and the LLP Regulations require disclosure, in tabular form, of:

- The amount of provisions at the beginning and the end of the year.
- Any amounts transferred to or from provisions during the year.

And

- The source and application of any amounts so transferred.

Particulars must be given of each provision included within the statutory heading 'other provisions' in any case where the amount of that provision is material. [1 Sch 59, 2 Sch 70, 3 Sch 77, 1 Sch 57 (LLP)].

4.2 Disclosures about contingent liabilities

Unless the possibility of any outflow of resources in settlement is remote, an entity must disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, when practicable:

- An estimate of its financial effect, measured in accordance with paragraphs 7 to 11 of Section 21 (see 3.8 above)
 - An indication of the uncertainties relating to the amount or timing of any outflow
- And
- The possibility of any reimbursement [FRS 102.21.15]

If it is impracticable to make one or more of these disclosures, that fact must be stated. [FRS 102.21.15]. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. [FRS 102 Appendix I].

Section 21 does not define or put a numerical measure of probability on the term 'remote'.

How we see it

In our view, it is reasonable to interpret 'remote' as meaning a likelihood of an outflow of resources that is not significant (see 3.6 above).

The Regulations and LLP Regulations require disclosure of the particulars and the total amount of any financial commitments, guarantees and contingencies that are not included in the balance sheet. [1 Sch 63(2), 2 Sch 77(1), 3 Sch 81(2), 1 Sch 60(2)(LLP)]. An indication of the nature and form of any valuable security given by the entity in respect of those commitments, guarantees and contingencies must be given. [1 Sch 63(3), 2 Sch 77(2), 3 Sch 81(3), 1 Sch 60(3)(LLP)]. The total amount of those commitments concerning pensions must be separately disclosed. [1 Sch 63(4), 2 Sch 77(3), 3 Sch 81(4), 1 Sch 60(4)(LLP)]. The entity must also state separately the total amount of those commitments, guarantees and contingencies which are undertaken on behalf of, or for the benefit of:

- Any parent undertaking or fellow subsidiary undertaking of the entity
- Any subsidiary undertaking of the entity
- Or
- Any undertaking in which the entity has a participating interest [1 Sch 63(7), 2 Sch 77(6), 3 Sch 81(7), 1 Sch 60(7)(LLP)]

4.3 Disclosures about contingent assets

If an inflow of economic benefits is probable (more likely than not) but not virtually certain, an entity must disclose:

- A description of the nature of the contingent assets at the end of the reporting period
- And
- When practicable, an estimate of their financial effect, measured using the principles set out in paragraphs 7 to 11 of Section 21 (see 3.8 above)

If it is impracticable to make one or more of these disclosures, that fact must be stated. [FRS 102.21.16]. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. [FRS 102 Appendix I].

4.4 Disclosure when information is seriously prejudicial

In extremely rare cases, disclosure of some or all of the information required (by the disclosure requirements at 4.1 to 4.3 above) can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such circumstances, an entity need not disclose all of the information required (by 4.1 to 4.3 above) insofar as it relates to the dispute, but is required to disclose at least the following: [FRS 102.21.17]

In relation to provisions:

- A table showing the reconciliation required by 4.1 above in aggregate, including the source and application of any amounts transferred to or from provisions during the reporting period.
- Particulars of each provision in any case where the amount of the provision is material.
- And
- The fact that, and reason why, the information required by 4.1 above has not been disclosed.

In relation to contingent liabilities:

- Particulars and the total amount of contingent liabilities (excluding those which arise out of insurance contracts) that are not included in the statement of financial position.

- The total amount of contingent liabilities which are undertaken on behalf of or for the benefit of:
 - Any parent or fellow subsidiary of the entity
 - Any subsidiary of the entity
 - Any entity in which the reporting entity has a participating interest
 Shall each be stated separately.
- The fact that, and reason why, the information required by paragraph 15 of Section 21 (see 4.2 above) has not been disclosed.

In relation to contingent assets, the entity is required to disclose the general nature of the dispute, together with the fact that, and reason why, the information required by 4.3 above has not been disclosed.

[FRS 102.21.17].

4.5 Disclosures about financial guarantee contracts

An entity must disclose the nature and business purpose of any financial guarantee contracts it has issued. *[FRS 102.21.17A]*. This appears to be required regardless of whether the financial guarantee contract meets the recognition criteria for provisions or the disclosure criteria for contingent liabilities discussed at 3.2 and 3.4 above. In addition, if applicable, the disclosures required for provisions (see 4.1 above), or contingent liabilities (see 4.2 above) must also be provided. *[FRS 102.21.17A]*.

The Regulations and LLP Regulations also require disclosure of the particulars of any financial commitments that have not been provided for and are relevant to assessing the entity's state of affairs.

[1 Sch 63(2), 2 Sch 77(1), 3 Sch 81(2), 1 Sch 60(2)(LLP)].

4.6 Disclosures about funding commitments (other than loan commitments)

An entity that has made a funding commitment (see 3.10 above) is required to disclose the following:

- The commitment made
- The timeframe of that commitment
- Any performance-related conditions attached to that commitment
- Details of how that commitment will be funded *[FRS 102.34.62]*

Separate disclosure is required for recognised and unrecognised commitments. Within each category, disclosure can be aggregated provided that such aggregation does not obscure significant information. *[FRS 102.34.63]*. Accordingly, material commitments are disclosed separately.

- For funding commitments that are not recognised, it is important that full and informative disclosures are made of their existence and of the sources of funding for these unrecognised commitments. *[FRS 102.34A.6]*.

5 Summary of GAAP differences

	FRS 102	IFRS
Scope - Provisions, contingent liabilities and contingent assets covered by another Section	Section 21 does not apply to provisions, contingent liabilities and contingent assets covered by another Section of FRS 102. However, where those other Sections contain no specific requirements to deal with contracts that have become onerous, Section 21 applies to those contracts.	Under IAS 37, where a provision, contingent liability or contingent asset is covered by another IFRS and that IFRS contains no specific requirements to deal with onerous contracts, there is no general requirement that IAS 37 be applied to those contracts. However, IAS 37 states that it does apply to: - Any lease that becomes onerous before the commencement date of the lease - Short-term leases and leases of low-value assets which are recognised as an expense in accordance with IFRS 16 and have become onerous - Contracts with customers that are, or have become, onerous
Scope - Financial guarantee contracts	Financial guarantee contracts are in scope of Section 21 unless: - The entity has chosen to apply IAS 39 or IFRS 9 to its financial instruments Or - The entity has elected under FRS 103 to continue the application of insurance contract accounting	In general, issuers of financial guarantee contracts must apply IAS 32, IFRS 9 and IFRS 7 to financial guarantee contracts even though they meet the definition of an insurance contract in IFRS 17, if the risk transferred is significant. However, if an entity has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 or IFRS 17. This election may be made contract by contract, but the election for each contract is irrevocable. For the holder, a financial guarantee contract held that is considered to be an integral component of the guaranteed debt instrument will be accounted for as part of the ECL on that debt instrument. IFRS does not cover the accounting for the holder of a financial guarantee contract which is not considered to be integral to the underlying debt instruments. In developing a policy, entities could look to the requirements of IAS 37 dealing with contingent assets or reimbursement assets, at least as far as recoveries under the contract are concerned. In certain situations, it could also be appropriate for the holder of a financial guarantee

FRS 102		IFRS
		contract to account for it as an asset at fair value through profit or loss. This might be the case if the guaranteed asset has itself been classified as at fair value through profit or loss.
Onerous contracts - unavoidable costs	Similar definition of onerous contract to IFRS. However, Section 21 Appendix Example 2 explains, the unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.	IAS 37 provides guidance that the costs of fulfilling a contract comprises the costs that relate directly to the contract. This consists of the incremental costs of fulfilling that contract and an allocation of other costs that relate directly to fulfilling contracts.
Disclosure -Provisions	Included within the disclosure requirements for provisions is a requirement to disclose the expected amount of payments resulting from an obligation. There is no requirement to disclose: - Major assumptions concerning future events that may affect the amount required to settle an obligation Or - A separate line item in the reconciliation of opening and closing provision balances showing the increase during the period in the discounted amount arising from the passage of time and the effect of any change in discount rate.	Included within the disclosure requirements for provisions are requirements to disclose: - Major assumptions concerning future events that may affect the amount required to settle an obligation where this is necessary to provide adequate information - A separate line item in the reconciliation of opening and closing provision balances showing the increase during the period in the discounted amount arising from the passage of time and the effect of any change in discount rate. - There is no requirement to disclose the expected amount of payments resulting from an obligation.
Disclosure when information is seriously prejudicial	Section 21 includes much more fulsome disclosure requirements in the case where information is considered seriously prejudicial than is required under IFRS. The disclosure requirements are set out in 4.4 above and significantly reduce the usefulness of the seriously prejudicial exemption under Section 21 compared to IFRS.	Under the seriously prejudicial exemption in IAS 37, entities must disclose the general nature of the dispute, together with the fact that, and the reason why, the information otherwise required by the standard has not been disclosed.

	FRS 102	IFRS
Disclosure - Financial guarantee contracts	An entity must disclose the nature and business purpose of any financial guarantee contracts it has issued, regardless of whether a provision is required. In addition, to the extent a provision is recognised for financial guarantee contracts, or a contingent liability disclosed, the general provision/contingent liability disclosures within Section 21 are also required.	Financial guarantee contracts issued are in scope of the disclosure requirements of IFRS 7 (if the issuer has elected to apply IFRS 9 or IAS 39 to the contracts), or IFRS 17. For the holder, the financial guarantee is accounted for as part of the Expected Credit Loss where the financial guarantee contract held is considered to be an integral component of the guaranteed debt instrument.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

constructive obligation	An obligation that derives from an entity's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
contingent asset	A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
contingent liability	A contingent liability is either: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the original or modified terms of a debt instrument.
liability	A present obligation of the entity to transfer an economic resource as a result of past events. ¹¹⁵
onerous contract	A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
present value	A current estimate of the present discounted value of the future net cash flows in the normal course of business.
probable	More likely than not.
provision	A liability of uncertain timing or amount. For the purposes of this definition, a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
restructuring	A restructuring is a programme that is planned and controlled by management and materially changes either: (a) the scope of a business undertaken by an entity; or (b) the manner in which that business is conducted.

¹¹⁵ For the purposes of Sections 21 and 22, a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit

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Chapter 25

Revenue

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Overview

Revenue is one of the most important indicators of an entity's performance. It might be perceived as an indicator of the desirability of an entity's products and services, and the growth or decline over time of a business. However, revenue does not represent all income for an entity. As discussed in Chapter 6 at 5.1.2, revenue is a subset of income, it is derived from the ordinary activities of an entity and might be referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent.

Identifying what is revenue and specifying how and when to measure and report it is critical to any accounting framework. Section 23 *Revenue from Contracts with Customers* provides accounting requirements for all revenue arising from contracts with customers to provide goods or services (unless the contracts are in the scope of other sections of FRS 102). Several other sections within FRS 102 deal with the recognition of revenue, for example, Section 20 *Leases* covers lease revenue and Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues* cover dividends and interest, which would represent revenue, if they are part of an entity's ordinary activities (see 3.1.3 below).

This chapter primarily covers Section 23 which only involves a subset of revenue - specifically, revenue that arises from a contract when the counterparty to that contract is a customer (as defined, see 3.1.3 below) and the contract is not specifically excluded from Section 23 (e.g., lease contracts within the scope of Section 20 or financial instruments within the scope of Section 11 or Section 12, see 3.1.1 below for a complete list of scope exclusions).

Section 23 describes the principles an entity must apply to report useful information about the nature, amount, timing and uncertainty of revenue and the related cash flows. The core principle is that an entity recognises revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer.

Other revenue items that are not within the scope of Section 23 but arise in the course of the ordinary activities of an entity (see 3.1.3 below), as well as the disposal of non-financial assets that are not part of the ordinary activities of the entity, for which Section 23's requirements are relevant, are discussed in 3.1.6 below.

What you need to know

- Section 23 provides a single source of revenue requirements for all entities in all industries.
- Section 23 applies to revenue from contracts with customers, unless explicitly excluded from the scope (e.g., leasing contracts, financial instruments).
- Section 23 is principles-based and includes detailed guidance. The lack of bright lines might require the use of judgement.
- Section 23 also specifies the accounting treatment for certain items other than revenue, such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets.

1 Introduction

Section 23 provides accounting requirements for all revenue arising from contracts with customers. It applies to all entities that enter into contracts to provide goods or services to their customers, unless the contracts are in the scope of other sections of FRS 102, such as that for leases. It also specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers (see 10.3 below) and provides a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment ('PP&E') (see 3.1.6.C below).

This chapter discusses Section 23 contained in the September 2024 version of FRS 102, which incorporates the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS - Periodic Review 2024* ('Periodic Review 2024 amendments') issued by the FRC in March 2024. Generally, the Periodic Review 2024 amendments provide closer alignment between FRS 102 and IFRS Accounting Standards ('IFRS').

As part of the Periodic Review 2024 amendments, Section 23 *Revenue* in the January 2022 version of FRS 102 (the 'legacy Section 23'), which included revenue recognition requirements based on IAS 11 *Construction Contracts* and IAS 18 *Revenue*, was entirely replaced with a new Section 23 *Revenue from Contracts with Customers* ('Section 23' or the 'revised Section 23'), providing a five-step revenue recognition model based on IFRS 15 *Revenue from Contracts with Customers* (see 3.2 below).

[FRS 102.BC.B23.1]. To apply the revenue recognition model, an entity has to identify distinct goods or services promised to the customer and the amount of consideration to which the entity is entitled in exchange for the promised goods or services.

Whilst the requirements allow an entity to use an accounting policy for revenue that meets the requirements of both FRS 102 and IFRS 15 to promote efficiency within groups, Section 23 includes accounting simplifications, compared to IFRS 15, to provide proportionate and practical solutions that are cost effective to apply. These simplifications include: [FRS 102.BC.B23.9]

- Not requiring an entity to adjust for the effects of time value of money on payments received in advance (see 6.5.2.A below).
- Flexibility in allocating discounts or variable consideration to the contract (see 7 below).
- An accounting policy choice on whether an entity capitalises its costs to obtain a contract with a customer (see 10.3.1 below).

And

- Greater use of hindsight when estimating variable consideration and evaluating contract modifications when an entity applies the revised Section 23 for the first time (see 12 below) or when an entity adopts FRS 102 for the first time (see Chapter 37).

The disclosure requirements in Section 23 are based on those in *Draft third edition of IFRS for SMEs Accounting Standard*, rather than IFRS 15, to provide proportionate and practical solutions that are cost effective to apply (see 11 below). [FRS 102.BC.B23.10]. The requirement in IFRS 15 to disclose significant judgements made in applying the requirements is not included in Section 23. However, the FRC noted that Section 8 *Notes to the Financial Statements* would also apply to the judgements applied in respect of Section 23. [FRS 102.BC.B23.11].

Transitional requirements allow entities to apply the revised Section 23 retrospectively in accordance with Section 10 *Accounting Policies, Estimates and Errors*, or retrospectively with the cumulative effect of initially applying the revised section recognised in the current year. The latter approach is similar to the 'cumulative catch-up' transition method in IFRS 15, but as a proportionate simplification also allows greater scope to use hindsight when estimating variable consideration and evaluating contract modifications on transition (see 12.2.3 below). [FRS 102.BC.B23.12].

The effective date of the revised Section 23 and the detailed transitional requirements are discussed in 12 below.

As discussed above, the requirements in Section 23 are more closely aligned with the requirements in IFRS 15. Applying the GAAP hierarchy in Section 10, an entity reporting under FRS 102 could apply relevant additional guidance in IFRS 15 as the principles in Section 23 are based on, and largely consistent with, those in IFRS 15. Relevant discussions, views and decisions reached by the IFRS Interpretations Committee (IFRS IC) and the Joint Transition Resource Group for Revenue Recognition (TRG) in relation to implementation of IFRS 15 could also be considered and applied by an entity reporting under FRS 102, provided that these are based on principles in IFRS 15 that are consistent with Section 23. [FRS 102.10.6].

Accordingly, where IFRS 15 (including relevant application guidance, illustrative examples and explanation in the Basis for Conclusions for IFRS 15) provides additional guidance that is consistent with the principles in Section 23, we have considered such guidance in this chapter to explain the requirements in Section 23. Whilst agenda decisions of the IFRS IC do not directly apply to entities reporting under FRS 102, we expect agenda decisions issued in relation to the application of IFRS 15 to be relevant to entities applying Section 23 due to the close alignment of the requirements. Accordingly, we have considered IFRS IC agenda decisions in this chapter, where relevant.

Further, following the issuance of their revenue standards (i.e., IFRS 15 and ASC 606 *Revenue from Contracts with Customers*), the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) created the TRG to address implementation issues that might arise when entities implemented the new revenue standard. Views and guidance from the TRG discussions are also considered in this chapter, where relevant to applying the related Section 23 requirements.

Whilst this chapter addresses some of the complexities in Section 23, the EY publication, International GAAP® includes more detailed guidance regarding the application of IFRS 15 that might also be relevant in the application of the requirements in Section 23, as indicated later in this chapter.

2 Comparison between Section 23 and IFRS

Section 23 contains less extensive guidance than IFRS 15 and includes certain simplifications. The key differences between Section 23 and IFRS 15 are discussed at 2.1 to 2.6 below. The table at 13 below contains a summary of the GAAP differences.

2.1 Interactions with other sections of FRS 102 and/or other FRSS

If a contract with a customer is partially within the scope of Section 23 and partially within the scope of other sections of FRS 102, Section 23 requires an entity to separate or initially measure any parts of the contract which are in the scope of the other section according to the requirements in that section. [FRS 102.23.3]. This is applicable to all contracts with a customer.

By contrast, the requirements in paragraph 7 of IFRS 15 are only applicable to contracts with customers that are listed in paragraph 5 of IFRS 15 (see 13 below for the list). That is, the scope of paragraph 7 of IFRS 15 is narrow and not applicable to all contracts with customers that might be partially within the scope of another adopted IFRS, that is not specifically listed in paragraph 5. Further, insurance contracts within the scope of IFRS 17 *Insurance Contracts* are included in that list, whereas under UK GAAP, insurance contracts are within the scope of FRS 103 *Insurance Contracts*, not within the sections of FRS 102.

See 3.1.5 below for further discussion.

2.2 Time value of money

A key difference between Section 23 and IFRS 15 relates to advance payments received from customers. Section 23 does not require (but offers a policy choice) to adjust the promised amount of consideration for the effects of the time value of money and recognise the resulting interest expense. [FRS 102.23.59]. See further discussion in 6.5.2 below. However, under IFRS 15, there is no such policy choice or exemption from accounting for the effects of a significant financing component arising from advance payments. [IFRS 15.60].

IFRS 15 includes examples of several situations which do not provide the customer or the entity with a significant benefit of financing, and therefore, no adjustment for financing component is required. [IFRS 15.62]. However, Section 23 does not provide similar guidance.

2.3 Application of residual approach when estimating stand-alone selling prices

In allocating the transaction price to each performance obligation on a relative stand-alone selling price, an entity is required to estimate the stand-alone selling price of a good or service if such a price is not directly observable. The residual approach is one of three examples of potential estimation approaches an entity can use, but only if the stand-alone selling price of a good or service is highly variable or uncertain.

Under Section 23, in applying the residual approach, an entity could estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable or estimated stand-alone selling prices of other goods or services promised in the contract. [FRS 102.23.70(c)]. See 7.1.2 below for further discussion.

Under IFRS 15, application of the residual approach allows an entity to estimate the stand-alone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) stand-alone selling prices of other promised goods or services in the contract. [IFRS 15.79(c)]. Accordingly, in addition to meeting one of the two criteria (i.e., selling price is either highly variable or uncertain), the remaining promised goods or services in the contract must have at least one observable (i.e., not estimated) stand-alone selling prices in order to use the residual approach. That is, unlike Section 23, under IFRS 15, the residual approach cannot be used if there is no observable selling price for any of the goods or services in the contract.

2.4 Allocation of a discount or variable consideration

Both IFRS 15 and Section 23 provide two exceptions to the default method of allocating the transaction price to all performance obligations using the relative stand-alone selling price method. The two exceptions relate to the allocation of a discount and to variable consideration. For this purpose, a discount refers to the excess, if any, of the sum of the stand-alone selling prices of the goods or services promised in the contract over the promised consideration. Under these exceptions, a discount or variable consideration might be attributable to the entire contract or to a specific part of the contract.

Unlike Section 23, IFRS 15 includes specific criteria that must be met for these exceptions to apply. The criteria that must be satisfied to apply the allocation exception to variable consideration are different from the criteria for discounts. Where the respective criteria are met, discounts and variable consideration must be entirely allocated to one or more, but not all, performance obligations in the contract. [IFRS 15.83, IFRS 15.85]. However, under Section 23, the allocation requirements for discounts and variable consideration are combined into a single general requirement. This requires the exception to be applied, and another method used, if allocation using a relative stand-alone price method does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. [FRS 102.23.74]. This is a simplification introduced to provide flexibility in allocating discounts or variable consideration in the contract. [FRS 102.BC.B23.9]. See 7 below for further discussion.

Also, unlike Section 23, IFRS 15 establishes a hierarchy for allocation. Under IFRS 15, an entity identifies and allocates variable consideration first, if it meets the criteria for the exception, to one or some, but not all performance obligations. The general guidance related to allocation of transaction price to performance obligations on a relative stand-alone selling price basis and the specific requirements related to allocation of a discount are then applied to allocate the remaining amount of the transaction price that does not meet the criteria related to allocation of variable consideration. [IFRS 15.86].

In addition, when an entity meets the specified criteria and applies a discount to one or more performance obligations, IFRS 15 requires that the discount is allocated first before using the residual approach to estimate the stand-alone selling price of a good or service. [IFRS 15.83].

2.5 Capitalisation of costs to obtain a contract

Under IFRS 15, an entity recognises as an asset the incremental costs of obtaining a contract with a customer, if the entity expects to recover those costs. [IFRS 15.91]. Unlike IFRS 15, Section 23 allows an accounting policy choice on whether to expense or capitalise its incremental costs to obtain a contract with a customer that the entity expects to recover. [FRS 102.23.113].

A practical expedient is available under IFRS 15 where an entity could recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less. [IFRS 15.94]. A practical expedient similar to IFRS 15 is also available under Section 23, if an entity adopts a policy of recognising costs to obtain a contract as an asset. [FRS 102.23.114]. See 10.3.1 below for further discussion.

2.6 Disclosures

IFRS 15 requires a comprehensive and coherent set of revenue recognition disclosures. It contains a disclosure objective and detailed disclosure requirements including both quantitative and qualitative information. The disclosure requirements under Section 23 are similar to the requirements in IFRS 15 but at a reduced level to provide proportionate and practical solutions that are cost effective to apply. In addition, under Section 23, certain disclosure exemptions are available to qualifying entities.

See 11 below for the disclosure requirements of Section 23 and see 13 below for a summary of GAAP differences, which includes differences between the disclosure requirements of Section 23 and IFRS 15.

3 Requirements of Section 23

3.1 Scope

3.1.1 Scope of Section 23

Section 23 applies to all entities and all contracts with customers to provide goods or services in the ordinary course of business (see 3.1.3 below), except for the following contracts, which are specifically excluded: [FRS 102.23.1]

- Lease contracts within the scope of Section 20.
- Contracts within the scope of FRS 103.
- Financial instruments and other contractual rights or obligations within the scope of Section 9 *Consolidated and Separate Financial Statements*, Section 11, Section 12, Section 14 *Investments in Associates* and Section 15 *Joint Ventures*.

And

- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers (see 4.1.1 below).

In addition to the above, Section 23 specifically excludes incoming resources from non-exchange transactions for public benefit entities, which are within the scope of Section 34 *Specialised Activities* (see Chapter 36 at 6.4).

Arrangements must meet the criteria set out in paragraph 23.7 of FRS 102, which are discussed in 4.1 below, to be accounted for as a revenue contract under Section 23.

For certain arrangements, entities have to evaluate their relationship with the counterparty to the contract in order to determine whether a vendor-customer relationship exists. Some collaboration arrangements, for example, are more akin to a partnership, while others have a vendor-customer relationship. Only transactions that are determined to be with a customer are within the scope of Section 23. The definition of a customer is discussed in 3.1.3 below. See 3.1.4 below for a discussion on collaborative arrangements.

The interaction between Section 23 and other sections of FRS 102 can be challenging and might require significant judgement. Such interactions include when:

- An entity needs to apply requirements of other sections of FRS 102 to assets and liabilities arising from a revenue contract (e.g., applying certain requirements in Section 11 to contract assets, determining when an entity's right to consideration becomes unconditional (i.e., a receivable) such that Section 11 applies to that asset instead of Section 23, see 11.1 below for further discussion).
- Other sections of FRS 102 refer to guidance in Section 23 (e.g., the accounting for disposals of certain non-financial assets - as discussed in 3.1.6.C below or applying requirements in Section 23 to service concession arrangements that are within the scope of Section 34 - see Chapter 36 at 4).
- Two or more contracts need to be assessed together to determine the appropriate section(s) of FRS 102 to apply (e.g., sales with repurchase agreements (see 8.3 below) or sale and leaseback arrangements within the scope of Section 20).
- The legal form of the arrangement is not consistent with the substance. Accounting for such a transaction depends on the substance of the transaction and not its legal form. For example, if a contract is a lease in legal form but the arrangement does not meet the definition of a lease because the 'lessor' has a substantive right to substitute the underlying asset throughout the period of use and, hence, is out of scope of Section 20 (see Chapter 23 at 3), that entity might be providing a service within the scope of Section 23.
- A contract falls within the scope of more than one section of FRS 102 (e.g., a lease with a non-lease revenue component, a contract that includes the issuance of a financial instrument and a revenue component within the scope of Section 23). When entities enter into transactions that are partially within the scope of Section 23 and partially within the scope of other sections of FRS 102, Section 23 requires an entity to apply any separation and/or measurement requirements in the other section of FRS 102 first, before applying the requirements in Section 23. [FRS 102.23.3]. See 3.1.5 below for further discussion.

Many entities issue warranties together with, and/or related to, goods or services provided to a customer. While Section 23 of FRS 102 provides guidance that applies to warranties, some might be within the scope of FRS 103. Determining whether Section 23 of FRS 102 or FRS 103 applies might require significant judgement. This is discussed further in 10.1 below. If FRS 103 applies to a warranty within a contract with a customer, the requirements in FRS 102.23.3 will need to be considered to determine how to allocate the contract consideration between the two standards. See 3.1.5 below for further discussion.

3.1.1.A Non-monetary exchanges

Section 23 does not apply to non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, it does not apply to a contract between two oil companies that swap oil to fulfil demand from their respective customers in different locations on a timely basis and to reduce transportation costs. This scope exclusion applies even though the party exchanging goods or services with the entity might meet the definition of a customer on the basis that it has contracted with the entity to obtain an output of the entity's ordinary activities (see 3.1.3 below). This type of scenario might be common in industries with homogeneous products.

Not all non-monetary exchanges between entities are outside the scope of Section 23 and it does provide requirements for contracts involving non-cash consideration in exchange for goods or services (see 6.6 below on non-cash consideration and 6.6.2 below on barter transactions). Therefore, determining whether an exchange is to facilitate a sale to a customer could require judgement. Judgement might also be needed to determine whether entities are in the same line of business.

The following Illustration shows some of these considerations:

Illustration 2-1: Non-monetary exchange outside the scope of Section 23

An automobile dealer exchanges new model automobiles with another dealer to obtain the colour ordered by a customer. This non-monetary exchange is intended to facilitate a sale to a customer who is not a party to the exchange. In addition, it involves the exchange of inventory that both dealers hold for sale, as part of their ordinary activities (see 3.1.3 below), and the automobile dealers are in the same line of business. Accordingly, this transaction is outside the scope of Section 23.

Illustration 2-2: Non-monetary exchange in the scope of Section 23

An office supply retailer provides office equipment and supplies to an automobile dealer in exchange for an automobile. The automobile dealer will use the office equipment and supplies in its financing department. The new equipment is an upgrade from the automobile dealer's old equipment and will allow the automobile dealer to reduce administrative expenses. The office supply retailer will use the car received in its repair department, allowing the department to reduce response times and meet service level commitments. Although the exchange involves inventory held for sale by each entity, the transaction is not an exchange of a product held for sale in the ordinary course of business (see 3.1.3 below), for a product to be sold in the same line of business to facilitate sales to customers. Accordingly, this transaction is within the scope of Section 23 for each entity.

3.1.2 Other scope considerations

Certain arrangements executed by entities include repurchase provisions, either as a component of a sales contract or as a separate contract that relates to the same, or similar goods, in the original agreement. The form of the repurchase agreement and whether the customer obtains control of the asset will determine whether the agreement is within the scope of Section 23. See 8.3 below for a discussion of repurchase agreements.

Section 23 also specifies the accounting for certain costs, such as the incremental costs of obtaining a contract and the costs of fulfilling a contract. However, these requirements only apply if there are no other applicable requirements in other sections of FRS 102 for those costs. See 10.3 below for further discussion of the requirements relating to contract costs in Section 23.

Certain requirements in Section 23 are also relevant for the recognition and measurement of a gain or loss on the disposal of a non-financial asset not in the ordinary course of business (see 3.1.3 below and 3.1.6.C below for further discussion about determining whether a transaction is part of an entity's ordinary activities).

Entities sometimes enter into transactions with suppliers that result in the entity receiving consideration from a supplier (or from other parties that sell the goods or services to the supplier). In these situations, entities need to apply judgement to determine whether they need to account for the consideration received as revenue in accordance with the relevant section of FRS 102 (e.g., Section 23, Section 20, Section 11 or Section 12), a reimbursement of a cost incurred on behalf of a supplier, or a reduction of the cost of goods or services acquired. For further discussion of this topic, entities reporting under FRS 102 could also refer to our publication *Applying IFRS: Accounting for Payments from Suppliers*.¹¹⁶

3.1.3 Definition of a customer

FRS 102 defines a customer as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.” [FRS 102 Appendix I]. As discussed in Chapter 6 at 5.1.2, in the context of applying the requirements of Section 23, we believe that the reference to ‘ordinary activities’ pertains to primary business activities of an entity, rather than the incidental activities. Consequently, a customer in a revenue contract is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s primary business activities (rather than its incidental activities) in exchange for consideration.

In many transactions, the customer is easily identifiable. However, in transactions involving multiple parties, it might be less clear which counterparties are customers of the entity. For some arrangements, multiple parties could all be considered customers of the entity, while in other arrangements only some of the parties involved are considered customers.

During times of geopolitical and economic uncertainty, governments might grant wide-ranging assistance, particularly if there are restrictions on business activities. Identifying whether there is vendor-customer relationship might be challenging if the counterparty in an arrangement is the government or a similar body. To determine the appropriate section of FRS 102 to apply, an entity needs to consider all relevant facts and circumstances to understand whether there is an exchange transaction arising from a vendor-customer relationship (to which Section 23 applies) or if, for example, the entity is receiving government assistance or a grant (in scope of Section 24 *Government Grants* - see Chapter 26). Factors to consider include, but are not limited to, whether the government (or similar body) is providing assistance to the entity or to its customer (e.g., by paying the entity on a customer’s behalf), and whether the government (or similar body) is providing assistance in their capacity as the government (or similar body) or as the entity’s customer. An entity with an existing vendor-customer relationship with a government or similar body also needs to evaluate whether any additional assistance is a modification of a customer contract under Section 23. See 4.4 below for contract modifications.

The Illustration below shows how the party considered to be the customer might differ, depending on the specific facts and circumstances:

Illustration 2-3: Identification of a customer

An entity provides internet-based advertising services to companies. As part of those services, the entity purchases banner-space on various websites from a selection of publishers. For certain contracts, the entity provides a sophisticated service of matching the ad placement with the pre-identified criteria of the advertising party (i.e., the customer). In addition, the entity pre-purchases the banner-space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the principal in these contracts (see 5.4 below for further discussion on principal versus agent considerations). Accordingly, the entity identifies that its customer is the advertiser to whom it is providing services.

In other contracts, the entity simply matches advertisers with the publishers in its portfolio, but the entity does not provide any sophisticated ad-targeting services or purchase the advertising space from the publishers before it finds advertisers for that space. Assume that the entity appropriately concludes it is acting as the agent in these contracts. Accordingly, the entity identifies that its customer is the publisher to whom it is providing services.

In addition, the identification of the performance obligations in a contract (discussed further in 5 below) can have a significant effect on the determination of which party is the entity’s customer. Also see the discussion of the identification of an entity’s customer when applying the guidance on consideration paid or payable to a customer in 6.7 below.

¹¹⁶ Available on [ey.com/IFRS](https://www.ey.com/IFRS).

3.1.4 Collaborative arrangements

Entities often enter into collaborative arrangements to, for example, jointly develop and commercialise intellectual property such as a drug candidate in the life sciences industry or a motion picture in the entertainment industry. In such arrangements, a counterparty might not always be a 'customer' of the entity. Instead, the counterparty might be a collaborator or partner that shares in the risks and benefits of developing a product to be marketed. This is common in the pharmaceutical, biotechnology, oil and gas, and health care industries. However, depending on the facts and circumstances, these arrangements might also contain a vendor-customer relationship component. Such contracts could still be within the scope of Section 23, at least partially, if the collaborator or partner meets the definition of a customer for some, or all, aspects of the arrangement. If the collaborator or partner is not a customer, the transaction is not within the scope of Section 23.

In determining whether certain revenue-generating collaborative arrangements are within the scope of Section 23, the parties to such arrangements need to consider all facts and circumstances to determine whether a vendor-customer relationship exists that is subject to Section 23. However, in some circumstances, it might be appropriate for an entity to apply the principles in Section 23 to collaborations or partnerships (e.g., when there are no applicable or more relevant requirements that could be applied).

How we see it

Identifying the customer can be difficult, especially when multiple parties are involved in a transaction. This evaluation might require significant judgement and Section 23 does not provide many factors to consider.

Furthermore, transactions among partners in collaboration arrangements are not within the scope of Section 23. Therefore, entities need to use judgement to determine whether transactions are between partners acting in their capacity as collaborators or reflect a vendor-customer relationship.

3.1.5 Interaction with other sections of FRS 102 or other FRSs

Section 23 provides requirements for arrangements partially within the scope of Section 23 and partially within the scope of other sections of FRS 102 that apply to contracts with customers, as follows:

[FRS 102.23.3]

Extract from Section 23

23.3 A contract with a customer may be partially within the scope of this section and partially within the scope of other sections (eg a lease contract that includes the provision of services). If the other section specifies how to separate or initially measure any parts of the contract, then an entity shall first apply the separation or measurement requirements in that section. Otherwise, the entity shall apply this section to separate or initially measure those parts of the contract.

The requirements described above are only applicable to contracts that are partially within the scope of Section 23 and partially within the scope of any of the other sections of FRS 102. The requirements do not apply to contracts that might be partially within the scope of Section 23 and partially within the scope of other FRSs (e.g., FRS 103). [FRS 102.23.3].

Consider the following example:

Illustration 2-4: Transactions that might be in the scope of multiple sections of FRS 102 and/or other FRSs

A bank, Company A, offers credit cards to consumers. The credit cards provide lending facilities that allow cardholders to make purchases on deferred payment terms. Cardholders pay an annual fee to obtain a credit card, and in return are entitled to ancillary services, such as concierge services. In addition, Company A provides guarantees to cardholders in respect of goods or services purchased using the credit card.

Company A must consider whether this contract is entirely, or partially, within the scope of one, or multiple, sections of FRS 102 and/or other FRSs before it assesses whether Section 23 applies. For example, the guarantee provided to cardholders might give rise to an insurance contract that needs to be accounted for by applying FRS 103 (see Chapter 38). Furthermore, Company A must determine whether the fees and other features of the credit card arrangement are within the scope of Section 11 (see Chapter 11). Only any remaining components of the arrangement that are not in scope of any other sections of FRS 102 and/or other FRSs are accounted for by applying Section 23 (see Question 2-4 below), if in the scope of that section.

If a component of the arrangement is covered by another section of FRS 102 and that other section specifies how to separate and/or initially measure that component, an entity needs to first apply that section of FRS 102. An entity then applies Section 23 to the remaining components of the arrangement. Some examples of where separation and/or initial measurement are addressed in other sections of FRS 102 include the following:

- Section 11 and Section 12 generally require a financial instrument to be recognised at the transaction price, or when appropriate, at fair value, at initial recognition. For contracts that include the issuance of a financial instrument and revenue components within the scope of Section 23 and the financial instrument is required to be initially recognised at fair value, the fair value of the financial instrument is first measured and the remainder of the estimated contract consideration is allocated among the other components in the contract that are accounted for in accordance with Section 23.
- A contract might contain a lease coupled with an agreement to sell other goods or services (e.g., subject to Section 23). Section 20 requires that a lessor accounts separately for the lease component (in accordance with Section 20) and any non-lease components (in accordance with other sections of FRS 102) and provides guidance on separating the components of such a contract. [FRS 102.20.27-20.30]. A lessor allocates the consideration in a contract that contains a lease component and one or more additional lease or non-lease components by applying the requirements in Section 23 for allocating the transaction price to performance obligations and changes in the transaction price after contract inception (see 7 below). [FRS 102.20.36]. Care might be needed in such an allocation if the lease term (under Section 20) and the contract duration (under Section 23) differ. See Chapter 23 for more information on Section 20.

Conversely, if a component of the arrangement is covered by another section of FRS 102, but that section does not specify how to separate and/or initially measure that component, the entity needs to apply Section 23 to separate and/or initially measure each component. For example, specific requirements do not exist for the separation and measurement of the different parts of an arrangement when an entity sells a business and also enters into a long-term supply agreement with the other party. See 7.5 below for further discussion of the effect on the allocation of arrangement consideration when an arrangement includes both revenue and non-revenue components.

As noted above, if a contract includes a component that is covered by another FRS (e.g., FRS 103 in Illustration 2-4 above), the requirements of paragraph 23.3 of FRS 102 (as described above) do not apply. Since the requirements of Section 23 do not apply, if the other FRS does not specify how to separate the components between the FRSS, an entity would need to apply the requirements in Section 10 of FRS 102 to develop an accounting policy to determine how to separate the parts of the contract between Section 23 of FRS 102 and the other FRS. When developing its policy, an entity must, in accordance with Section 10 of FRS 102, refer to, and consider the applicability of requirements and guidance in an FRS (which could be Section 23 of FRS 102) that deals with similar and related issues. [FRS 102.10.5].

The requirements in IFRS 15.7 to separate or initially measure part (or parts) of a contract are only applicable to contracts that are partially within the scope of IFRS 15 and partially within the scope of any of the other adopted IFRS that are listed in IFRS 15.5 (see 13 below for the list). Included in that list are insurance contracts within the scope of IFRS 17 *Insurance Contracts*. By contrast, under Section 23, the requirements in paragraph 23.3 of FRS 102 to separate or initially measure any parts of the contract are applicable to all contracts that might be partially within the scope of other sections of FRS 102. Insurance contracts are within the scope of FRS 103, not within FRS 102.

Also, as described above, the scope of paragraph 23.3 is applicable to all contracts that might be partially within the scope of other sections of FRS 102. In contrast, the scope of paragraph 7 of IFRS 15 is narrow and not applicable to all contracts that might be partially within the scope of another adopted IFRS that is not specifically listed in paragraph 5 of IFRS 15.

Frequently asked questions

Question 3-1: Are pre-production activities in the scope of Section 23?

Manufacturing and production entities in various industries might perform activities and incur costs before they produce goods. In some arrangements (including long-term supply arrangements), entities perform upfront engineering and design activities and/or incur costs related to set-up activities to create new technology or adapt existing technology according to the needs of the customer. These pre-production activities are often a prerequisite to delivering any units under a production contract.

Entities need to evaluate whether the pre-production activities are promises in a contract with a customer (and potentially performance obligations) under Section 23. When making this evaluation, entities need to determine whether the activities transfer a good or service to a customer. See Question 5-1 in 5.1 below for further discussion on determining whether pre-production activities are promised goods or services under Section 23. If an entity determines that these activities are promised goods or services, it will apply the requirements in Section 23 to those goods or services. Also see Question 5-1 in 5.1 below and Questions 10-17 and 10-18 in 10.3.2 below for a discussion of scope and accounting considerations for costs related to pre-production activities and pre-contract or set-up activities, respectively.

Question 3-2: Are sales of by-products or scrap materials in the scope of Section 23?

Consider an example in which a consumer products entity sells by-products or accumulated scrap materials that are produced as a result of its manufacturing process. In determining whether the sale of by-products or scrap materials to third parties is in the scope of Section 23, an entity first determines whether the sale of such items is an output of the entity's ordinary activities (see 3.1.3 above). This is because FRS 102 defines revenue as "income arising in the course of an entity's ordinary activities".

[FRS 102 Appendix I]. If an entity determines the sale of such items represents revenue from a contract with a customer, it would generally recognise the sale under Section 23.

If an entity determines that such sales are not in the course of its ordinary activities, the entity would recognise those sales separately from revenue from contracts with customers because they represent sales to non-customers.

Question 3-3: Are the sales of prepaid gift cards within the scope of Section 23?

Entities might sell prepaid gift cards in their normal course of business in exchange for cash. The prepaid gift cards typically provide the customer with the right to redeem those cards in the future for goods or services of the entity and/or third parties. For any unused balance of the prepaid gift cards, entities need to recognise a liability that will be released upon redemption of that unused balance. However, the features of each prepaid gift card might vary and the nature of the liability depends on the assessment of these features. Entities might need to use judgement in order to determine whether the prepaid gift card is within the scope of Section 23 or another section of FRS 102.

Prepaid gift cards that give rise to financial liabilities are within the scope of Section 11 and Section 12 (see Chapter 11). If a prepaid gift card does not give rise to a financial liability, it is likely to be within the scope of Section 23. See Illustration 7-13 in 7.5 below for an example of a prepaid gift cards that give rise to financial liabilities.

For further guidance on applying Section 23 to prepaid gift cards within its scope, see 8.9 below.

Question 3-4: How does a utility entity determine whether a contract that includes a non-refundable upfront fee received for establishing a connection to a network (i.e., a connection fee) is within the scope of Section 23?

See response to Question 6-30 in 6.8 below.

Question 3-5: Are equity instruments issued by an entity to a customer in connection with a revenue arrangement within the scope of Section 23?

Whether or not an entity needs to apply Section 23 to a transaction in which equity instruments (e.g., shares) are issued to a customer in connection with a revenue arrangement depends on the substance and purpose of the transaction.

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

According to paragraph 23.3 of FRS 102, a contract with a customer might be partially within the scope of Section 23 and partially within the scope of other sections of FRS 102. Section 23 does not specify whether equity instruments issued by an entity to a customer are a type of consideration paid or payable to customer, nor does Section 26 *Share-based Payment* specifically address such transactions.

How we see it

Depending on the facts and circumstances, several standards (or a combination of standards) might be applicable (e.g., Section 22 *Financial Liabilities and Equity*, Section 23, Section 26). To determine the substance of the transaction and which section(s) apply, entities will need to consider all relevant facts and circumstances, including the purpose of the transaction. Such determinations might require significant judgement.

3.1.6 Other income and other revenue

As income and revenue are defined broadly, not all income-generating transactions are in the scope of Section 23. As discussed in 3.1.1 above, an entity applies Section 23 only to a contract in which the counterparty to the contract meets the definition of a customer (unless the contract is specifically excluded from the scope of Section 23 (see 3.1.1 above for a list of scope exclusions)).

Below, we highlight some other items of income that are not within the scope of Section 23 and note whether they are covered by another section of FRS 102. Some of these items of income might represent other revenue (i.e., non-Section 23 revenue) if they are part of the entity's ordinary activities (see 3.1.3 above). For a further discussion of whether income outside the scope of Section 23 can be presented as revenue, please see Question 11.7 in 11.2 below.

3.1.6.A Income and distributable profits

In general, neither FRS 102 nor adopted IFRS address the issue of the distribution of profit. Whether or not revenue and gains recognised in accordance with FRS 102 or adopted IFRS are distributable to shareholders of an entity will depend entirely on the national laws and regulations with which the entity needs to comply. The fact that income is reported in accordance with FRS 102 or adopted IFRS does not necessarily imply that such income is either realised or distributable under a reporting entity's applicable national legislation.

In the UK, the determination of profits available for distribution is a complex area where accounting and company law interface. In determining profits available for distribution, a UK entity could refer to Technical Release 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006* issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland, or any successor document, to determine profits available for distribution. [FRS 102.A3.29].

3.1.6.B Interest and dividends

Entities (e.g., financial institutions) might earn interest or dividends in the course of their ordinary activities (see 3.1.3 above) and, therefore, present these transactions as revenue. The relevant recognition and measurement requirements are included in Section 11 and/or Section 12. These transactions are recognised as follows:

- Interest: using the effective interest method [FRS 102 Appendix I, FRS 102.11.16] as discussed in Chapter 13 at 6.2.
- Dividends: when the shareholder's right to receive payment is established, it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably. [FRS 102.11.14A, FRS 102.12.9A]. See Chapter 13 at 6.3.2.

3.1.6.C Disposal of non-financial assets not in the ordinary course of business

When an entity disposes of an asset that is within the scope of Section 16 *Investment Property*, Section 17 or Section 18 *Intangible Assets other than Goodwill*, and that disposal is not part of the entity's ordinary activities, the transaction is within the scope of those sections, not Section 23. Accounting for derecognition of investment property is not addressed specifically within Section 16 (see Chapter 19 at 3.5), while Section 18 provides limited guidance on derecognising an intangible asset (see Chapter 21 at 3.3.6). However, Section 17 includes requirements in respect of derecognition of an item of PP&E. Section 17 also requires entities to apply certain requirements in Section 23 when determining the date of disposal of an item of PPE and consequent timing of the recognition of gains or losses arising from the

disposal. [FRS 102.17.29]. Section 17 requires that the gain or loss arising from the disposal of an item of PP&E be included in profit or loss when the item is derecognised (i.e., at the date the recipient obtains control of that item), unless Section 20 requires otherwise on a sale and leaseback transaction. Section 20 applies to disposal via a sale and leaseback. [FRS 102.17.29]. The gain or loss on disposal of an item of PP&E is the difference between the net disposal proceeds, if any, and the carrying amount of the item. [FRS 102.17.30]. Applying the GAAP hierarchy in Section 10, an entity could apply the derecognition requirements in Section 17 to the derecognition of an investment property or an intangible asset. [FRS 102.10.6].

When presenting gains on disposal of an item of PP&E in the income statement, Section 17 specifically prohibits classification of any such gain as revenue. [FRS 102.17.28]. However, there is an exception in the case of entities that are in the business of renting and subsequently selling the same assets (discussed in 3.1.6.D below). In contrast, the sale of investment property is generally not recognised as revenue. The rationale and possible treatment of investment property in such cases are discussed in detail in Chapter 19 at 3.4, 3.5 and 4.2.

3.1.6.D Sale of assets held for rental

In general, Section 17 prohibits the classification of gains arising from the derecognition of PP&E as revenue. [FRS 102.17.28]. However, Section 17 does not specify accounting for entities that are in the business of renting and subsequently selling the same asset. In this case, applying the GAAP hierarchy in Section 10, an entity could follow the specific provisions in paragraph 16 of IAS 16. [FRS 102.10.6]. The IASB has agreed that the presentation of revenue, rather than a net gain or loss on the sale of the assets, would better reflect the ordinary activities (see 3.1.3 above) of such entities. [IAS 16.BC35C]. See Chapter 20 at 3.8.1 and Chapter 6 at 5.1.2 for further discussion.

Therefore, where an entity, in the course of its ordinary activities (see 3.1.3 above), routinely sells to others items of PP&E, that it has held for rental, the entity transfers the assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets are recognised as revenue in accordance with IFRS 15 (or, in this case, Section 23 of FRS 102) on a gross basis. [IAS 16.68A].

In the cash flow statement, the above results in presentation within operating activities of cash payments to manufacture or acquire such assets and cash receipts from rents and sales of such assets (see Chapter 20 at 3.7.1).

3.2 Revenue recognition model

Section 23 describes the principles an entity must apply to measure and recognise revenue and the related cash flows. The section establishes a revenue recognition model for accounting for revenue from contracts with customers. The objective of the model is for an entity to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. [FRS 102.23.4].

To apply the model, the principles in Section 23 are applied using the following five steps: [FRS 102.23.4]

1. Identify the contract(s) with a customer (see 4 below)
2. Identify the performance obligations in the contract (see 5 below)
3. Determine the transaction price (see 6 below)
4. Allocate the transaction price to the performance obligations in the contract (see 7 below)
5. Recognise revenue when (or as) the entity satisfies a performance obligation (see 8 below)

Entities need to exercise judgement when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. Entities also have to apply the requirements of Section 23 consistently to contracts with similar characteristics and in similar circumstances. [FRS 102.23.5].

The five-step model is applied to individual contracts with customers, unless the contract combination requirements discussed in 4.3 below are met. However, there might be situations in which it could be practical for an entity to group contracts for revenue recognition purposes i.e., an entity could use the 'portfolio approach' for similar contracts (or performance obligations). This is discussed further in 4.3.1 below). [FRS 102.23.6].

4 Step 1 – Identify the contract with a customer

To apply the five-step model in Section 23, an entity must first identify the contract, or contracts, to provide goods or services to customers.

A contract is defined as ‘an agreement between two or more parties that creates enforceable rights and obligations’. [FRS 102 Appendix I]. Accordingly, a contract with a customer that creates enforceable rights and obligations fall within the scope of the model in Section 23. Such contracts might be written, oral or implied by an entity’s customary business practices. For example, if an entity has an established practice of starting performance based on oral agreements with its customers, it might determine that such oral agreements meet the definition of a contract. As a result, an entity might need to account for a contract as soon as performance begins, rather than delay revenue recognition until the arrangement is documented in a signed contract.

Certain arrangements might require a written contract to comply with laws or regulations in a particular jurisdiction. These requirements must be considered when determining whether a contract exists. That is, entities need to look at the relevant legal framework to determine whether the contract is enforceable because factors that determine enforceability might differ among jurisdictions.

Note also that, while the contract must be legally enforceable to be within the scope of the model in Section 23, all of the promises do not have to be enforceable to be considered performance obligations (see 5.1 below). That is, a performance obligation can be based on the customer’s valid expectations (e.g., due to the entity’s customary business practice of providing an additional good or service that is not specified in the contract). [FRS 102.23.19]. In addition, Section 23 clarifies that some contracts have no fixed duration and can be terminated or modified by either party at any time. Other contracts automatically renew on a specified periodic basis. Entities are required to apply Section 23 to the contractual period in which the parties have present enforceable rights and obligations. [FRS 102.23.11]. Contract enforceability and termination clauses are discussed in 4.2 below.

Illustration 4-1: Oral contract

IT Support Ltd. provides online technology support for customers remotely via the internet. For a fixed fee, IT Support Ltd. will scan a customer’s personal computer (PC) for viruses, optimise the PC’s performance and solve any connectivity problems. When a customer calls to obtain the scan services, IT Support Ltd. describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. IT Support Ltd. then gives the customer the information it needs to obtain the scan services (e.g., an access code for the website). It provides the services when the customer connects to the internet and logs onto the entity’s website (which might be that day or a future date).

In this example, IT Support Ltd. and its customer are entering into an oral agreement, which is legally enforceable in this jurisdiction, for IT Support Ltd. to repair the customer’s PC and for the customer to provide consideration by transmitting a valid credit card number and authorisation over the telephone. The required criteria for a contract with a customer (discussed further in 4.1 below) are all met. As such, this agreement is within the scope of the model in Section 23 at the time of the telephone conversation, even if the entity has not yet performed the scanning services.

4.1 Attributes of a contract

To help entities determine whether (and when) their arrangements with customers are contracts within the scope of the model in Section 23, certain attributes of a contract must be present. The criteria, which must be all met before an entity applies the model in Section 23, are as follows: [FRS 102.23.7]

- The parties have approved the contract and are committed to perform their respective obligations.
- Each party’s rights regarding the goods or services to be transferred can be identified.
- Payment terms can be identified.
- The contract has commercial substance.
- It is probable that the customer will have the ability and intention to pay the consideration to which the entity will be entitled when it is due.

These criteria are assessed at the inception of the arrangement. If the criteria are met at that time, an entity does not reassess these criteria unless there is an indication of a significant change in facts and circumstances. [FRS 102.23.8]. IFRS 15 provides further guidance which entities reporting under FRS 102 could also consider. For example, as noted in paragraph 13 of IFRS 15 – if the customer’s ability to pay significantly deteriorates, an entity would have to reassess whether it is probable that the entity will collect

the consideration to which it is entitled in exchange for transferring the remaining goods or services under the contract. The updated assessment is prospective in nature and would not change the conclusions associated with goods or services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognised under the contract. [IFRS 15.BC34].

If the criteria are not met (and until the criteria are met), the arrangement is not considered a revenue contract under Section 23 and the requirements discussed in 4.5 below must be applied.

Section 23 does not contain examples to illustrate application of the above guidance. Entities could consider Example 4 in IFRS 15 which provides an example of a significant change in facts and circumstances that results in the reassessment of the contract criteria in paragraph 9 of IFRS 15 (which are similar to the criteria in paragraph 23.7 of FRS 102). [IFRS 15.IE Example 4, IFRS 15.IE14-IE17]. See also discussion in Question 4-5 in 4.1.5.B below.

Frequently asked questions

Question 4-1: Does a master supply arrangement (MSA) create enforceable rights and obligations to be considered a contract within the scope of the model in Section 23?

An entity might use an MSA to govern the overall terms and conditions of a business arrangement between itself and a customer (e.g., scope of services, pricing, payment terms, warranties and other rights and obligations). Typically, when an entity and a customer enter into an MSA, purchases are subsequently made by the customer by issuing a non-cancellable purchase order or an approved online authorisation that explicitly references the MSA and specifies the products, services and quantities to be delivered.

In such cases, the MSA is unlikely to create enforceable rights and obligations, which are needed to be considered a contract within the scope of the model in Section 23. This is because, while the MSA might specify the pricing or payment terms, it usually does not specify the specific goods or services, or quantities thereof, to be transferred. Therefore, each party's rights and obligations regarding the goods or services to be transferred are not identifiable. It is likely that the MSA and the customer order, taken together, would constitute a contract under Section 23. As such, entities need to evaluate both the MSA and the subsequent customer order(s) together to determine whether and when the criteria in paragraph 23.7 are met. [FRS 102.23.7].

If an MSA includes an enforceable clause requiring the customer to purchase a minimum quantity of goods or services, the MSA alone might constitute a contract under Section 23 because enforceable rights and obligations exist for this minimum amount of goods or services.

Question 4-2: How would an entity determine whether a contract exists within the scope of the model during a free trial period?

Free trial periods are common in certain subscription arrangements (e.g., magazines, streaming services). A customer might receive a number of 'free' months of goods or services at the inception of an arrangement; before the paid subscription begins; or as a bonus period at the beginning or end of a paid subscription period.

How we see it

Under Section 23, revenue is not recognised until an entity determines that a contract within the scope of the model exists. Once an entity determines that a Section 23 contract exists, it is required to identify the promises in the contract. Therefore, if the entity has transferred goods or services prior to the existence of a Section 23 contract, we believe that the free goods or services provided during the trial period would generally be accounted for as marketing incentives.

Consider an example in which an entity has a marketing programme to provide a three-month free trial period of its services to prospective customers. The entity's customers are not required to pay for the services provided during the free trial period and the entity is under no obligation to provide the services under the marketing programme. If a customer enters into a contract with the entity at the end of the free trial period that obliges the entity to provide services in the future (e.g., signing up for a subsequent 12-month period) and obliges the customer to pay for the services, the services provided as part of the marketing programme might not be promises that are part of an enforceable contract with the customer. However, if an entity, as part of a negotiation with a prospective customer, agrees to provide three free months of services if the customer agrees to pay for 12 months of services (effectively providing the customer a discount on 15 months), the entity would identify the free months as promises in the contract because the contract requires it to provide them.

The above interpretation applies if the customer is not required to pay any consideration for the additional goods or services during the trial period (i.e., they are free). If the customer is required to pay consideration in exchange for the goods or services received during the trial period (even if it is only a nominal amount), a different accounting conclusion could be reached. Entities need to apply judgement to evaluate whether a contract exists that falls within the scope of the model in Section 23.

Question 4-3: Do entities need to consider side agreements when determining whether a contract exists within the scope of the model?

All terms and conditions that create or negate enforceable rights and obligations must be considered when determining whether a contract exists under Section 23. Understanding the entire contract, including any side agreements or other amendments, is critical to this determination.

Side agreements are amendments to a contract that can be either undocumented or documented separately from the main contract. The potential for side agreements is greater for complex or material transactions or when complex arrangements or relationships exist between an entity and its customers. Side agreements might be communicated in many forms (e.g., oral agreements, email, letters or contract amendments) and could be entered into for a variety of reasons.

Side agreements might provide an incentive for a customer to enter into a contract near the end of a financial reporting period or to enter into a contract that it would not enter into in the normal course of business. Side agreements might entice a customer to accept delivery of goods or services earlier than required or could provide the customer with rights in excess of those customarily provided by the entity. For example, a side agreement might extend contractual payment terms; expand contractually stated rights; provide a right of return; or commit the entity to provide future products or functionality not contained in the contract or to assist resellers in selling a product. Therefore, if the provisions in a side agreement differ from those in the main contract, an entity assesses whether the side agreement creates new rights and obligations or changes existing rights and obligations. See 4.3 and 4.4 below, respectively, for further discussion of the Section 23's requirements on combining contracts and contract modifications.

4.1.1 Parties have approved the contract and are committed to perform their respective obligations

Before applying the model in Section 23, the parties must have approved the contract. A contract might not be legally enforceable without the approval of both parties. Furthermore, the form of the contract (i.e., oral, written or implied) is not determinative in assessing whether the parties have approved the contract. Instead, an entity must consider all relevant facts and circumstances when assessing whether the parties intend to be bound by the terms and conditions of the contract. In some cases, the parties to an oral or implied contract might have the intent to fulfil their respective obligations. However, in other cases, a written contract might be required before an entity can conclude that the parties have approved the arrangement.

In addition to approving the contract, the entity must be able to conclude that both parties are committed to perform their respective obligations. [FRS 102.23.7(a)]. That is, the entity must be committed to providing the promised goods or services. In addition, the customer must be committed to purchasing those promised goods or services. In the Basis for Conclusions on IFRS 15, the IASB clarified that an entity and a customer do not always have to be committed to fulfilling all of their respective rights and obligations for a contract to meet this requirement. The IASB cited, as an example, a supply agreement between two parties that includes stated minimums. The customer does not always buy the required minimum quantity and the entity does not always enforce its right to require the customer to purchase the minimum quantity. In this situation, the IASB stated that it might still be possible for the entity to determine that there is sufficient evidence to demonstrate that the parties are substantially committed to the contract. [IFRS 15.BC36]. This criterion does not address a customer's intent and ability to pay the consideration. Ability and intention to pay is a separate criterion and is discussed in 4.1.5 below.

Termination clauses are also an important consideration when determining whether both parties are committed to perform under a contract and, consequently, whether a contract within the scope of the model in Section 23 exists. See 4.2 below for further discussion of termination clauses and how they affect contract duration.

4.1.2 Each party's rights regarding the goods or services to be transferred can be identified

This criterion is relatively straightforward. If the goods or services to be provided in the arrangement cannot be identified, it is not possible to conclude that an entity has a contract within the scope of the model in Section 23. Furthermore, if the promised goods or services cannot be identified, the entity cannot assess whether those goods or services have been transferred because the entity would be unable to assess each party's rights with respect to those goods or services.

4.1.3 Payment terms can be identified

Identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. As long as there is an enforceable right to payment (i.e., enforceability as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price (see further discussion in 6 below), the contract would qualify for accounting under Section 23 (assuming the remaining criteria set out in paragraph 23.7 of FRS 102, discussed in 4.1 above, have been met).

4.1.4 Commercial substance

The model in Section 23 does not apply if an arrangement does not have commercial substance. Commercial substance means that either the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract. Historically, some entities in high-growth industries allegedly engaged in transactions to artificially inflate revenue; for example, goods or services might be transferred back and forth between the same entities in an attempt to show higher transaction volume and gross revenue (sometimes known as 'round-tripping'). This is also a risk in arrangements that involve non-cash consideration (e.g., barter transactions).

Determining whether a contract has commercial substance for the purposes of Section 23 might require significant judgement. In all situations, the entity must be able to demonstrate a substantive business purpose exists, considering the nature and structure of its transactions.

Section 23 does not contain requirements specific to barter transactions. Entities need to carefully consider the commercial substance criterion when evaluating these types of transactions (see 6.6.2 below for further discussion on barter transactions).

4.1.5 Ability and intention to pay

Under section 23, this criterion is described from the perspective of the customer, that is, it is probable that the customer will have the ability and intention to pay the amount of consideration to which the entity will be entitled when it is due. [FRS 102.23.7(e)]. Under IFRS 15 this criterion is described from the perspective of the entity, that is, it is probable that the entity will collect the consideration to which it is entitled. However, in evaluating whether collectability of an amount of consideration is probable, IFRS 15 requires an entity to consider only the customer's ability and intention to pay that amount of consideration when it is due. [IFRS 15.9(e)]. Considering the criterion is consistent with the corresponding requirement under IFRS 15, it is described as 'collectability' in this chapter. Entities reporting under FRS 102 could also consider further guidance in IFRS 15.

Note that in the Basis for Conclusions on IFRS 15, an entity needs to assess a customer's ability to pay based on the customer's financial capacity and its intention to pay considering all relevant facts and circumstances, including past experiences with that customer or customer class. [IFRS 15.BC45]. In the Basis for Conclusions on IFRS 15, the IASB noted that the purpose of the criteria in paragraph 9 of IFRS 15 (which is similar to the criteria in paragraph 23.7 of FRS 102) is to require an entity to assess whether a contract is valid and represents a genuine transaction. The collectability criterion (i.e., determining whether the customer has the ability and the intention to pay the promised consideration) is a key part of that assessment. In addition, the IASB noted that, in general, entities only enter into contracts in which it is probable that the entity will collect the amount to which it will be entitled. [IFRS 15.BC43]. That is, in most instances, an entity would not enter into a contract with a customer if there was significant credit risk associated with that customer without also having adequate economic protection to ensure that it would collect the consideration.

Paragraph 23.7(e) requires an entity to evaluate at contract inception whether it is *probable* that the customer will have the ability and intention to pay the 'consideration to which the entity will be entitled when it is due'. An entity is also required to reassess collectability after contract inception, when significant facts and circumstances change (see Question 4-5 in 4.1.5.B below for further discussion). [FRS 102.23.8]. We discuss each of the italicised concepts below:

- *Probable* - The term 'probable' is defined as "more likely than not". [FRS 102 Appendix I]. If it is not probable that the entity will collect amounts to which it is entitled, the model in Section 23 is not applied to the contract until the concerns about collectability have been resolved. However, other requirements in Section 23 apply to such arrangements (see 4.5 below for further discussion).
- *Consideration to which it will be entitled when it is due* - The amount of consideration that is assessed for collectability is the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to a customer. That is, the amount of consideration assessed for collectability is often the transaction price, but it could be a lower amount in certain circumstances, as discussed further below. [FRS 102.23.7(e)].

It is important to note that the transaction price might be less than the stated contract price for the goods or services in the contract. Entities need to determine the transaction price in Step 3 of the model (as discussed in 6 below) before assessing the collectability of that amount. The contract price and transaction price most often will differ because of variable consideration (e.g., rebates, discounts, or explicit or implicit price concessions) that reduces the amount of consideration stated in the contract. For example, the transaction price for the items expected to be transferred might be less than the stated contract price for those items if an entity concludes that it has offered, or is willing to accept, a price concession on products sold to a customer. See 6.2.1.A below for further discussion on price concessions.

An entity deducts from the contract price any variable consideration that would reduce the amount of consideration to which it expects to be entitled (e.g., an estimated price concession) at contract inception in order to derive the transaction price for those items. The collectability assessment is then performed on the determined transaction price.

Note that in the Basis for Conclusions on IFRS 15, the IASB noted that, if the customer were to fail to perform as promised and the entity were able to stop transferring additional goods or services to the customer in response, the entity would not consider the likelihood of payment for those goods or services that would not be transferred in its assessment of collectability. [IFRS 15.BC46]. The IASB also noted that the assessment of collectability criterion requires an entity to consider how the entity's contractual rights to the consideration relate to its performance obligations. That assessment considers the business practices available to the entity to manage its exposure to credit risk throughout the contract (e.g., through advance payments or the right to stop transferring additional goods or services). [IFRS 15.BC46C].

In addition to the Section 23 collectability assessment, an entity has to assess any contract assets or trade receivables arising from a Section 23 contract for any impairment loss under Section 11 (for further discussion see 11.1 below and Chapter 13).

How we see it

At contract inception, significant judgement is required to determine when an expected partial payment indicates that: (i) there is an implied price concession in the contract that affects the determination of the transaction price and the amount assessed for collectability under Section 23; (ii) there is a credit loss (accounted for as an impairment loss under Section 11); or (iii) the arrangement lacks sufficient substance to be considered a contract under Section 23. See 6.2.1.A below for further discussion of implicit price concessions.

4.1.5.A Variable consideration versus credit risk

In some cases, it might be difficult to determine whether the entity has implicitly offered a price concession (i.e., variable consideration) or whether the entity has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (i.e., impairment losses under Section 11). Section 23 does not have guidance for distinguishing between price concessions (recognised as variable consideration through revenue) and a credit loss to be accounted for as an impairment loss under Section 11 (i.e., outside revenue). Therefore, an entity needs to consider all relevant facts and circumstances when analysing situations in which, at contract inception, it is willing to accept a lower price than the amount stated in the contract. In 6.2.1.A below, we discuss certain factors that might suggest the entity has implicitly offered a price concession to the customer.

After the entity has determined the amount to assess for collectability under paragraph 23.7(e), it also has to apply the requirements in Section 11 to account for any credit losses for the receivable (or contract asset) that is recorded (i.e., after consideration of any variable consideration, such as an implicit price concession). It presents any resulting impairment loss as an expense under Section 11 (i.e., not as a reduction of the transaction price). Illustration 6-2 included in 6.2.1.A below, Example 3 and Example 23 in IFRS 15 illustrate a situation where the transaction price that is evaluated for collectability is not the amount stated in the contract. In contrast, Illustration 4-3 in Question 4-4 in 4.1.5.B below illustrates a situation in which an entity, at contract inception, believes it is probable that its customers will pay amounts owed and the transaction price (i.e., revenue recorded) equals the contract price, even though, on a portfolio basis, 2% is not expected to be collected.

4.1.5.B Example of assessing the collectability criterion

Illustration 4-2 below, which is based on Example 1 in IFRS 15, shows how an entity might assess the collectability criterion: [IFRS 15.IE Example 1, IFRS 15.IE3-IE6]

Illustration 4-2: Collectability of the consideration

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for £1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition and the customer has little experience in the restaurant industry.

The customer pays a non-refundable deposit of £50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95% of the promised consideration. The financing arrangement is provided on a non-recourse basis, which means that if the customer defaults, the entity can repossess the building, but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is £600,000. The customer obtains control of the building at contract inception.

In assessing whether the contract meets the criteria in paragraph 23.7 of FRS 102, the entity concludes that the criterion in paragraph 23.7(e) is not met because it is not probable that the entity will collect the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay might be in doubt because of the following factors:

- (a) The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).
 - (b) The customer lacks other income or assets that could be used to repay the loan.
- And

- (c) The customer's liability under the loan is limited because the loan is non-recourse.

Because the criteria in paragraph 23.7 are not met, the entity applies paragraphs 23.9 to 23.10 to determine the accounting for the non-refundable deposit of £50,000. The entity observes that none of the events described in paragraph 23.10 have occurred; that is, the entity has not received substantially all of the consideration and it has not terminated the contract. Consequently, in accordance with paragraph 23.9, the entity accounts for the non-refundable £50,000 payment as a deposit liability. The entity continues to account for the initial deposit, as well as any future payments of principal and interest, as a deposit liability, until such time that the entity concludes that the criteria in paragraph 23.7 are met (i.e., the entity is able to conclude that it is probable that the entity will collect the consideration) or one of the events in paragraph 23.10 has occurred. The entity continues to assess the contract in accordance with paragraph 23.9 to determine whether the criteria in paragraph 23.7 are subsequently met or whether the events in paragraph 23.10 have occurred.

Frequently asked questions

Question 4-4: How would an entity assess collectability for a portfolio of contracts?¹¹⁷

If an entity has determined it is probable that a customer will have the ability and intention to pay amounts owed under a contract, but the entity has historical experience that some of the customers within a portfolio of contracts will not pay the consideration (see 4.3.1 below), it would be appropriate for the entity to record revenue for the contract in full and separately evaluate the corresponding contract asset or receivable for impairment. That is, the entity would not conclude the arrangement contains an implicit price concession and would not reduce revenue for the uncollectable amounts. See 6.2.1.A below for a discussion of evaluating whether an entity has offered an implicit price concession.

If an entity determines that payment by the customer is probable, that does not mean that the risk of a credit loss is zero. Entities still need to apply Section 11 to estimate the credit losses on contract assets or receivables resulting from the application of Section 23.

Consider the following Illustration:

Illustration 4-3: Assessing collectability for a portfolio of contracts

An entity has a large volume of similar customer contracts for which it invoices its customers in arrears, on a monthly basis. Before accepting a customer, the entity performs procedures designed to determine if it is probable that the customer will have the ability and intention to pay the amounts owed. It does not accept customers if it is not probable that the customer will pay the amounts owed. Because these procedures are only designed to determine whether the payment is probable (and, thus, not a certainty), the entity anticipates that it will have some customers that will not pay all of the amounts owed. While the entity collects the entire amount due from the vast majority of its customers, on average, the entity's historical evidence (which is representative of its expectations for the future) indicates that the customers will only pay 98% of the amounts invoiced.

In this case, the entity would recognise revenue for the full amount due. That is, when the entity satisfies the performance obligations in the contracts, it would recognise revenue of 100% of the amount due and a corresponding receivable for the same amount representing its unconditional right to the full consideration. It would then assess impairment in accordance with Section 11 for 2% of the amount due (i.e., the amount the entity does not expect to collect).

In this example, the entity concludes that collectability is probable for each customer based on procedures it performed prior to accepting each customer and on its historical experience with this customer class, while also accepting that there is some credit risk inherent with this customer class. Furthermore, the entity concludes that any amounts not collected do not represent implied price concessions. Instead, they are due to credit risk that is present in a limited number of customer contracts.

The analysis to determine whether to recognise an impairment loss for a contract in the same period in which revenue is recognised (instead of reducing revenue for an anticipated price concession) will require judgement. See Chapter 13 at 6.5 for further information on recognition and measurement of impairment under Section 11.

Question 4-5: When would an entity reassess collectability?¹¹⁸

As discussed in 4.1.5 above, paragraph 23.8 of FRS 102 requires an entity to reassess whether it is probable that it will collect the consideration to which it will be entitled when significant facts and circumstances change. [FRS 102.23.8]. Section 23 and IFRS 15 are consistent in this area and entities reporting under FRS 102 could consider the guidance provided in IFRS 15.

Example 4 in IFRS 15 illustrates a situation in which a customer's financial condition declines and its current access to credit and available cash on hand is limited. In this case, the entity does not reassess the collectability criterion. However, in a subsequent year, the customer's financial condition further declines after losing access to credit and its major customers. In the example, this subsequent change in the customer's financial condition is so significant that a reassessment of the criteria for identifying a contract is required, resulting in the collectability criterion not being met. [IFRS 15.IE Example 4, IFRS 15.IE14-IE17]. This shows that relatively minor changes (i.e., those that do not call into question the validity of the contract) do not need reassessment. Entities might need to exercise judgement to determine whether changes in the facts and circumstances are significant enough to indicate that a contract no longer exists under the standard.

¹¹⁷ Based on TRG Agenda paper no. 13, *Collectibility*, dated 26 January 2015.

¹¹⁸ Based on TRG Agenda paper no. 13, *Collectibility*, dated 26 January 2015 and TRG Agenda paper no. 25, *January 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 30 March 2015.

4.2 Contract enforceability and termination clauses

An entity has to determine the duration of the contract (i.e., the stated contractual term or a shorter period) before applying certain aspects of the revenue model (e.g., identifying performance obligations, determining the transaction price). The contract duration under Section 23 is the period in which parties to the contract have present enforceable rights and obligations. An entity cannot assume that there are present enforceable rights and obligations for the entire term stated in the contract and it is likely that an entity will have to consider enforceable rights and obligations in individual contracts, as described in Section 23: [FRS 102.23.11]

Extract from Section 23

23.11 Some contracts with customers may have no fixed duration or may automatically renew periodically. An entity shall apply this section to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations.

The period in which enforceable rights and obligations exist might be affected by termination provisions in the contract. Significant judgement is required to determine the effect of termination provisions on the contract duration. Entities need to review the overall contractual arrangements, including any master service arrangements, wind-down provisions and business practices to identify terms or conditions that might affect the enforceable rights and obligations in their contracts.

This determination is critical because the contract duration to which Section 23 is applied might affect the number of performance obligations identified and the determination of the transaction price. It might also affect the amounts disclosed in some of the required disclosures. See Questions 4-6 to 4-8 below for further discussion of how termination provisions might affect the contract duration.

It is also worth considering further guidance provided in IFRS 15 on this matter. Under IFRS 15, if each party has the unilateral right to terminate a 'wholly unperformed' contract (as defined in IFRS 15.12) without compensating the counterparty, IFRS 15 states that, for purposes of the revenue standard, a contract does not exist and its accounting and disclosure requirements would not apply. This is because the contracts would not affect an entity's financial position or performance until either party performs. Any arrangement in which the entity has not provided any of the contracted goods or services and has not received or is not entitled to receive any of the contracted consideration is considered to be a 'wholly unperformed' contract. [IFRS 15.12].

Under IFRS 15, the requirements for 'wholly unperformed' contracts do not apply if the parties to the contract have to compensate the other party if either of them exercises their right to terminate the contract and the termination payment is considered substantive, and all facts and circumstances related to the contract need to be considered.

Because the contract duration is determined on the basis of the period over which the parties to the contract have present enforceable rights and obligations, certain economic factors (e.g., economic compulsion) are not considered in this assessment because they do not create or modify the present enforceable rights and obligations of either party in the contract.

For example, consider a long-term contract between an entity and a customer that permits the customer to terminate the contract at any time without paying a substantive termination penalty. The entity believes that it is virtually certain that the customer will not terminate the contract because the customer's business relies on a good or service that only the entity can provide. However, when determining the duration of the contract, the entity would not consider the perceived economic compulsion on the customer's part because it does not create or modify any present enforceable rights and obligations. As a result, the contract would have a shorter duration than the stated term because the terminating party is not required to compensate the other party.

Similarly, if there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums), the contract duration does not extend beyond the period in which both parties have present enforceable rights and obligations even when a customer is expected to be economically compelled to exercise an option for additional goods and services (e.g., the customer would forgo a substantial discount on the optional purchases if it were to cancel the contract). Rather, the discount on optional purchases is assessed to determine whether it conveys a material right. See Question 5-19 in 5.6 below for further discussion.

How we see it

We believe that entities are required to account for contracts with longer stated terms as month-to-month (or possibly a shorter duration) contracts if the parties can terminate the contract without penalty. When determining a contract's duration, entities need to carefully evaluate the contractual terms (including any substantive termination provisions) and the present enforceable rights and obligations of both parties. Certain economic factors (e.g., economic compulsion) are not relevant because they do not create or modify present enforceable rights and obligations of either party.

Frequently asked questions

Question 4-6: How do termination clauses and termination payments affect the duration of a contract (i.e., the contractual period)?¹¹⁹

Entities need to carefully evaluate termination clauses and any related termination payments to determine how they affect contract duration (i.e., the period in which there are enforceable rights and obligations).

Enforceable rights and obligations generally exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. For example, if a contract includes a substantive termination payment, the duration of the contract would equal the period through which a termination penalty would be due. This could be the stated contractual term or a shorter duration if the termination penalty does not extend to the end of the contract. However, the determination of whether a termination penalty is substantive, and what constitutes enforceable rights and obligations under a contract, requires judgement and consideration of the facts and circumstances. If an entity concludes that the duration of the contract is less than the stated term because of a termination clause, any termination penalty needs to be included in the transaction price. If the termination penalty is variable, the requirements for variable consideration, including the constraint (see 6.2.3 below), apply.

If a contract with a stated contractual term can be terminated by either party at any time for no consideration, the contract duration ends when control of the goods or services that have already been provided transfers to the customer (e.g., a month-to-month service contract), regardless of the contract's stated contractual term. In this case, entities also need to consider whether a contract includes a notification or cancellation period (e.g., the contract can be terminated with 90 days' notice) that would cause the contract duration to extend beyond the date when control of the goods or services that have already been provided were transferred to the customer. If such a period exists, the contract duration would be shorter than the stated contractual term, but would extend beyond the date when control of the goods or services that have already been provided were transferred to the customer.

Consider the following illustrations that show how termination provisions affect the duration of a contract:

Illustration 4-4: Determining the duration of the contract

Entity A enters into a four-year service contract with a customer. The customer is required to pay a non-refundable annual fee of £100,000, which is the stand-alone selling price for each year of service.

To determine the duration of the contract in each of the scenarios below, the entity considers these facts and whether the contract provides cancellation rights and termination penalties.

Scenario A

Assume no cancellation rights are provided to either party. In this case, the enforceable rights and obligations exist for the entire stated contractual term and the contract duration is four years.

Scenario B

Assume the contract provides the customer with a right to cancel the contract at the end of each year without cause, but with a termination penalty. The penalty decreases annually throughout the contract term at the end of each year. The following illustrates the payments under the contract:

	Year 1	Year 2	Year 3	Year 4
Annual fee (£)	100,000	100,000	100,000	100,000
Termination penalty (£)	225,000	150,000	75,000	-

¹¹⁹ Based on TRG Agenda paper no. 10, *Contract enforceability and termination clauses*, dated 31 October 2014.

If Entity A determines that the penalty is substantive in each period, enforceable rights and obligations exist for the stated contractual term of four years.

Scenario C

Assume the contract provides the customer with a right to cancel at the end of each year, with no termination penalty.

In this case, Entity A determines that the contract duration is one year, with options to renew for each of the following three years because the customer can choose whether to receive the service during those years. That is, Entity A determines that enforceable rights and obligations do not exist throughout the entire stated contractual term because there is no substantive termination penalty. The options to renew are not material rights because they are offered at the stand-alone selling price of £100,000.

Illustration 4-5: Duration of a contract without a termination penalty

Entity A enters into a three-year contract with a customer to provide maintenance services. Entity A begins providing the services immediately. Consideration is payable in equal monthly instalments and each party has the unilateral right to terminate the contract without compensating the other party if it provides 30 days' notice.

While the stated contractual term is three years, Entity A's rights and obligations are enforceable only for 30 days. Therefore, under Section 23, the contract is accounted for as a one-month contract with a renewal option for additional months of maintenance services. This is because the customer or Entity A could cancel the agreement with 30 days' notice without paying a substantive termination payment.

Entity A also needs to evaluate the accounting for the renewal option(s) to determine whether it is a material right (see 3.4.6 below).

Question 4-7: How would an entity evaluate the contract term when only the customer has the right to cancel the contract without cause and how do termination penalties affect this analysis?¹²⁰

Enforceable rights and obligations exist throughout the term in which each party has the unilateral enforceable right to terminate the contract by compensating the other party. A customer-only right to terminate is generally not sufficient to warrant a different conclusion than one in which both parties have the right to terminate, as discussed in Question 4-6 above.

Generally, a substantive termination penalty payable by a customer to the entity is evidence of enforceable rights and obligations of both parties throughout the period covered by the termination penalty. For example, consider a four-year service contract in which the customer has the right to cancel without cause at the end of each year, but for which the customer would incur a termination penalty that decreases each year and is determined to be substantive. In this case, the arrangement generally would be treated as a four-year contract. See Illustration 4-4, Scenario B in Question 4-6 above.

There could also be situations in which a contractual penalty for not meeting contractual minimums would result in including optional goods or services in the accounting for the original contract (see Question 5-21 in 5.6 below).

The determination of whether a termination penalty is substantive, and what constitutes enforceable rights and obligations under a contract, would likely require judgement and consideration of the facts and circumstances. In addition, it is possible that payments that effectively act as a termination penalty and create or negate enforceable rights and obligations might not be labelled as such in a contract. Consider, as an example, an entity that sells equipment and consumables. The equipment is sold at a discount, but the customer is required to repay some or all of the discount if it does not purchase a minimum number of consumables. In this instance, it can be concluded that the penalty (i.e., repaying the upfront discount) is substantive and is evidence of enforceable rights and obligations up to the minimum quantity. This example is discussed further in Question 5-21 at 5.6 below.

If enforceable rights and obligations do not exist throughout the entire term stated in the contract, the customer cancellation rights would generally be treated as customer options. Examples include when there are no (or non-substantive) contractual penalties that compensate the entity upon cancellation and when the customer has the unilateral right to terminate the contract for reasons other than cause or contingent events outside the customer's control. Note that this is consistent with the Basis for Conclusions on IFRS 15 i.e., the IASB noted that a cancellation option or termination right can be similar to a renewal option. [IFRS 15.BC391]. An entity would need to determine whether a cancellation option indicates that the customer has a material right that would need to be accounted for as a performance obligation (e.g., there is a discount for goods or services provided during the cancellable period that provides the customer with a material right) (see 5.6 below for further discussion on customer options and the determination of whether an option represents a material right).

¹²⁰ Based on TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

Question 4-8: If an entity has a past practice of not enforcing termination payments, does this affect the duration of the contract (i.e., the contractual period)?¹²¹

The evaluation of the termination payment in determining the duration of a contract depends on whether the law (which might vary by jurisdiction) considers past practice as limiting the parties' enforceable rights and obligations. An entity's past practice of allowing customers to terminate the contract early without enforcing collection of the termination payment only affects the contract duration in cases in which the parties' legally enforceable rights and obligations are limited because of the lack of enforcement by the entity. If that past practice does not change the parties' legally enforceable rights and obligations, the contract duration equals the period throughout which a substantive termination penalty would be due (which could be the stated contractual term or a shorter duration if the termination penalty did not extend to the end of the contract).

Question 4-9: How would an entity account for a partial termination of a contract (e.g., a change in the contract term from three years to two years prior to the beginning of year two)?**How we see it**

We believe an entity accounts for the partial termination of a contract as a contract modification (see 4.4 below) because it results in a change in the scope of the contract.

Section 23 states that "a contract modification either creates new enforceable rights and obligations, or changes such rights and obligations that already exist". [FRS 102.23.13]. A partial termination of a contract results in a change to the enforceable rights and obligations in the existing contract (also see Question 4-20 in 4.4.2.C below regarding contract modifications that decrease the scope of a contract). Note that this conclusion is consistent with TRG's discussion in agenda paper no. 48, which states, "a substantive termination penalty is evidence of enforceable rights and obligations throughout the contract term. The termination penalty is ignored until the contract is terminated at which point it is accounted for as a modification".¹²²

Consider the following Illustration:

Illustration 4-6: Partial termination of a contract

An entity enters into a contract with a customer to provide monthly maintenance services for three years at a fixed price of £500 per month (i.e., total consideration of £18,000). The contract includes a termination clause that allows the customer to cancel the third year of the contract by paying a termination penalty of £1,000 (which is considered substantive for the purpose of this example). That is, the entity determines the contract duration is three years. However, at the end of the first year, the customer decides to cancel the third year of the contract and pays the £1,000 termination penalty specified in the contract.

In this example, the modification is not accounted for as a separate contract because it does not result in the addition of distinct goods or services (see 4.4.2 below). Since the remaining services are distinct, the entity applies the requirements in FRS 102.23.16(a) and accounts for the modification prospectively. The remaining consideration of £7,000 (£6,000 per year under the original contract for the second year, plus the £1,000 payment upon modification) is recognised over the remaining revised contract period of one year. That is, the entity recognises the £1,000 termination penalty over the remaining performance period.

In contrast, if the entity determined that the termination penalty was not substantive, the contract duration would be two years (not the three-year stated term). As discussed in Question 4-6 above, because the entity concluded that the contract duration was less than the stated term due to a termination clause, the termination penalty would need to be included in the transaction price at contract inception. The penalty would effectively result in an adjusted price per month of £542 for two years (i.e., total consideration of £13,000 ÷ 24 months). Determining whether a termination penalty is substantive will require judgement and consideration of the facts and circumstances.

Question 4-10: How is consideration that was received from a customer, but not yet recognised as revenue, accounted for when the contract is cancelled?

When a contract is cancelled (by either the customer or the entity), it is a contract modification that reduces the scope of the contract. As discussed in Question 4-9 above and Question 4-20 in 4.4.2.C below, such a modification would not be accounted for as a separate contract because it does not result in the addition of distinct goods or services. Rather, the accounting will depend on whether there are any remaining goods and services to be provided after the cancellation and, if so, whether they are distinct from the goods and services already provided as discussed in 4.4 below. That is, if a contract is cancelled but there are remaining goods and services to be provided, the entity applies the Section 23's contract modification requirements.

If there are no remaining goods and services to be provided after the cancellation, the accounting depends on whether the consideration is refundable or non-refundable. To determine whether consideration is refundable or non-refundable, entities might need to consider termination penalties, legal requirements for refund, customary business practices of providing refunds or statements made to customers that create a constructive or legal obligation to provide a refund.

If the consideration received from the customer is refundable and there are no remaining goods and services to be provided after the cancellation, the entity has a refund liability. This might require the entity to reclassify any existing contract liability to refund liability. In some cases, the entity might ask the customer to waive their right to a refund of the consideration in exchange for vouchers, for example, and/or discounts on future goods or services. The accounting for such offers (including the accounting for the liability) depends on the specific facts and circumstances and could require judgement.

How we see it

If the consideration received from the customer is non-refundable and there are no remaining goods and services to be provided after the cancellation, we believe that the entity can recognise revenue for the consideration received when the contract is cancelled, and the related contract liability would also be derecognised.

This accounting treatment is similar to the guidance for breakage (e.g., for gift cards, see 8.9 below) and the recognition of revenue for arrangements that fail the criteria required in paragraph 23.10 (see 4.5 below). In both of those situations, Section 23 provides guidance that permits an entity to derecognise a liability and recognise revenue, provided the relevant criteria are met, when:

- The entity expects the customer will not exercise its contractual rights (for breakage).
[FRS 102.23.130]
- Or
- The contract is effectively completed or cancelled (for contracts that do not meet the contract criteria in FRS 102.23.7). [FRS 102.23.10].

In some cases, an entity might be entitled to termination fees in the event of cancellation. The accounting for termination fees is discussed in Question 4-9 above.

Question 4-11: How does an entity account for services provided during a period after contract expiration in which enforceable rights and obligations do not exist until the contract is renewed?

How we see it

If an entity continues to provide services to a customer during a period when a contract does not exist because a previous contract has expired and the contract has not yet been renewed, we believe that the entity would need to recognise revenue for providing those services on a cumulative catch-up basis at the time the contract is renewed (i.e., when enforceable rights and obligations exist between the entity and its customer).

As discussed in 4.1 above, determining whether an enforceable contract exists under the model might require judgement and an evaluation of the relevant legal framework.

This approach to record revenue on a cumulative catch-up basis reflects the performance obligations that are partially satisfied at the time enforceable rights and obligations exist and is consistent with the overall principle of Section 23 that requires revenue to be recognised when (or as) an entity transfers control of goods or services to a customer under an enforceable contract. This conclusion is also consistent with the discussion in Question 8-20 in 8.1.4.E below on the accounting for goods or services provided to a customer before the contract establishment date.

121 Based on TRG Agenda paper no. 10, *Contract enforceability and termination clauses*, dated 31 October 2014.

122 TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015, paragraph 47a.

Consider the following Illustration:

Illustration 4-7: Services provided during a period after contract expiration

Entity A enters into a non-cancellable one-year contract with a customer on 1 January 20X6 to provide web-hosting services that are transferred to the customer over time. The total consideration of £1,200 is payable upfront and is non-refundable. After the expiration of the contract, at its discretion, Entity A continues to provide web-hosting services to the customer for a limited time to allow the customer to contemplate renewing the contract. If the customer renews the contract, the pricing would include the web-hosting services provided during the period between the original contract expiration and the contract renewal.

The customer agrees to renew the contract on 1 February 20X7. Entity A agrees to provide web-hosting services from 1 January 20X7 to 31 December 20X7 for total consideration of £1,200, which is payable on the renewal date. Entity A determines that enforceable rights and obligations exist on 1 February 20X7 and recognises revenue on a cumulative catch-up basis to reflect the entity's transfer of control of the web-hosting services for one month (i.e., January 20X7). Accordingly, Entity A recognises £100 on 1 February 20X7 for the web-hosting services provided to the customer before the renewal date. The remaining consideration of £1,100 is recognised from 1 February 20X7 to 31 December 20X7 as the entity performs.

An entity might receive consideration from the customer for the goods or services transferred before the existence of an enforceable contract. If so, the entity would need to follow the requirements in paragraphs 23.9 and 23.10 (discussed in 4.5 below). This requires that when an arrangement does not meet the criteria to be a contract under Section 23, an entity would recognise the non-refundable consideration received as revenue only if one of the two events has occurred (e.g., the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received by the entity and is non-refundable).

4.3 Combining contracts

In most cases, entities apply the model to individual contracts with a customer. However, Section 23 requires entities to combine contracts entered into at, or near, the same time with the same customer (or related parties of the customer as defined in Appendix I to FRS 102) if they meet one or more of the following criteria: [FRS 102.23.12]

- The contracts are negotiated as a package with a single commercial objective
- The consideration to be paid for one contract is dependent on the price or performance of the other contract

Or

- The goods or services promised in the contracts are a single performance obligation (see 5 below)

Entities need to apply judgement to determine whether contracts are entered into at or near the same time because Section 23 does not provide a bright line for making this assessment. In the Basis for Conclusions on IFRS 15, the IASB noted that the longer the period between entering into different contracts, the more likely it is that the economic circumstances affecting the negotiations of those contracts will have changed. [IFRS 15.BC75].

Negotiating multiple contracts at the same time is not sufficient evidence to demonstrate that the contracts represent a single arrangement for accounting purposes. In the Basis for Conclusions on IFRS 15, the IASB also noted that there are pricing interdependencies between two or more contracts when either of the first two criteria (i.e., the contracts are negotiated as a package with a single commercial objective or the price in one contract depends on the price or performance of the other contract) are met, so the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer if those contracts were not combined. The IASB also explained the third criterion (i.e., the goods or services in the contracts are a single performance obligation) was included to avoid any structuring opportunities that would effectively allow entities to bypass the requirements for identifying performance obligations. [IFRS 15.BC73]. That is, an entity cannot avoid determining whether multiple promises made to a customer at, or near, the same time need to be bundled into one or more performance obligations in accordance with Step 2 of the model (see 5 below) solely by including the promises in separate contracts.

4.3.1 Portfolio approach practical expedient

Under Section 23, the five-step model is applied to individual contracts with customers, unless the contract combination requirements discussed in 4.3 above are met. However, there might be situations in which it could be more practical for an entity to group contracts for revenue recognition purposes, rather than attempt to account for each contract separately. Specifically, Section 23 includes the following practical expedient: *[FRS 102.23.6]*

Extract from Section 23

23.6 This section specifies the accounting for an individual contract with a customer. An entity may apply this section to a portfolio of similar contracts (or performance obligations) if the entity reasonably expects that the result of doing so would not differ materially from the result of applying this section to the individual contracts (or performance obligations) within that portfolio.

In order to use the portfolio approach, an entity must reasonably expect that the accounting result will not be materially different from the result of applying Section 23 to the individual contracts. However, the Basis for Conclusions on IFRS 15 noted that the IASB did not intend for an entity to quantitatively evaluate every possible outcome when concluding that the portfolio approach is not materially different. Instead, they indicated that an entity would be able to take a reasonable approach to determine portfolios that are representative of its types of customers and that an entity needs to use judgement in selecting the size and composition of those portfolios. *[IFRS 15.BC69]*.

How we see it

Application of the portfolio approach will likely vary based on the facts and circumstances of each entity. An entity can choose to apply the portfolio approach to only certain aspects of the model (e.g., determining the transaction price in Step 3).

Frequently asked questions

Question 4-12: How would an entity assess collectability for a portfolio of contracts?

See response to Question 4-4 in 4.1.5.B above.

4.4 Contract modifications

Parties to an arrangement frequently agree to modify the scope or price (or both) of their contract. If that happens, an entity must determine whether the modification is accounted for as a new contract or as part of the existing contract. Generally, it is clear when a contract modification has taken place, but in some circumstances, that determination is more difficult. To assist entities when making this determination, Section 23 states the following: *[FRS 102.23.13, FRS 102.23.14]*

Extract from Section 23

23.13 A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. A contract modification either creates new enforceable rights and obligations, or changes such rights and obligations that already exist.

23.14 If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with the requirements for estimating variable consideration (see paragraphs 23.44 to 23.48).

The extract above illustrates that these requirements focus on rights and obligations and therefore apply more broadly than only to finalised modifications. That is, Section 23 indicates that an entity might have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both). Instead of focusing on the finalisation of a modification, Section 23 focuses on the enforceability of the changes to the rights and obligations in the contract. Once an entity determines the revised rights and obligations are enforceable, it accounts for the contract modification. Contract terminations (either partial or full) are also considered a form of contract modification under Section 23. Illustration 4-8 below, which is based on Example 9 in IFRS 15, is an example to illustrate the accounting for an unapproved modification: *[IFRS 15.IE Example 9, IFRS 15.IE42-IE43]*

Illustration 4-8: Unapproved change in scope and price

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including *force majeure*) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 23.13 to 23.16. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 23.16(b) by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation (see 4.4.2.B below). The entity considers the constraint on estimates of variable consideration in paragraph 23.46 when estimating the transaction price (see 6.2.3 below).

Once an entity has determined that a contract has been modified, the entity determines the appropriate accounting treatment for the modification. Certain modifications are treated as separate stand-alone contracts (discussed in 4.4.1 below), while others are combined with the original contract (discussed in 4.4.2 below) and accounted for in that manner. In addition, an entity accounts for some modifications on a prospective basis and others on a cumulative catch-up basis.

Section 23 includes the following requirements for determining the appropriate accounting treatment:
[FRS 102.23.15, FRS 102.23.16]

Extract from Section 23

23.15 An entity shall account for a contract modification as a separate contract if:

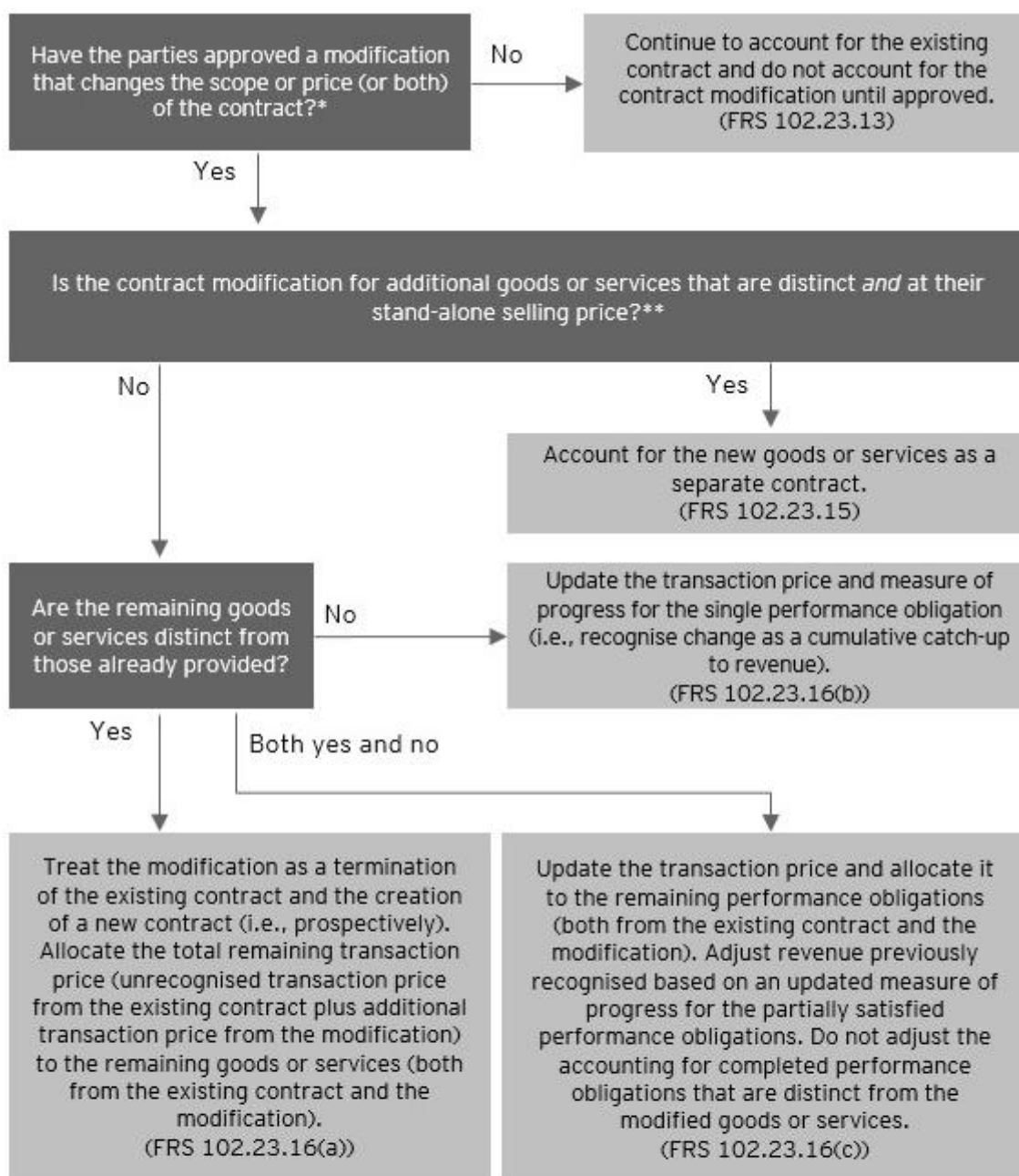
- (a) the modification increases the scope of the existing contract because of additional goods or services promised that are distinct from those in the existing contract; and
- (b) the modification increases the price of the existing contract by an amount of consideration that reflects the entity's stand-alone selling price of the additional goods or services and any appropriate adjustments to that price to reflect the circumstances of that contract.

23.16 If a contract modification is not accounted for as a separate contract, an entity shall account for the contract modification as follows:

- (a) If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, an entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract. The transaction price for the new contract is the sum of:
 - (i) the consideration included in the estimate of the transaction price for the existing contract that had not been recognised as revenue; and
 - (ii) the consideration promised as part of the contract modification.
- (b) If the remaining goods or services are not distinct from the goods or services transferred on or before the date of the contract modification, an entity shall account for the contract modification as if it had always been part of the existing contract. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, shall be recognised as an adjustment to revenue at the date of the contract modification (ie on a cumulative catch-up basis).
- (c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

The following flow chart illustrates these requirements:

Figure 4-1: Contract modifications



* A contract modification can be approved in writing, by oral agreement or implied by customary business practices. FRS 102.23.14 indicates that an entity may have to account for a contract modification prior to the parties reaching final agreement on changes in scope or pricing (or both), provided the rights and obligations that are created or changed by a modification are enforceable.

** In accordance with FRS 102.23.15, an entity may make appropriate adjustments to the stand-alone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract.

When determining how to account for a contract modification, an entity must consider whether any additional goods or services are distinct, giving consideration to whether those goods or services are distinct within the context of the modified contract (see 5.2.1 below for further discussion on evaluating whether goods or services are distinct). That is, although a contract modification might add a new good or service that would be distinct in a stand-alone transaction, that new good or service might not be distinct when considered in the context of the contract, as modified. For example, in a building renovation project, a customer might request a contract modification to add a new room. The construction firm might commonly sell the construction of an added room on a stand-alone basis, which would indicate that the service is

capable of being distinct. However, when that service is added to an existing contract and the entity has already determined that the entire project is a single performance obligation, the added goods or services would normally be combined with the existing bundle of goods or services.

In contrast to the construction example (for which the addition of otherwise distinct goods or services are combined with the existing single performance obligation and accounted for in that manner), a contract modification that adds distinct goods or services to a single performance obligation that comprise a series of distinct goods or services (see 5.2.2 below) is accounted for either as a separate contract or as the termination of the old contract and the creation of a new contract (i.e., prospectively).

In addition to determining whether any additional goods or services are distinct, an entity also needs to determine whether the additional goods or services are added at the stand-alone selling price that exists at the contract modification date. As stated in FRS 102.23.15, an entity might make appropriate adjustments to the stand-alone selling price to reflect the circumstances of the contract and still meet the criteria to account for the modification as a separate contract. See further discussion in 4.4.1 below.

Furthermore, as shown in Illustration 4-11 in 4.4.2.A below), a contract modification might include compensation to a customer for performance issues (e.g., poor service by the entity, defects present in transferred goods). An entity might need to account for the compensation to the customer as a change in the transaction price (see 7.4 below) separate from other modifications to the contract.

Frequently asked questions

Question 4-13: When would an entity evaluate a contract under the contract modification requirements?

An entity typically enters into a separate contract with a customer to provide additional goods or services. Hence, an entity would consider whether a new contract with an existing customer needs to be evaluated under the contract modification requirements.

A new contract with an existing customer needs to be evaluated under the contract modification requirements if the new contract results in a change in the scope or price of the original contract. FRS 102.23.13 states that “a contract modification either creates new enforceable rights and obligations, or changes such rights and obligations that already exist”. [FRS 102.23.13]. Therefore, an entity needs to evaluate whether a new contract with an existing customer represents a legally enforceable change in scope or price (or both) to an existing contract. A legally enforceable change in scope or price to an existing contract could also be accomplished by terminating the existing contract and entering into a new contract with the same customer. In those situations, entities also need to consider the contract modification requirements in Section 23.

In some cases, the determination of whether a new contract with an existing customer creates new or changes existing enforceable rights and obligations is straightforward because the new contract does not contemplate goods or services in the existing contract, including the pricing of those goods or services. Purchases of additional goods or services under a separate contract that do not modify the scope or price of an existing contract do not need to be evaluated under the contract modification requirements. Rather, they are accounted for as new (separate) contract.

How we see it

In other cases, the determination of whether a new contract is a modification of an existing contract requires judgement. In such circumstances, we believe an entity needs to consider the specific facts and circumstances surrounding the new contract in order to determine whether it represents a contract modification, which could include considering factors such as those included in the contract combination requirements discussed below.

The factors in the contract combination requirements (see 4.3 above) include:

- Whether the contracts were negotiated as a package with a single commercial objective (this might be the case in situations where the existing contract contemplates future modifications)
- Whether the amount of consideration to be paid in one contract depends on the price or performance of the other contract
- Whether the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation

If the pricing in the new contract is dependent on the original contract, or if the terms of the new contract are in some other way negotiated based on the original contract, it is likely that the new contract needs to be evaluated under the contract modification requirements.

Question 4-14: When an arrangement that has already been determined to meet the Section 23's contract criteria is modified, would an entity need to reassess whether that arrangement still meets the criteria to be considered a contract within the scope of the five-step model and/or the stand-alone selling prices of the underlying goods and services?

How we see it

Whether an entity needs to make these reassessments depends on the nature of the modification. For a contract modification that is accounted for by updating the transaction price and measure of progress for the single performance obligation in the modified contract (in accordance with paragraph 23.16 of FRS 102 - see 4.4.2.B below), an entity will need to apply judgement to determine whether to reassess the contract and determine whether it still meets the criteria to be considered a contract in the scope of the model. However, if a contract is modified, we believe that might indicate that "a significant change in facts and circumstances" has occurred (see 4.1 above) and that the entity must reassess the criteria in paragraph 23.7 for the modified contract.

Any reassessment is prospective in nature and would not change the conclusions associated with goods or services already transferred. That is, an entity would not reverse any receivables, revenue or contract assets already recognised under the contract because of the reassessment of the contract criteria in paragraph 23.7. However, due to the contract modification accounting, the entity might need to adjust contract assets or cumulative revenue recognised in the period of the contract modification, but it would not update the stand-alone selling prices of the goods and services underlying the existing, modified contract.

For a contract modification that is accounted for as a separate contract (in accordance with paragraph 23.15 - see 4.4.1 below), an entity needs to assess whether that separate contract meets the criteria to be considered a contract within the scope of the model in Section 23. If the separate contract meets the criteria to be considered a separate contract, the entity applies the requirements in Section 23 to account for the separate contract, including assessing the stand-alone selling price of the underlying goods and services as at the separate contract's inception date (i.e., the modification date). The accounting for the original contract would not be affected. That is, an entity would not need to reassess whether the original contract still meets the criteria to be considered a contract with the scope of the model in Section 23, and the stand-alone selling prices of the underlying goods and services in the original contract would also not be updated.

For a modification that is accounted for as a termination of the old contract and the creation of a new contract (in accordance with paragraph 23.16(a) - see 4.4.2.A below), an entity needs to assess whether the new contract meets the criteria to be considered a contract within the scope of the model. If the new contract meets the criteria to be considered a contract, the entity applies the requirements in Section 23 to account for the new contract, including assessing the stand-alone selling price of the remaining underlying goods and services as at the new contract's inception date (i.e., the modification date).

For a modification that is accounted for as a combination of a modification of the existing contract and the creation of a new contract (in accordance with paragraph 23.16(c) - see 4.4.2.C below), many of the considerations noted above are also relevant. Entities need to apply judgement to appropriately reassess the related contracts and stand-alone selling prices for these types of modifications.

For further discussion on updating stand-alone selling prices, see 7.1.3 below.

Question 4-15: How does an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

An entity might need to apply judgement to determine whether a change in the transaction price is the result of either:

- A contract modification (due to a change in the parties' enforceable rights and obligations after contract inception).
- Or
- New information obtained about variable consideration that existed (and was estimated) at contract inception.

While a contract modification might result in a change in the transaction price, not all changes in the transaction price are due to contract modifications. An entity needs to evaluate the facts and circumstances related to the change in the transaction price to assess whether it creates new, or changes existing, enforceable rights and obligations or is a change in the estimate of variable consideration. For example, a decision by both parties to reduce the amount of goods or services promised in the contract would generally represent a contract modification.

Conversely, a change in transaction price due to an update of the estimate of variable consideration does not create new or change existing enforceable rights and obligations. When a contract with a customer includes variable consideration (see 6.2 below), the entity is generally required to estimate, at contract inception and throughout the contract term, the amount of consideration to which it will be entitled in exchange for transferring promised goods or services.

Changes to the transaction price that are related to a change in estimates of variable consideration (because they result in the resolution of variability that existed at contract inception), are allocated to the performance obligations in the contract on the same basis as at contract inception (see 7.4 below). [FRS 102.23.76]. In contrast, changes in the transaction price that are related to a contract modification are accounted for in accordance with the contract modification requirements (as described above in paragraphs 13 to 23.16).

Question 4-16: How would an entity distinguish between a contract modification and a marketing offer when an entity provides customer incentives?

An entity might provide incentives to customers to encourage demand. Customer incentives might include free goods or services, options for additional goods and services at a discount (e.g., additional loyalty points, prospective coupons or discounts) or cash payments to customers. The accounting for these incentives will depend on the facts and circumstances of the offer. An offer to a current customer that creates new enforceable rights and obligations or changes the enforceable rights and obligations of the parties to an existing contract is accounted for as a contract modification. In some cases, an offer might not result in a contract modification and would be accounted for as a marketing offer (i.e., an expense).

How we see it

Entities need to carefully consider the terms and conditions of any customer incentive to determine whether the offer needs to be accounted for as a contract modification or a marketing offer, including consideration of the above circumstances.

In addition, as discussed in Question 4-13 above, we believe that the accounting principles for determining when contracts have to be combined under paragraph 23.12 of FRS 102 will be helpful when determining whether an offer of free goods or services to an existing customer is a contract modification.

An offer that is the result of negotiations with a specific customer or group of customers might indicate the addition of new enforceable rights and obligations to an existing contract or changes to existing enforceable rights and obligations. However, the following circumstances might indicate that the entity has made a marketing offer:

- The same offer is available to both existing customers and counterparties that do not meet the definition of a customer.
- The offer is available to a broad group of (or all) current customers and is not the result of negotiations with individual customers.
- The entity has the right to rescind the offer.

For any payments to customers, entities will need to consider the requirements for consideration paid or payable to a customer (see 6.7 below). Such payments would be accounted for as a reduction of the transaction price (and, therefore, revenue) unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

Question 4-17: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?

See response to Question 5-27 in 5.6 below.

Question 4-18: How do entities account for modifications and other changes to licences of intellectual property?

See response to Question 9-1 in 9.1.4 below.

4.4.1 Contract modification represents a separate contract

Certain contract modifications are treated as separate, new contracts. [FRS 102.23.15]. For these modifications, the accounting for the original contract is not affected by the modification and the revenue recognised to date on the original contract is not adjusted. Furthermore, any performance obligations remaining under the original contract continue to be accounted for under the original contract. The accounting for this type of modification reflects the fact that there is no economic difference between a separate contract for additional goods or services and a modified contract for those same items, provided the two criteria required for this type of modification are met.

The first criterion that must be met for a modification to be treated as a separate contract is that the additional promised goods or services in the modification must be distinct from the promised goods or services in the original contract. [FRS 102.23.15(a)]. This assessment is done in accordance with Section 23's general requirements for determining whether promised goods or services are distinct (see 5.2.1 below). Only modifications that add distinct goods or services to the arrangement can be treated as separate contracts. Arrangements that reduce the amount of promised goods or services or change the scope of the original promised goods or services cannot, by their very nature, be considered separate contracts. Instead, they are modifications of the original contract (see 4.4.2 below).

The second criterion is that the amount of consideration expected for the added promised goods or services must reflect the stand-alone selling prices of those promised goods or services at the contract modification date. However, when determining the stand-alone selling price, entities have some flexibility to adjust the stand-alone selling price, depending on the facts and circumstances. [FRS 102.23.15(b)]. For example, an entity might give an existing customer a discount on additional goods because the entity would not incur selling-related costs that it would typically incur for new customers. In this example, the entity might determine that the additional transaction consideration meets the criterion, even though the discounted price is less than the stand-alone selling price of that good or service for a new customer. In another example, an entity might conclude that, with the additional purchases, the customer qualifies for a volume-based discount (see Questions 5-23 and 5-24 in 5.6 below on volume discounts).

The following Illustration shows considerations for determining whether the amount of consideration expected for the additional goods and services reflects the stand-alone selling price:

Illustration 4-9: Determining whether the amount of consideration reflects the stand-alone selling price of additional goods or services

Entity E agrees to construct a manufacturing facility on a customer's land for £10 million. During construction, the customer determines that a separate storage facility is needed at the location. The parties agree to modify the contract to include the construction of the storage facility, which is to be completed within three months of completing the manufacturing facility, for a total price of £11 million (i.e., when the contract is modified, an additional £1 million is added to the consideration Entity E will receive). Assume that Entity E determines that the construction of the separate storage facility is distinct (i.e., a performance obligation) and that it transfers control of each facility over time. Entity E must determine whether the £1 million represents the stand-alone selling price of the separate storage facility.

Scenario A

Entity E determines that £1.1 million is the stand-alone selling price at the contract modification date for the construction of a similar facility. However, much of the equipment and labour force necessary to complete construction of the storage facility is already onsite and available for use by Entity E. Thus, Entity E concludes that the additional £1 million reflects the stand-alone selling price at contract modification, adjusted for the circumstances of the contract.

Scenario B

Entity E determines that £1.5 million is the stand-alone selling price at the contract modification date for the construction of a similar facility. While Entity E can attribute some of the discount to its ability to use equipment and labour that are already onsite, the price reduction was primarily driven by other factors (e.g., a desire to maintain the customer relationship). Therefore, the additional £1 million does not reflect the stand-alone selling price at contract modification.

In situations with highly variable pricing, determining whether the additional consideration in a modified contract reflects the stand-alone selling price for the additional goods or services might not be straightforward. Entities need to apply judgement when making this assessment. Evaluating whether the price in the modified contract is within a range of prices for which the goods or services are typically sold to similar customers might be an acceptable approach.

Illustration 4-10 below, which is based on Case A within Example 9 in IFRS 15, illustrates a contract modification that represents a separate contract: *[IFRS 15.IE Example 5 Case A, IFRS 15.IE19-IE21]*

Illustration 4-10: Modification of a contract for goods - Additional products for a price that reflects the stand-alone selling price

An entity promises to sell 120 products to a customer for £12,000 (£100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

When the contract is modified, the price of the contract modification for the additional 30 products is an additional £2,850 or £95 per product. The pricing for the additional products reflects the stand-alone selling price of the products at the time of the contract modification (see 7.1 below) and the additional products are distinct (in accordance with FRS 102.23.21 - see 5.2.1 below) from the original products.

In accordance with paragraph 23.15, the contract modification for the additional 30 products is, in effect, a new and separate contract for future products that does not affect the accounting for the existing contract. The entity recognises revenue of £100 per product for the 120 products in the original contract and £95 per product for the 30 products in the new contract.

4.4.2 Contract modification is not a separate contract

If one or both of the criteria discussed in 4.4.1 above are not met (i.e., distinct goods or services are not added or the distinct goods or services are not priced at their stand-alone selling price), the contract modifications are accounted for as changes to the original contract and not as separate contracts. This includes contract modifications that modify or remove previously agreed-upon goods or services or reduce the price of the contract. An entity accounts for the effects of these modifications differently, depending on which of the three scenarios described in FRS 102.23.16 (see the extract in 4.4 above), and discussed in 4.4.2.A-4.4.2.C below, most closely aligns with the facts and circumstances of the modification.

[FRS 102.23.16].

4.4.2.A Modification is a termination of the existing contract and the creation of a new contract

If the remaining goods or services after the contract modification are distinct from the goods or services transferred on, or before, the contract modification (but the distinct goods or services added in the modification were not added at their stand-alone selling prices at the date of the contract modification), the entity accounts for the modification as if it were a termination of the old contract and the creation of a new contract. *[FRS 102.23.16(a)].*

For these modifications, the revenue recognised to date on the original contract (i.e., the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining portion of the original contract and the modification are accounted for, together, on a prospective basis by allocating the remaining consideration (i.e., the unrecognised transaction price from the existing contract plus the additional transaction price from the modification) to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified as a series, see 5.2.2 below), including those added in the modification. *[FRS 102.23.16(a)].*

When a contract where the performance obligation is a series of distinct goods or services is modified, the goods or services provided after the contract modification are distinct from those provided before the contract modification. An entity might consider Example 7 in IFRS 15 which illustrates the accounting for a contract modification of a services contract that is determined to be a series of distinct goods or services (see 5.2.2 below) and meets the criteria in paragraph 23.16(a) to be accounted for as a termination of the existing contract and the creation of a new contract. As the performance obligation is a series, the services provided after the contract modification are distinct from those provided before the contract modification. *[IFRS 15.IE Example 7, IFRS 15.IE33-IE36].*

Illustration 4-11 below, which is based on Case B within Example 9 in IFRS 15, also illustrates a modification that is treated as a termination of an existing contract and the creation of a new contract:

[IFRS 15 IE Example 5 Case B, IFRS 15.IE19, IFRS 15.IE22-IE24]

Illustration 4-11: Modification of a contract for goods - Additional products for a price that does not reflect the stand-alone selling price

An entity promises to sell 120 products to a customer for £12,000 (£100 per product). The products are transferred to the customer over a six-month period. The entity transfers control of each product at a point in time. After the entity has transferred control of 60 products to the customer, the contract is modified to require the delivery of an additional 30 products (a total of 150 identical products) to the customer. The additional 30 products were not included in the initial contract.

During the process of negotiating the purchase of an additional 30 products, the parties initially agree on a price of £80 per product. However, the customer discovers that the initial 60 products transferred to the customer contained minor defects that were unique to those delivered products. The entity promises a partial credit of £15 per product to compensate the customer for the poor quality of those products. The entity and the customer agree to incorporate the credit of £900 (£15 credit × 60 products) into the price that the entity charges for the additional 30 products. Consequently, the contract modification specifies that the price of the additional 30 products is £1,500 or £50 per product. That price comprises the agreed-upon price for the additional 30 products of £2,400, or £80 per product, less the credit of £900.

At the time of modification, the entity recognises the £900 as a reduction of the transaction price and, therefore, as a reduction of revenue for the initial 60 products transferred. In accounting for the sale of the additional 30 products, the entity determines that the negotiated price of £80 per product does not reflect the stand-alone selling price of the additional products (see 7.1 below). Consequently, the contract modification does not meet the conditions in FRS 102.23.15 to be accounted for as a separate contract (see 4.4.1 above). Because the remaining products to be delivered are distinct from those already transferred, the entity applies the requirements in FRS 102.23.16(a) and accounts for the modification as a termination of the original contract and the creation of a new contract.

Consequently, the amount recognised as revenue for each of the remaining products is a blended price of £93.33 $\{[(£100 \times 60 \text{ products not yet transferred under the original contract}) + (£80 \times 30 \text{ products to be transferred under the contract modification})] \div 90 \text{ remaining products}\}$.

In Illustration 4-11 above, the entity attributed a portion of the discount provided on the additional products to the previously delivered products because they contained defects. This is because the compensation provided to the customer for the previously delivered products is a discount on those products, which results in variable consideration (i.e., a price concession) for them. The new discount on the previously delivered products was recognised as a reduction of the transaction price (and, therefore, revenue) on the date of the modification. Changes in the transaction price after contract inception are accounted for in accordance with paragraphs 23.76-23.77 (see 7.4 below).

In similar situations, it might not be clear from the change in the contract terms whether an entity has offered a price concession on previously transferred goods or services to compensate the customer for performance issues related to those items (that would be accounted for as a reduction of the transaction price) or has offered a discount on future goods or services (that would be included in the accounting for the contract modification). An entity needs to apply judgement when performance issues exist for previously transferred goods or services to determine whether to account for any compensation to the customer as a change in the transaction price for those previously transferred goods or services.

4.4.2.B Modification is part of the existing contract

The remaining goods or services to be provided after the contract modification might not be distinct from those goods or services already provided and, therefore, form part of a single performance obligation that is partially satisfied at the date of modification. [FRS 102.23.16(b)].

If this is the case, the entity accounts for the contract modification as if it were part of the original contract. This would be the case regardless of whether the additional goods or services were added at their stand-alone selling prices at the contract modification date. The entity adjusts revenue previously recognised (either up or down) to reflect the effect that the contract modification has on the transaction price and update the measure of progress (i.e., the revenue adjustment is made on a cumulative catch-up basis). [FRS 102.23.16(b)]. This scenario is illustrated below, which is based on Example 8 in IFRS 15:

[IFRS 15.IE Example 8, IFRS 15.IE37-IE41]

Illustration 4-12: Modification resulting in a cumulative catch-up adjustment to revenue

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of £1 million and a bonus of £200,000 if the building is completed within 24 months (a variable consideration - see 6.2 below). The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with FRS 102.23.81(b) because the customer controls the building during construction (see 8.1.2 below).

At the inception of the contract, the entity expects the following:

	£
Transaction price	1,000,000
Expected costs	<u>700,000</u>
Expected profit (30%)	<u>300,000</u>

At contract inception, the entity excludes the £200,000 bonus from the transaction price because it cannot conclude that it is highly probable that the entity will be entitled to cumulative amount of revenue recognised in the future in accordance with FRS 102.23.46 (see 6.2.3 below). Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress towards complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60% of its performance obligation on the basis of costs incurred to date (£420,000) relative to total expected costs (£700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraph 23.46 (see 6.2.3 below). Consequently, the cumulative revenue and costs recognised for the first year are as follows:

	£
Revenue	600,000
Costs	<u>420,000</u>
Gross profit	<u>180,000</u>

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by £150,000 and £120,000, respectively. Total potential consideration after the modification is £1,350,000 (£1,150,000 fixed consideration + £200,000 completion bonus). In addition, the allowable time for achieving the £200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is highly probable that including the bonus in the transaction price will not result in a reversal in the amount of cumulative revenue recognised and therefore, it is highly probable that the entity will be entitled to cumulative amount of revenue recognised in the future in accordance with paragraph 23.46 (see 6.2.3 below) and so, the entity includes the £200,000 in the transaction price. In assessing the contract modification, the entity evaluates FRS 102.23.16(b) and concludes (on the basis of the factors in paragraph 23.24 - see 5.2.1.B below) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation. Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 23.16(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2% of its performance obligation (£420,000 actual costs incurred ÷ £820,000 total expected costs). The entity recognises additional revenue of CU91,200 [(51.2% complete × £1,350,000 modified transaction price) - £600,000 revenue recognised to date] at the date of the modification as a cumulative catch-up adjustment.

4.4.2.C Modification is part of the existing contract and the creation of a new contract

A change in a contract might also be treated as a combination of the two: a modification of the existing contract and the creation of a new contract. This would be the case when some, but not all, of the goods or services added in the modification are distinct from those already provided as at the date of the modification. In this case, an entity would not adjust the accounting treatment for completed performance obligations that are distinct from the modified goods or services. However, the entity would adjust revenue

previously recognised (either up or down) to reflect the effect of the contract modification on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and would update the measure of progress. [FRS 102.23.16(c)].

Frequently asked questions

Question 4-19: How would an entity account for a partial termination of a contract (e.g., a change in the contract term from three years to two years prior to the beginning of year two)?

See response to Question 4-9 in 4.2 above.

Question 4-20: How would an entity account for a contract modification that decreases the scope of a contract?

A modification that decreases the scope of a contract is not accounted for as a separate contract because it does not result in the addition of distinct goods or services (see 4.4.2 above). The accounting will depend on whether the remaining goods and services to be provided after the contract modification are distinct from the goods and services already provided. If the remaining goods and services are distinct (including goods or services that are part of a single performance obligation that is a series of distinct goods or services), the contract modification is accounted for as a termination of the old contract and the creation of a new contract (i.e., prospectively). If the remaining goods and services are not distinct, the contract modification is accounted for as if it were part of the original contract (i.e., cumulative catch-up). See Question 4-9 in 4.2 above regarding a partial termination of a contract.

How we see it

To modify a contract, a customer might agree to pay a fee to terminate, or decrease the scope of, some of the rights and obligations included in the original contract (e.g., a termination fee, one-time payment, lump-sum payment). We believe that such a fee is additional consideration that needs to be included in the modified transaction price and allocated to the remaining goods and services to be provided to the customer.

Consider the following Illustration:

Illustration 4-13: Contract modification that decreases the scope of the promised goods or services in a contract

Entity X enters into a non-cancellable contract with a customer to provide information technology (IT) outsourcing services continuously for a three-year period. Entity X determines that the arrangement contains a single performance obligation comprising a series of distinct services that is transferred to the customer over time. Entity X bills the customer a fixed price of £500 per month (i.e., the total consideration is £500 x 36 months = £18,000).

At the end of the second year, Entity X and the customer modify the contract to remove certain discrete services from the overall outsourcing service. As part of the modification, the customer agrees to pay a contract modification fee of £500 and reduce the monthly payments to £400 per month.

The services provided after the contract modification are distinct from those provided before the contract modification. This is because the performance obligation is a series of distinct services. Accordingly, Entity X applies the requirements in paragraph 23.16(a) and accounts for the modification prospectively (see 4.4.2.B above). The remaining consideration of £5,300 (£400 x 12 months = £4,800 for the services to be provided in the third year, plus the £500 payment upon modification) is recognised over the remaining contract period of one year. That is, Entity X recognises the £500 contract modification fee over the remaining performance period.

Question 4-21: How would an entity account for a 'blend-and-extend' contract modification?

A 'blend-and-extend' contract modification typically is one in which an entity, in exchange for a customer extending the term of the contract (and, therefore, purchasing additional units of a good or service), agrees to decrease the price per unit for all units to be provided (i.e., the new units, as well as the remaining units on the existing contract), resulting in a new blended price per unit. These types of contracts often occur in the power and utilities industry when market prices for the good or service decline after contract inception.

These arrangements are subject to the contract modification requirements in Section 23. Since these arrangements typically include the addition of distinct goods or services, the next step is for entities to evaluate whether the additional distinct goods or services are added at their stand-alone selling price in order to determine the accounting for the contract modification (i.e., as a separate contract or as a termination of the existing contract and the creation of a new contract).

When making this evaluation, a question that could arise is whether an entity needs to compare the blended contractual cash selling price or the overall contract price increase to the stand-alone selling price of the additional promised goods or services.

How we see it

We believe that entities need to establish an approach based on the facts and circumstances of their modifications and apply that approach consistently to similar fact patterns.

Consider the following Illustration:

Illustration 4-14: Blend-and-extend contract modification

Entity N enters into a four-year non-cancellable contract with Customer A to provide 100,000 widgets per year at a fixed price of £10 per widget. Each widget is a distinct good transferred at a point in time.

At the end of the second year, Entity N and Customer A modify the contract to extend the term of the contract by another two years (i.e., Entity N will continue to provide 100,000 widgets in years 5 and 6). The stand-alone selling price of the widget has declined and is now £8 per widget. As part of the modification, Entity N agrees to reduce the price to a blended rate of £9 per widget (based on £10 in years 3 and 4 and £8 in years 5 and 6) in exchange for Customer A extending the contract term.

Entity N determines that each widget provided after the modification date is distinct from the widgets provided before the modification date.

Approach A - Compare the overall contract price increase to the stand-alone selling price of the additional promised goods or services

Since the price of the contract increases by an amount of consideration that reflects the stand-alone selling prices of the additional widgets (i.e., £8 per widget in years 5 and 6), Entity N determines that the contract modification is accounted for as a separate contract in accordance with paragraph 23.15. Entity N will continue to recognise revenue of £10 per widget for the remaining period in the initial contract (i.e., years 3 and 4) and recognise revenue of £8 per widget in years 5 and 6.

Approach B - Compare the blended contractual cash selling price to the stand-alone selling price of the additional promised goods or services

Since the blended price of £9 per widget does not reflect the stand-alone selling price of widgets at the modification date (i.e., £8 per widget), Entity N applies the requirements in FRS 102.23.16(a) and accounts for the modification as if it were a termination of the original contract and the creation of a new contract (see 4.4.2.A above). Total consideration of £3,600,000 ($100,000 \times £10 \times 2 \text{ years} = £2,000,000$ for the widgets to be provided the years 3 and 4, plus $£1,600,000$ ($100,000 \times £8 \times 2 \text{ years}$) for the widgets to be provided in years 5 and 6) is allocated to each of the remaining widgets to be provided (400,000 widgets). Entity N will recognise revenue for each widget at a blended rate of £9 per widget ($£3,600,000 \div 400,000$ widgets).

The accounting will be different in contract modifications where an entity determines that the remaining goods or services to be provided after the modification date are not distinct from those goods or services provided before the modification date.

There is no presumption that such contract modifications contain effects of time value of money that needs to be recognised. That is, the mere act of blending the rate in connection with a contract extension in which the customer pays more cash consideration for the same amount of goods or services at the beginning of the contract than the end of the contract does not automatically create a financing transaction. However, each contract's facts and circumstances would need to be evaluated to determine whether a financing transaction exists (see 6.5 below for further discussion on time value of money).

Question 4-22: How would an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract?

See response to Question 11-5 in 11.1.5 below.

4.5 Arrangements that do not meet the definition of a contract under Section 23

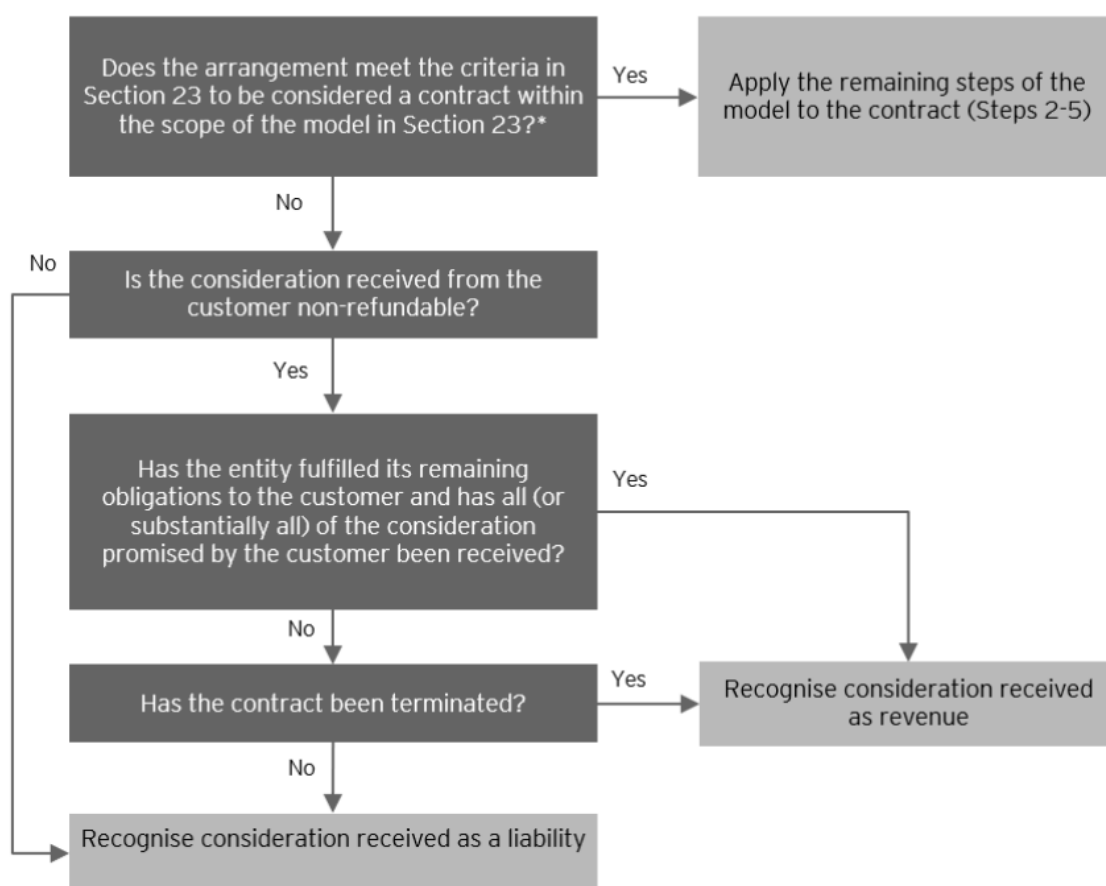
If an arrangement does not meet the criteria to be considered a contract under Section 23, it must be accounted for as follows: [FRS 102.23.9, FRS 102.23.10]

Extract from Section 23

- 23.9** If a contract with a customer does not meet the criteria in paragraph 23.7, an entity shall continue to reassess the contract until the criteria are met. The entity shall recognise any consideration received from the customer as a liability until those criteria are met or until one of the events in paragraph 23.10 occurs.
- 23.10** When a contract with a customer does not meet the criteria in paragraph 23.7, an entity shall recognise any consideration received from the customer as revenue when either:
- (a) the entity has no remaining obligations to transfer goods or services to the customer and all, or substantially all, of the consideration promised by the customer has been received and is non-refundable; or
 - (b) the contract is terminated and the consideration received is non-refundable.

The following flow chart illustrates this requirement:

Figure 4-2: Arrangements that do not meet the definition of a contract under Section 23



* Entities need to continue to assess the criteria in FRS 102.23.7 throughout the term of the arrangement to determine whether they are subsequently met.

If a contract does not initially meet the criteria in paragraph 23.7 (as discussed in 4.1 above), an entity continues to assess the criteria throughout the term of the arrangement to determine whether they are subsequently met. Once the criteria are met, the model in Section 23 applies, rather than the requirements discussed below. [FRS 102.23.9]. If an entity determines that the criteria in paragraph 23.7 are subsequently met, revenue is recognised on a cumulative catch-up basis as at the date when a contract exists within the scope of the model (i.e., at the 'contract establishment date', reflecting the performance obligations that are partially, or fully, satisfied at that date). This accounting is consistent with the discussion in Question 8-20 in 8.1.4.E below.

If an arrangement does not meet the criteria in paragraph 23.7 (and until the criteria are met), an entity only recognises non-refundable consideration received as revenue when one of the events outlined above has occurred (i.e., full performance and all (or substantially all) consideration received or the contract has been terminated) or the arrangement subsequently meets the criteria in paragraph 23.7.

Until one of these events happens, any consideration received from the customer is initially accounted for as a liability (not revenue) and the liability is measured at the amount of consideration received from the customer.

Frequently asked questions

Question 4-23: When is a contract considered terminated for purposes of applying FRS 102.23.10(b)?

Determining whether a contract is terminated might require significant judgement.

In the Basis for Conclusions on IFRS 15, "the IASB noted that contracts often specify that an entity has the right to terminate the contract in the event of non-payment by the customer and that this would not generally affect the entity's rights to recover any amounts owed by the customer. The IASB also noted that an entity's decision to stop pursuing collection would not typically affect the entity's rights and the customer's obligations under the contract with respect to the consideration owed by the customer. On this basis, ... the existing requirements in IFRS 15 are sufficient for an entity to conclude ... that a contract is terminated when it stops providing goods or services to the customer." [IFRS 15.BC46H].

5 Step 2 – Identify the performance obligations in the contract

To apply Section 23, an entity is required to identify the promised goods or services within the contract and determine which of those goods or services are separate performance obligations. Because Section 23 requires entities to allocate the transaction price to performance obligations, identifying the correct unit of account is fundamental to recognising revenue on a basis that faithfully depicts the entity's performance in transferring the promised goods or services to the customer.

Section 23 provides the following requirements with respect to identifying the performance obligations in a contract: [FRS 102.23.17, FRS 102.23.18]

Extract from Section 23

- 23.17** At contract inception, an entity shall assess the goods and services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:
- (a) a distinct good or service (or a distinct bundle of goods or services); or
 - (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
- 23.18** A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:
- (a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 23.81 to be a performance obligation satisfied over time; and
 - (b) in accordance with paragraphs 23.98 to 23.104, the same method would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

5.1 Identifying the promised goods or services in the contract

As a first step in identifying the performance obligation(s) in the contract, Section 23 requires an entity to identify, at contract inception, the promised goods or services in the contract. Section 23 provides guidance on the types of items that could be goods or services promised in the contract, as follows: [FRS 102.23.19, FRS 102.23.20]

Extract from Section 23

- 23.19** A contract with a customer generally explicitly states the goods or services that an entity promises to transfer. However, promises may be implied by an entity's customary business practices, published policies or specific statements if these create a valid expectation of the customer that the entity will transfer a good or service to the customer.
- 23.20** Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to the customer. For example, set-up activities and administrative tasks which do not transfer a good or service to the customer would be disregarded for the purposes of identifying performance obligations in a contract.

In order for an entity to identify the promised goods or services in a contract, Section 23 indicates that an entity considers whether there is a valid expectation on the part of the customer that the entity will provide a good or service. [FRS 102.23.19]. If the customer has a valid expectation that it will receive certain goods or services, it is likely that the customer would view those promises as part of the negotiated exchange. This expectation is most commonly created from an entity's explicit promise in a contract to transfer a good(s) or service(s) to the customer.

However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices or standard industry norms (i.e., outside of the written contract). As discussed in 4 above, while the contract must be legally enforceable to be within the scope of the revenue model, not all of the promises (explicit or implicit) have to be legally enforceable to be considered when determining the entity's performance obligations. That is, a performance obligation can be based on a customer's valid expectations (e.g., due to the entity's business practice of providing an additional good or service that is not specified in the contract).

Promised goods or services might include items such as 'free' handsets provided by telecommunication entities, 'free' maintenance provided by automotive manufacturers and customer loyalty points awarded by supermarkets, airlines and hotels. Some might suggest that these types of promised goods or services would be excluded from the scope and accounted for as marketing expenses or incidental obligations, even though the promises would meet the definition of a performance obligation. However, while an entity might not consider those goods or services to be the 'main' items that the customer contracts to receive, they are goods or services for which the customer pays and to which the entity allocates consideration for the purpose of recognising revenue.

Section 23 states that promised goods or services do *not* include activities that an entity must undertake to fulfil a contract unless those activities transfer control of a good or service to a customer. [FRS 102.23.20]. For example, internal administrative activities that an entity must perform to satisfy its obligation to deliver the promised goods or services, but do not transfer control of a good or service to a customer, would not be promised goods or services.

How we see it

An entity might have to apply judgement when determining whether an activity it will perform is a promised good or service that will be transferred to a customer. The following questions could be relevant for an entity to consider when making this judgement:

- Is the activity identified as a good or service to be provided in the contractual arrangement with the customer? Activities that are not specifically identified could relate to an internal process of the entity, but they could also relate to implicit promises to the customer.
- Does the activity relate to the entity establishing processes and procedures or training its employees, so that it can render the contracted goods or services to the customer (e.g., set-up activities)?
- Is the activity administrative in nature (e.g., tasks performed to determine whether to accept or reject a customer, establishing the customer's account, invoicing the customer)?
- Is the customer aware of when the activity will be performed?

The FRC's FRS 102 Factsheet 10 *Revenue from Contracts with Customers*¹²³ notes that there are no restrictions on the goods or services that an entity might promise in a contract with customer. It also set out the following examples of goods or services that an entity might promise (the list is not exhaustive):

- (a) Sale of goods produced by an entity (for example, inventory of a manufacturer)
 - (b) Resale of goods purchased by an entity (for example, merchandise of a retailer)
 - (c) Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal)
 - (d) Performing a contractually agreed-upon task (or tasks) for a customer
 - (e) Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
 - (f) Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party)
 - (g) Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
 - (h) Constructing, manufacturing or developing an asset on behalf of a customer
 - (i) Granting licences
- And
- (j) Granting options to purchase additional goods or services (when those options provide a customer with a material right)

¹²³ [FRS 102 Factsheet 10 Revenue from Contracts with Customers](#), FRC, issued on 27 November 2024, Section 2 The five-step revenue recognition model, Step 2 - Identify the contract(s) with a customer, page 8.

Item (e) in the above list describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to use it. That is, a stand-ready obligation is the promise that the customer has access to a good or service, rather than a promise to transfer the underlying good or service itself. Stand-ready obligations are common in the software industry (e.g., unspecified updates to software on a when-and-if-available basis) and might be present in other industries. See Questions 5-2 and 5-3 below for further discussion on stand-ready obligations.

Item (g) notes that a promise to a customer might include granting rights to goods or services to be provided in the future that the customer can resell or provide to its own customers. Such a right might represent promises to the customer if it existed at the time that the parties agreed to the contract. Accordingly, a performance obligation might exist for a promise to provide a good or service in the future (e.g., when an entity makes a promise to provide goods or services to its customer's customer). These types of promises exist in distribution networks in various industries and are common in the automotive industry.

After identifying the promised goods or services in the contract, an entity then determines which of these promised goods or services (or bundle of goods or services) represent separate performance obligations. The following flowchart illustrates the guidance an entity uses to assess whether the activities it will perform are promised goods or services and whether they are accounted for as performance obligations under Step 2 of the five-step model in Section 23:

Figure 5-1: Identifying the performance obligation(s) in the contract

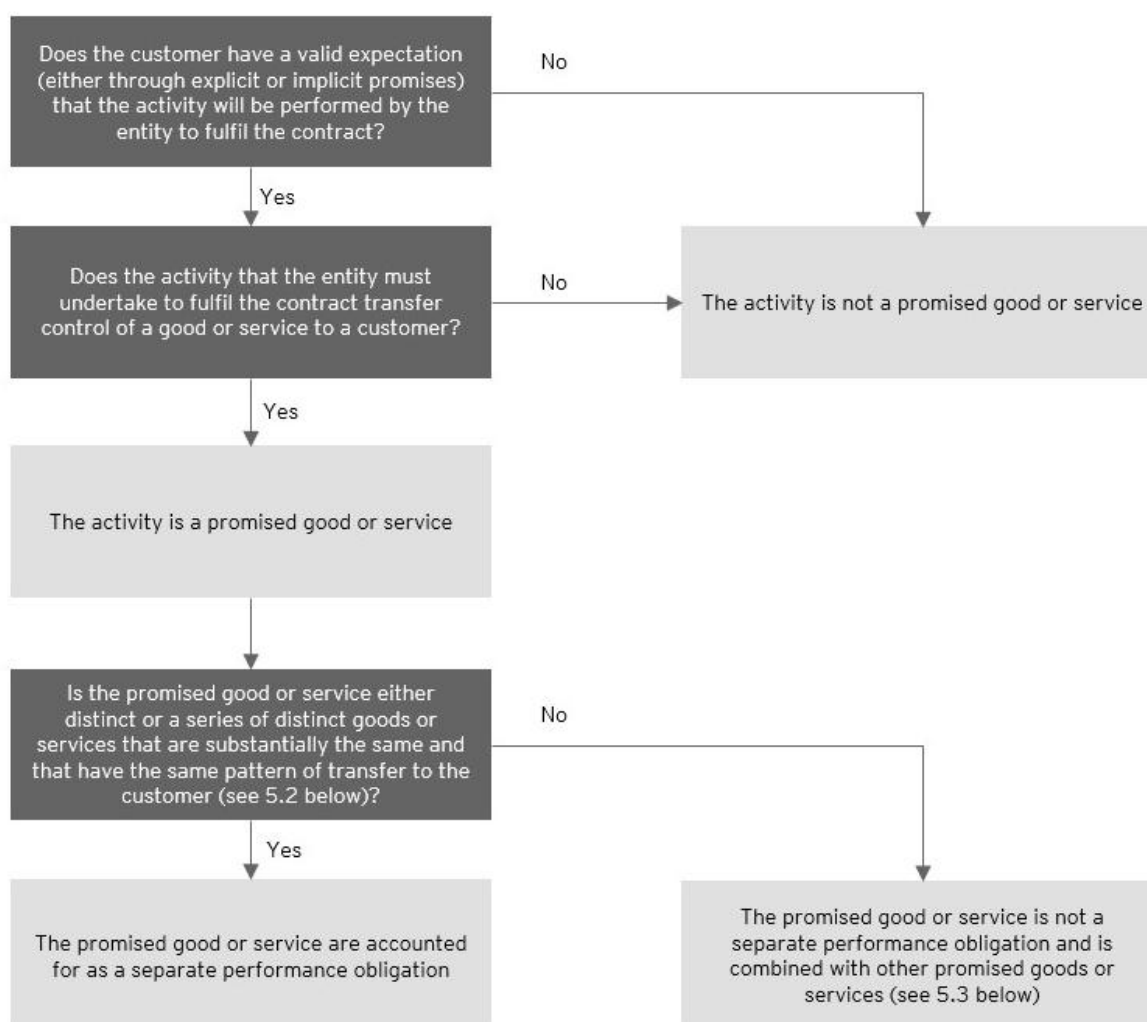


Illustration 5-1 below is based on Illustrative Example 12 in IFRS 15 which shows how an entity would identify the promised goods or services in a contract (including both explicit and implicit promises). The example also evaluates whether the identified promises are performance obligations, which is further discussed in 5.2 below. [IFRS 15.IE Example 12, IFRS 15.IE59-IE65A]. The IFRS IC also discussed the assessment of whether there is an implicit promise in a contract as part of a principal versus agent assessment during its April 2022 meeting. See Illustration 5-18 in 5.4.2 below for further details.

Illustration 5-1: Explicit and implicit promises in a contract

An entity, a manufacturer, sells a product to a distributor (i.e., its customer) who will then resell it to an end customer.

Scenario A - Explicit promise of service

In the contract with the distributor, the entity promises to provide maintenance services for no additional consideration (i.e., 'free') to any party (i.e., the end customer) that purchases the product from the distributor. The entity outsources the performance of the maintenance services to the distributor and pays the distributor an agreed-upon amount for providing those services on the entity's behalf. If the end customer does not use the maintenance services, the entity is not obliged to pay the distributor.

The contract with the customer includes two promised goods or services - (a) the product and (b) the maintenance services. The promise of maintenance services is a promise to transfer goods or services in the future and is part of the negotiated exchange between the entity and the distributor. The entity assesses whether each good or service is distinct in accordance with paragraph 23.21. The entity determines that both the product and the maintenance services meet the criterion in paragraph 23.21(a). The entity regularly sells the product on a stand-alone basis, which indicates that the customer can benefit from the product on its own. The customer can benefit from the maintenance services together with a resource the customer already has obtained from the entity (i.e., the product).

The entity further determines that its promises to transfer the product and to provide the maintenance services are separately identifiable (in accordance with paragraph 23.21(b)) on the basis of the principle and the factors in paragraph 23.24. The product and the maintenance services are not inputs to a combined item in the contract. The entity is not providing a significant integration service because the presence of the product and the services together in this contract do not result in any additional or combined functionality. In addition, neither the product nor the services modify or customise the other. Lastly, the product and the maintenance services are not highly interdependent or highly interrelated because the entity would be able to fulfil each of the promises in the contract independently of its efforts to fulfil the other (i.e., the entity would be able to transfer the product even if the customer declined maintenance services and would be able to provide maintenance services in relation to products sold previously through other distributors). The entity also observes, in applying the principle in paragraph 23.24, that the entity's promise to provide maintenance is not necessary for the product to continue to provide significant benefit to the customer. Consequently, the entity allocates a portion of the transaction price to each of the two performance obligations (i.e., the product and the maintenance services) in the contract.

Scenario B-Implicit promise of service

The entity has historically provided maintenance services for no additional consideration (i.e., 'free') to end customers that purchase the entity's product from the distributor. The entity does not explicitly promise maintenance services during negotiations with the distributor and the final contract between the entity and the distributor does not specify terms or conditions for those services.

However, on the basis of its customary business practice, the entity determines at contract inception that it has made an implicit promise to provide maintenance services as part of the negotiated exchange with the distributor. That is, the entity's past practices of providing these services create valid expectations of the entity's customers (i.e., the distributor and end customers) in accordance with paragraph 23.19. Consequently, the entity assesses whether the promise of maintenance services is a performance obligation. For the same reasons as in Scenario A, the entity determines that the product and maintenance services are separate performance obligations.

Scenario C-Services are not a promised service

In the contract with the distributor, the entity does not promise to provide any maintenance services. In addition, the entity typically does not provide maintenance services and, therefore, the entity's customary business practices, published policies and specific statements at the time of entering into the contract have not created an implicit promise to provide goods or services to its customers. The entity transfers control of the product to the distributor and, therefore, the contract is completed. However, before the sale to the end customer, the entity makes an offer to provide maintenance services to any party that purchases the product from the distributor for no additional promised consideration.

The promise of maintenance is not included in the contract between the entity and the distributor at contract inception. That is, in accordance with paragraph 23.19, the entity does not explicitly or implicitly promise to provide maintenance services to the distributor or the end customers. Consequently, the entity does not identify the promise to provide maintenance services as a performance obligation. Instead, the obligation to provide maintenance services is accounted for in accordance with Section 21 *Provisions and Contingencies*.

Although the maintenance services are not a promised service in the current contract, in future contracts with customers the entity would assess whether it has created a business practice resulting in an implied promise to provide maintenance services.

Frequently asked questions

Question 5-1: How would an entity assess whether pre-production activities are a promised good or service?¹²⁴

Manufacturing and production entities in various industries might perform activities and incur costs before they produce goods. Some arrangements (including long-term supply arrangements) require an entity to incur upfront costs, such as non-recurring engineering and design costs or costs related to set-up activities, to create new technology or adapt existing technology to the needs of the customer.

These pre-production activities are often a prerequisite to delivering any units under a production contract. For example, a manufacturer might incur costs to perform certain services related to the design and development of products it will sell under long-term supply arrangements. It might also incur costs to design and develop moulds, dies and other tools that will be used to produce those products. A contract might require the customer to reimburse the manufacturer for these costs. Alternatively, reimbursement might be implicitly guaranteed as part of the price of the product or by other means.

The determination of whether pre-production activities are a promised good or service or fulfilment activities generally requires judgement and consideration of the facts and circumstances. When assessing whether pre-production activities are promises in a contract with a customer (and potentially performance obligations under Section 23), entities need to determine whether the activities transfer a good or service to a customer. If an entity determines that these activities are promised goods or services, it applies the requirements in Section 23) to those goods or services. Also see Questions 10-14 and 10-15 in 10.3.2 below for a discussion of how an entity accounts for costs related to pre-production activities and pre-contract or set-up activities, respectively.

If an entity is having difficulty determining whether a pre-production activity is a promised good or service in a contract, the entity generally needs to consider whether control of that good or service transfers to the customer. For example, if an entity is performing engineering and development services as part of developing a new product for a customer and the customer will own the resulting intellectual property (e.g., patents), it is likely that the entity would conclude that it is transferring control of the intellectual property and that the engineering and development activities are a promised good or service in the contract.

Assessing whether control transfers in such arrangements might be challenging. In some arrangements, legal title of the good or service created from the pre-production activity is transferred to the customer. However, an entity generally has to consider all indicators of control transfer under Section 23 and that the transfer of legal title is not a presumptive indicator.

When an entity is determining whether control transfers to a customer in such arrangements, one of the three over time revenue recognition criteria could be applicable to pre-production activities. That criterion is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. [FRS 102.23.81(a)]. As further discussed in 8.1.1 below, paragraph 23.81(a)) notes that if an entity cannot readily identify whether this criterion is met, it considers whether another entity would need to re-perform the work the entity had completed to date if that other entity were required to fulfil the remaining performance obligation. [FRS 102.23.81(a)].

For example, assume an entity is performing engineering and development as part of developing a new product for a customer. If the entity provided the customer with periodic progress reports in a level of detail that would not require the customer to contract with another entity to re-perform the work, or if the entity were required to provide the customer with the design information completed to date in the case of a termination, it is likely that the entity would conclude that control of that service transfers to the customer as the entity performs.

If a pre-production activity is determined to be a promised good or service, an entity allocates a portion of the transaction price to that good or service (as a single performance obligation or as part of a combined performance obligation that includes the pre-production activities along with other goods or services). If the pre-production activities are included in a performance obligation satisfied over time, they are considered when measuring progress toward satisfaction of that performance obligation (see 8.1.4 below).

¹²⁴ Based on TRG Agenda paper no. 46, *Pre-Production Activities*, dated 9 November 2015.

If a pre-production activity does not result in the transfer of control of a good or service to a customer, an entity considers other requirements that might be applicable (e.g., Section 17 *Property, Plant and Equipment*, Section 18 *Intangible Assets other than Goodwill*, paragraphs 23.116 to 23.118 of Section 23 on costs to fulfil a contract with a customer).

Question 5-2: What is the nature of the promise in a 'typical' stand-ready obligation?¹²⁵

Generally, the nature of the promise in a stand-ready obligation is the promise that the customer will have access to a good or service, not the delivery of the underlying good or service. Item '(e)' in FRC's FRS 102 Factsheet 10¹²⁶ (as set out in 5.1 above) describes a stand-ready obligation as a promised service that consists of standing ready to provide goods or services or making goods or services available for a customer to use as and when it decides to do so.

The following are types of promises to a customer that could be considered stand-ready obligations, depending on the facts and circumstances:

- Obligations for which the delivery of the good, service or intellectual property is within the control of the entity, but is still being developed (e.g., a software entity's promise to transfer unspecified software upgrades at its discretion).
- Obligations for which the delivery of the underlying good or service is outside the control of the entity and the customer (e.g., an entity's promise to remove snow from an airport runway in exchange for a fixed fee for the year).
- Obligations for which the delivery of the underlying good or service is within the control of the customer (e.g., an entity's promise to provide periodic maintenance on a when-and-if needed basis on a customer's equipment after a pre-established amount of usage by the customer).
- Obligations to make a good or service available to a customer continuously (e.g., a gym membership that provides unlimited access to a customer for a specified period of time).

An entity needs to carefully evaluate the facts and circumstances of its contracts to appropriately identify whether the nature of a promise to a customer is the delivery of the underlying good(s) or service(s) or the service of standing ready to provide goods or services. Entities also have to consider other promises in a contract that includes a stand-ready obligation to appropriately identify the performance obligations in the contract. Generally, all contracts with a stand-ready element do not necessarily include a single performance obligation (see Question 5-3 below).

See Question 5-13 in 5.2.2 below for a discussion on whether stand-ready obligations are generally considered to be a series of distinct goods or services.

Stand-ready obligations are common in the software industry and might be present in other industries. For example, a software entity's promise to provide an unspecified number of software updates on a when-and-if-available basis typically represents a stand-ready obligation. In contrast, a promise to provide certain specified software updates would generally not be a stand-ready obligation.

Furthermore, an arrangement that requires the customer to make additional purchasing decisions (e.g., through the submission of a purchase order) is generally not a stand-ready obligation. This is because the entity is not obligated to fulfil the purchase order until it is submitted. Therefore, the nature of the promise to the customer is the delivery of the underlying goods or service and not a promise to stand ready to provide goods or services.

For the discussion on measuring progress toward satisfaction for a stand-ready obligation that is satisfied over time, see Question 8-14 in 8.1.4.E below.

Question 5-3: Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?¹²⁷

Generally, the stand-ready element in a contract does not always represent a single performance obligation satisfied over time. This conclusion is consistent with the discussion in Question 5-2 above that, when identifying the nature of a promise to a customer, an entity might determine that a stand-ready element exists, but it is not the promised good or service for revenue recognition purposes. Instead, the underlying goods or services are the goods or services promised to the customer and accounted for by the entity.

Consider the following Illustration:

¹²⁵ Based on TRG Agenda paper no. 16, *Stand-Ready Performance Obligations*, dated 26 January 2015.

¹²⁶ [FRS 102 Factsheet 10 Revenue](#) from *Contracts with Customers*, FRC, issued on 27 November 2024, Section 2 The five-step revenue recognition model, Step 2 - Identify the contract(s) with a customer, page 8.

¹²⁷ Based on TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

Illustration 5-2: Determining the nature of the promise in a contract with a stand-ready element

An entity is required to stand ready to produce a part for a customer under an MSA. The customer is not obligated to purchase any parts (i.e., there is no minimum guaranteed volume). However, it is highly likely the customer will purchase parts because the part is required to manufacture the customer's product and it is not practical for the customer to buy parts from multiple suppliers. The nature of the promise in this example is most likely to be the delivery of the parts, rather than a service of standing ready. When the customer submits a purchase order under the master supply arrangement, it is contracting for a specific number of distinct goods and the purchase order creates new performance obligations for the entity. However, if the entity determined that the nature of the promise is a service of standing ready, the contract would be accounted for as a single performance obligation satisfied over time. In that situation, the entity might be required to estimate the number of purchases to be made throughout the contract term (i.e., make an estimate of variable consideration and apply the constraint on variable consideration) and continually update the transaction price and its allocation among the transferred goods or services.

Also, in this example, the entity is not obligated to transfer any parts until the customer submits a purchase order (i.e., the customer makes a separate purchasing decision). This contrasts with a stand-ready obligation, which requires the entity to make a promised service available to the customer and does not require the customer to make any additional purchasing decisions.

See Question 5-20 in 5.6 below for further discussion on determining whether a contract involving variable quantities of goods or services is accounted for as variable consideration (i.e., if the nature of the promise is to transfer one overall service to the customer, such as a stand-ready obligation) or a contract containing customer options (i.e., if the nature of the promise is to transfer the underlying distinct goods or services).

Question 5-4: How would an entity evaluate whether an exclusivity provision in a contract with customer represents a promised good or service?

How we see it

We generally believe that an exclusivity provision does not represent a promised good or service.

Contracts with customers involving the sale of products or services might contain exclusivity clauses whereby the entity agrees that it will not provide the products or services to others or will do so only on a limited basis. Such provisions could restrict the distribution of the products or services in certain geographical areas and/or prohibit the sale of the products or services to a customer's competitors. For example, an entity that provides advertising on its website might agree to run a banner advertisement for one customer for a specified period of time and exclude advertisements for similar products or services from the advertiser's competitors.

Also, as explained in 9.1.3 below, the IASB discussed exclusivity in relation to licences of intellectual property and concluded that exclusivity is a restriction that represents an attribute of a licence, rather than the nature of the underlying intellectual property or the entity's promise in granting the licence. That is, exclusivity provisions define the scope of the customer's rights to intellectual property and would not be accounted for separately.

As explained above, we believe that the same principles would apply when evaluating exclusivity provisions in contracts that do not contain a licence of intellectual property. That is, exclusivity is an attribute of the promise to the customer, rather than a separate promised good or service. This is because exclusivity does not change the nature of the entity's performance to provide the underlying goods or services to the customer.

Any upfront payment received from a customer related to an exclusivity provision would need to be evaluated to determine whether it represents a material right (see further discussion in 6.8 below). Conversely, an entity might make a payment to a customer for being the customer's exclusive provider for certain goods or services. Any payment made by the entity to the customer would need to be evaluated in accordance with the requirements for consideration paid or payable to a customer (see further discussion in 6.7 below).

Question 5-5: Does a guarantee to defend or maintain a patent represent a promised good or service?

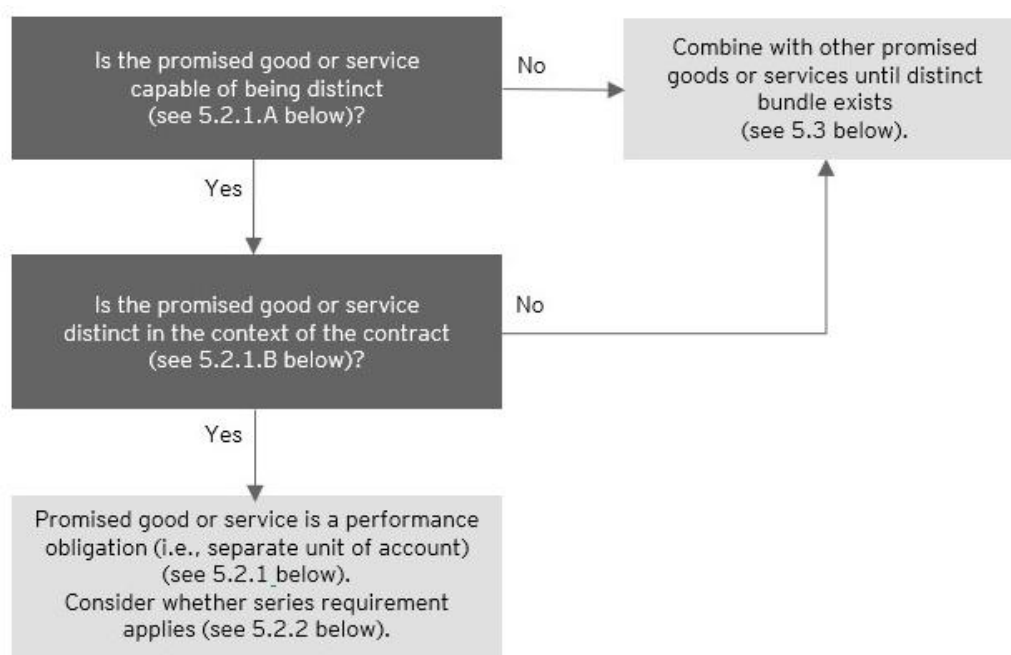
A guarantee to defend or maintain a patent does not represent a promised good or service - see discussion in 9.1.4 below.

5.2 Determining when promises are performance obligations

After identifying the promised goods or services within a contract, an entity determines which of those goods or services will be treated as separate performance obligations. That is, the entity identifies the individual units of account. Promised goods or services represent separate performance obligations if the goods or services are distinct (by themselves, or as part of a bundle of goods or services) (see 5.2.1 below) or if the goods or services are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (see 5.2.2 below).

If a promised good or service is not distinct, an entity is required to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that, together, is distinct. An entity is required to account for all the goods or services promised in a contract as a single performance obligation if the entire bundle of promised goods or services is the only performance obligation identified. [FRS 102.23.25]. See 5.3 below for further discussion. The following flow chart illustrates these requirements:

Figure 5-2: Determining when promises are performance obligations



A single performance obligation could include a licence of intellectual property and other promised goods or services. It is worth noting that IFRS 15 identifies two examples of licences of intellectual property that are not distinct from other promised goods or services in a contract: (1) a licence that is a component of a tangible good and that is integral to the functionality of the tangible good; and (2) a licence that the customer can benefit from only in conjunction with a related service (e.g., an online hosting service that enables a customer to access the content provided by the licence of intellectual property). [IFRS 15.B54]. See 9.1.2 below for further discussion on these two examples.

Section 23 also specifies that the following items are performance obligations:

- Customer options for additional goods or services that provide material rights to customers (see 5.6 below) [FRS 102.23.31-23.35]
- Service-type warranties (see 10.1 below) [FRS 102.23.26-23.28]

Entities do not apply the general model to determine whether these goods or services are performance obligations because the Section 23 deemed them to be performance obligations if they are identified as promises in a contract.

Note that under IFRS 15, the IASB noted that an entity is not precluded from accounting for distinct goods or services that are delivered concurrently and have the same pattern of transfer, as a single performance obligation, if the outcome would be the same as accounting for the goods and services as individual performance obligations. [IFRS 15.BC116]. A similar observation can be made under Section 23, i.e., an entity would not be precluded from accounting for a series of distinct goods or services as a single performance obligation if the outcome would be the same as accounting for the goods and services as individual performance obligations (see 5.2.2 below).

5.2.1 Determination of 'distinct'

Section 23 provides the following requirements: [FRS 102.23.21]

Extract from Section 23

- 23.21** A good or service that is promised by an entity to a customer is distinct if both of the following criteria are met:
- (a) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (ie the good or service is capable of being distinct); and
 - (b) the entity's promise to transfer the good or service is separate from other promises in the contract (see paragraph 23.24).

Section 23 outlines a two-step process for determining whether a promised good or service (or a bundle of goods or services) is distinct: [FRS 102.23.21]

- Consideration at the level of the individual good or service of whether the customer can benefit from the good or service on its own or with other readily available resources (i.e., the good or service is capable of being distinct)
- Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract)

Both of these criteria must be met to conclude that the good or service is distinct. If these criteria are met, the individual good or service must be accounted for as a separate unit of account (i.e., a performance obligation).

Both steps are important in determining whether a promised good or service is accounted for separately. The first criterion (i.e., capable of being distinct) establishes the minimum characteristics for a good or service to be accounted for separately. However, even if the individual goods or services promised in a contract are capable of being distinct, it might not be appropriate to account for each of them separately because doing so would not result in a faithful depiction of the entity's performance in that contract or appropriately represent the nature of an entity's promise to the customer. Therefore, an entity also needs to consider the interrelationship of those goods or services to apply the second criterion (i.e., distinct within the context of the contract) and determine the performance obligations within a contract.

The IFRS IC received a request about the identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land, which is discussed in 5.2.1.G below.

5.2.1.A Capable of being distinct

The first criterion requires that a promised good or service must be capable of being distinct by providing a benefit to the customer either on its own or together with other resources that are readily available to the customer.

Section 23 provides the following requirements on how to determine whether a promised good or service is capable of being distinct: [FRS 102.23.22, FRS 102.23.23]

Extract from Section 23

- 23.22** The criterion in paragraph 23.21(a) is satisfied for goods or services that are regularly sold separately.
- 23.23** For the purposes of applying the criterion in paragraph 23.21(a), readily available resources are:
- (a) goods or services sold separately (by the entity or another entity); or
 - (b) goods or services that the customer has already obtained from the entity (including goods or services transferred to the customer under the contract) or from other transactions or events.

Determining whether a good or service is capable of being distinct is straightforward in many situations. For example, if an entity regularly sells a good or service separately, this fact demonstrates that the good or service provides benefit to a customer on its own or with other readily available resources.

The evaluation might require more judgement in other situations, particularly when the good or service can only provide benefit to the customer with readily available resources provided by other entities. These are resources that meet either of the following conditions:

- They are sold separately by the entity (or another entity).
- The customer has already obtained them from the entity (including goods or services that the entity has already transferred to the customer under the contract) or from other transactions or events.

The Basis for Conclusions on IFRS 15 further noted that the assessment of whether the customer can benefit from the goods or services (either on its own or with other readily available resources) is based on the characteristics of the goods or services themselves, instead of how the customer might use the goods or services. [IFRS 15.BC100]. Consistent with this notion, an entity disregards any contractual limitations that might prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment. This is illustrated in Case D within Example 11 in IFRS 15. [IFRS 15.IE Example 11 Case D, IFRS 15.IE58A-IE58K]. The IFRS IC also reiterated this point during its March 2018 meeting (see 5.2.1.G below for further discussion).

The Basis for Conclusions on IFRS 15 further explained that it is not necessary for a delivered item to have 'value to the customer on a stand-alone basis' for an entity to account for that item separately. This is to avoid implying that an entity must assess a customer's intended use for a promised good or service when it is identifying performance obligations because it would be difficult, if not impossible, for an entity to know a customer's intent. [IFRS 15.BC101].

5.2.1.B Distinct within the context of the contract

Once an entity has determined whether a promised good or service is capable of being distinct based on the individual characteristics of the promise, the entity considers the second criterion of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct within the context of the contract).

Section 23 provides the following requirements for making this determination: [FRS 102.23.24]

Extract from Section 23

- 23.24** The purpose of the criterion in paragraph 23.21(b) is to determine whether the nature of the entity's promise, within the context of the contract, is to transfer the good or service individually, rather than to transfer a combined item or items to which the good or service is an input. Factors that indicate that two or more goods or services promised in a contract are inputs to a combined item or items and are therefore not distinct include, but are not limited to, the following:
- (a) The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element or unit. An example is a construction contract when an entity provides an integration (or contract management) service to manage and co-ordinate the various construction tasks necessary for the construction of an **asset**.
 - (b) One or more of the goods or services significantly modifies or customises, or is significantly modified or customised by, one or more of the other goods or services promised in the contract. An example is a software contract when an entity promises to provide existing software and to customise that software, if the customisation service significantly modifies the software.
 - (c) The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because an entity would not be able to fulfil its promise by transferring each of the goods or services independently.

5.2.1.C Distinct within the context of the contract: separately identifiable principle

To determine whether promised goods or services are separately identifiable (i.e., whether a promise to transfer a good or service is distinct within the context of the contract), an entity needs to evaluate whether its promise is to transfer each good or service individually or a combined item (or items) that comprises the individual goods or services promised in the contract. Therefore, an entity would evaluate whether the promised goods or services in the contract are outputs or whether they are inputs to a combined item (or items). In many cases, a combined item (or items) is more than (or substantially different from) the sum of the underlying promised goods or services.

The evaluation of whether an entity's promise is separately identifiable considers the relationship between the various goods or services in the context of the process to fulfil the contract. Therefore, an entity considers the level of integration, interrelation or interdependence among the promises to transfer goods or services.

Section 23 includes three factors (discussed individually in 5.2.1.D - 5.2.1.F below) that are intended to help entities identify when the promises in a bundle of promised goods or services are not separately identifiable and, therefore, need to be combined into a single performance obligation. [FRS 102.23.24]. These three factors are not an exhaustive list and that not all of the factors need to exist to conclude that the entity's promises to transfer goods or services are not separately identifiable. As emphasised by the IFRS IC during its March 2018 meeting (see the discussion in 5.2.1.G below), the three factors also are not intended to be criteria that are evaluated independently of the separately identifiable principle.

Given the wide variety of arrangements that are within the scope of Section 23, it is expected that there are some instances in which certain factors are less relevant to the evaluation of the separately identifiable principle. Entities might need to apply significant judgement to evaluate whether a promised good or service is separately identifiable. The evaluation requires a thorough understanding of the facts and circumstances present in each contract. Entities would generally consider the following questions, which summarise what is discussed in the Basis for Conclusions on IFRS 15: [IFRS 15.BC116J, IFRS 15.BC116K, IFRS 15.BC116L]

- Is the combined item greater than, or substantively different from, the sum of the promised goods or services?
- Is an entity, in substance, fulfilling a single promise to the customer?
- Is the risk an entity assumes to fulfil its obligation to transfer a promised good or service inseparable from the risk relating to the transfer of the other promised goods or services in the bundle?
- Do two or more promised goods or services each significantly affect the other?
- Does each promised good or service significantly affect the other promised good or service's utility to the customer?

Further discussions on 'separately identifiable' principle within the context of the contract are available in the EY publication, International GAAP®.

5.2.1.D Distinct within the context of the contract: significant integration service

The first factor (described in 5.2.1.B above) is the presence of a significant integration service. When an entity provides a significant service of integrating the goods or services with other goods or services promised in a contract into a bundle of goods or services, the bundle of integrated goods or services represents a combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer [FRS 102.23.24(a)]. In line with this, the Basis for Conclusions on IFRS 15 added that when an entity provides a significant integration service, the risk of transferring individual goods or services is inseparable from the bundle of integrated goods or services because a substantial part of an entity's promise to the customer is to make sure the individual goods or services are incorporated into the combined output or outputs. [IFRS 15.BC107]. When evaluating this factor, entities need to consider whether they are providing a significant integration service that effectively *transforms* the individual promised goods or services (the inputs) into a combined output(s) (as discussed in Case E within Example 11 in IFRS 15). When more than one party is involved in providing goods or services to a customer, entities could refer to Example 46 in IFRS 15. [IFRS 15.IE Example 11 Case E, IFRS 15.IE58G-IE58K, IFRS 15.IE Example 46, IFRS 15.IE234-IE238].

This factor applies even if there is more than one output. Furthermore, as described in Section 23, a combined output or outputs might include more than one phase, element or unit. An example is a construction contract when an entity provides an integration (or contract management) service to manage and co-ordinate the various construction tasks necessary for the construction of an asset. [FRS 102.23.24(a)].

Usually, an integration service provided by the contractor often includes coordinating the activities performed by any subcontractors and making sure the quality of the work performed is in compliance with contract specifications and that the individual goods or services are appropriately integrated into the combined item that the customer has contracted to receive. For this type of construction contract and an analysis of whether it contains a significant integration service, an entity could consider the illustration in Case A within Example 10 in IFRS 15, [IFRS 15.IE Example 10, IFRS 15.IE45-IE48C], and in Illustration 5-3 below. In addition, when more than one party (e.g., a subcontractor) is involved in providing goods or services to a customer, Section 23 requires the entity to determine whether it is a principal or an agent in these transactions (see 5-4 below).

Illustration 5-3: Significant integration service

Contractor Q, a construction firm, enters into a contract with a customer to design and construct a concert hall. The project has two phases, design and construction and the contract provides separate compensation for each phase.

For purposes of this example, assume that the individual goods and services provided in each phase are capable of being distinct. Contractor Q must then determine whether each of the individual goods and services in each phase are distinct in the context of the contract. Contractor Q provides a significant service of: (1) integrating the various design services to produce project plans in the design phase; and (2) integrating the various materials and construction services to build the concert hall in the construction phase. Contractor Q then evaluates whether the aggregated goods and services in the design phase (i.e., project plans) and aggregated goods and services in the construction phase (i.e., concert hall) are distinct in the context of the contract and, therefore, are two performance obligations or whether together they represent a single performance obligation.

In this Illustration, the design and construction of a concert hall is necessary to satisfy Contractor Q's contract with the customer. Given the complex nature of the project, assume Contractor Q will be required to frequently alter the design of the concert hall during construction and to continually assess the propriety of the materials to be used. These changes might cause Contractor Q to rework the construction of the concert hall. Contractor Q determines it is providing a significant service of integrating goods and services into the combined output for which the customer has contracted (i.e., a completed concert hall). Contractor Q concludes that the design services and construction services are not distinct in the context of the contract and instead are combined and accounted for as one performance obligation.

5.2.1.E Distinct within the context of the contract: significant modification or customisation

The second factor (described in 5.2.1.B above) is the presence of significant modification or customisation. [FRS 102.23.24(b)]. In the Basis for Conclusions on IFRS 15, the IASB explained that in some industries, the notion of inseparable risks is more clearly illustrated by assessing whether one good or service significantly modifies or customises another. This is because if a good or service modifies or customises another good or service in a contract, each good or service is being assembled together (as an input) to produce a combined output. [IFRS 15.BC109].

Section 23 provided an example which the following Illustration is based on: [FRS 102.23.24(b)]

Illustration 5-4: Significant customisation service

Assume that an entity promises to provide a customer with software that it will significantly customise to make the software function with the customer's existing infrastructure. Based on its facts and circumstances, the entity determines that it is providing the customer with a fully integrated system and that the customisation service requires it to significantly modify the software in such a way that the risks of providing it and the customisation service are inseparable (i.e., the software and customisation service are not separately identifiable).

The *significance* of modification or customisation services can affect an entity's conclusion about the number of identified performance obligations for similar fact patterns. An entity could consider Case A and Case B within Example 11 in IFRS 15. In Case A, each of the promised goods or services are determined to be distinct because the installation services being provided to the customer do not significantly modify the software. In Case B, two of the promised goods or services are combined into one performance obligation because one promise (the installation) significantly customises another promise (the software). [IFRS 15.IE Example 11 Case A-Case B, IFRS 15.IE49-IE58].

5.2.1.F Distinct within the context of the contract: highly interdependent or highly interrelated

The third factor (described in 5.2.1.B above) is whether the promised goods or services are highly interdependent or highly interrelated. [IFRS 102.23.24(c)]. This is often the most difficult distinct factor for entities to assess. Promised goods or services are highly interdependent or highly interrelated if each of the promised goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because an entity would not be able to fulfil its promise by transferring each of the goods or services independently. [IFRS 102.23.24(c)]. As discussed above, an entity would evaluate how two or more promised goods or services affect each other and not just evaluate whether one item, by its nature, depends on the other. That is, an entity needs to evaluate whether there is a significant two-way dependency or transformative relationship between the promised goods or services to determine whether the promises are highly interdependent or highly interrelated. Determining whether a two-way dependency is significant such that the promises are highly interdependent or highly interrelated with each other is a judgement that requires careful consideration.

The following illustration is based on an example provided in the Basis for Conclusions on IFRS 15. [IFRS 15.BC112].

Illustration 5-5: Highly interdependent and highly interrelated

An entity promises to design an experimental new product for a customer and to manufacture ten prototype units of that product. Because the product and manufacturing process is unproven, the entity is required to continue to revise the design of the product during the construction and test of the prototypes and make any necessary modifications to in-progress or completed prototypes. The entity expects that most, or all, of the units to be produced will require some rework because of design changes made during the production process. That is, the customer is not likely to be able to choose whether to purchase only the design service or the manufacturing service without one significantly affecting the other. The entity determines that the design and manufacturing promises are highly interdependent on, and highly interrelated with, the other promises in the contract. Consequently, although each promise might provide a benefit on its own, the promises are not separately identifiable within the context of the contract.

Conversely, if the design was similar to that of a previous product and/or the entity did not expect to have to rework the prototypes due to design changes, the entity might determine that the two promises are not highly interdependent or highly interrelated and might conclude the contract contains multiple performance obligations.

Goods or services might not be separately identifiable if they are so highly interdependent on, or highly interrelated with, other goods or services under the contract. This might occur when the customer's decision not to purchase one promised good or service would significantly affect the other promised goods or services. In other words, the promised goods or services are so highly interrelated or highly interdependent with each other that the entity could not fulfil an individual promise independently from the other promises in the contract.

One aspect on which this evaluation must focus is the specific utility that can only be delivered through the combination of the goods or services. That is, it is important to establish that the utility each good or service can provide on its own is significantly less than the utility of the combined goods or services. Often, gaining sufficient understanding of the specific utility of the individual goods or services, as well as the combined offering, might involve discussion with employees from various departments (e.g., engineering, sales), in addition to those in the accounting and finance departments. An entity also needs to consider how its products and services are described in publicly available information (e.g., the entity's website, investor relations reports, financial statement filings). Those descriptions might indicate which functionalities are critical to the overall offering and influence customer expectations and whether those functionalities significantly affect the utility of other goods or services in the contract. Overall, the specific facts and circumstances of each offering and contract have to be carefully considered.

An entity could consider the concept regarding an entity's ability to separately fulfil a promise to a customer highlighted in Case E within Example 11 in IFRS 15. This example includes a contract for the sale of equipment and specialised consumables to be used with the equipment. In this example, the entity determines that the equipment and consumables are not highly interdependent or highly interrelated because the two promises do not significantly affect each other. As part of its analysis, the entity concludes that it would be able to fulfil each of its promises in the contract independently of the other promises.

[IFRS 15.IE Example 11 Case E, IFRS 15.IE58A-IE58K].

5.2.1.G Distinct within the context of the contract: March 2018 IFRS IC discussion and frequently asked questions

In 2017, the IFRS IC received a request regarding the identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land. The request also asked about the timing of revenue recognition for each performance obligation (either over time or at a point in time), which is discussed in Question 8-11 in 8.1.3.B below. At its March 2018 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide sufficient guidance for an entity to recognise revenue in a contract for the sale of a real estate unit that includes the transfer of land. Consequently, the IFRS IC decided not to add this matter to its agenda.¹²⁸

In considering this request, the IFRS IC noted that the assessment of the distinct criteria requires judgement. Furthermore:

- The assessment of the first criterion is based on the characteristics of the goods or services themselves. Accordingly, an entity disregards any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity (see 5.2.1.A above). [IFRS 15.BC100].
- The objective underlying the second criterion is to determine the nature of the promise within the context of the contract. That is, whether the entity has promised to transfer either the promised goods or services individually or a combined item to which those goods or services are inputs. IFRS 15 also includes some factors that indicate that two or more promises to transfer goods or services are not separately identifiable. [IFRS 15.29]. However, these factors are not intended to be criteria that an entity evaluates independently of the 'separately identifiable' principle because, in some instances, one or more of the factors might be less relevant to the evaluation of that principle (see 5.2.1.C above). [IFRS 15.BC116N].

In the Basis for Conclusions on IFRS 15, the IASB indicated that the separately identifiable concept is influenced by the idea of separable risks. That is, whether the risk assumed to fulfil the obligation to transfer one of the promised goods or services to the customer is separable from the risk relating to the transfer of the other promised goods or services. Evaluating whether an entity's promise is separately identifiable considers the interrelationship between the goods or services within the contract in the context of the process to fulfil the contract. Accordingly, an entity considers the level of integration, interrelation or interdependence among the promises in the contract to transfer goods or services. An entity evaluates whether, in the process of fulfilling the contract, there is a transformative relationship between the promises, rather than considering whether one item, by its nature, depends upon another (i.e., whether the promises have a functional relationship). [IFRS 15.BC105, IFRS 15.BC116J, IFRS 15.BC116K]. That is, the conclusion about whether the promised goods or services are separately identifiable hinges on whether there is a *significant two-way dependency* between the items. Determining whether a two-way dependency is significant such that the promises are separately identifiable is a judgement that requires careful consideration (this is discussed further in 5.2.1.F above).

The following Illustration is based on the example from the IFRS IC agenda paper used by the IFRS IC when it discussed the identification of performance obligations in its March 2018 meeting¹²⁹:

Illustration 5-6: Identification of performance obligations in a contract for the sale of a real estate unit that includes the transfer of land

Entity A enters into a non-cancellable contract with a customer for the sale of a real estate unit that involves the transfer of a plot of land and a building that Entity A constructs on that land. The land represents all of the area on which the building will be constructed and the contract is for the entire building.

At contract inception, Entity A transfers the legal title of the land and the customer pays the price specified in the contract for it. The transfer of legal title to the customer cannot be revoked, regardless of what happens during the construction of the building. Throughout the construction period, the customer makes milestone payments that do not necessarily correspond to the amount of work completed to date.

The design and specification of the building were agreed between the counterparties before the contract was signed. However, during the construction of the building, the customer can request changes to the design and specification that are priced by Entity A based on a methodology specified in the contract. If the customer

¹²⁸ [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

¹²⁹ [IASB Staff Paper 2D](#): Project: *Revenue recognition in a real estate contract that includes the transfer of land (IFRS 15)*, IFRS IC Meeting, Paper topic: *Agenda decision to finalise*, March 2018; and [IFRIC Update](#), March 2018. Available on the IFRS Foundation's website.

decides to proceed with the proposed changes, Entity A can reject them only for a limited number of reasons (e.g., when the change would breach planning permission). Entity A can only request changes if not doing so would lead to an unreasonable increase in costs or delay construction. However, the customer must approve those changes.

Entity A first assesses whether the land and the building are each capable of being distinct in accordance with paragraph 23.21(a) (see 5.2.1.A above). Entity A determines that the customer could benefit from the land on its own or together with other resources readily available to it (e.g., by hiring another developer to construct a building on the land). Also, Entity A determines that the customer could benefit from the construction of the building on its own or together with other resources readily available to it (e.g., by obtaining the construction services from Entity A or another developer without transferring the land). Therefore, Entity A concludes that the land and the building are each capable of being distinct.

The criterion in paragraph 23.21(b) is then assessed by Entity A in order to determine whether the land and the building are distinct in the context of the contract (see 5.2.1.B above). In making this assessment, Entity A considers the factors in paragraph 23.24, including the following (see 5.2.1.B above):

- (a). Whether it provides a significant service of integrating the land and the building into a combined output. Entity A analyses the transformative relationship between the transfer of the land and the construction of the building in the process of fulfilling the contract. As part of this analysis, it considers whether its performance in constructing the building would be different if it did not also transfer the land and *vice versa*. Despite the functional relationship between the land and the building (because the building cannot exist without the land on which its foundations will be built), the risks assumed by Entity A in transferring the land might, or might not, be separable from those assumed in constructing the building.
- (b). Whether the land and the building are highly interdependent or highly interrelated. Entity A determines whether its promise to transfer the land could be fulfilled if it did not also construct the building and *vice versa*.

Based on the above, the two promises would be separately identifiable if Entity A concluded that (a) its performance in constructing the building would be the same regardless of whether it also transferred the land; and (b) it would be able to fulfil its promise to construct the building even if it did not also transfer the land, and would be able to fulfil its promise to transfer the land even if it did not also construct the building.

5.2.1.H Distinct within the context of the contract: examples

IFRS 15 and Section 23 have consistent requirements when identifying performance obligations. The IASB included some examples in IFRS 15 that illustrate the application of the requirements for identifying performance obligations. The examples include analysis of how an entity might determine whether the promises to transfer goods or services are distinct within the context of the contract (see 5.2.3 below).

How we see it

The assessment of whether a good or service is distinct must consider the specific contract with a customer. That is, an entity cannot assume that a particular good or service is distinct (or not distinct) in all instances. The manner in which promised goods or services are bundled within a contract can affect the conclusion of whether a good or service is distinct. As a result, entities might account for the same goods or services differently, depending on how those goods or services are bundled within a contract.

Frequently asked questions

Question 5-6: How does an entity determine whether 'connected' hardware sold with cloud services represent one or more performance obligations?

To identify performance obligations in contracts containing connected hardware and cloud services, entities must determine whether the hardware and cloud services are each capable of being distinct and whether they are distinct within the context of the contract (as discussed in 5.2.1 above). An increasing number of connected hardware devices are now available (e.g., security cameras, home equipment). In contracts where a customer purchases hardware, the hardware might require the installation of an app or the purchase of a cloud service subscription in order to be used. Alternatively, the hardware might provide additional functionalities when paired with the cloud service.

In evaluating the distinct criteria, entities need to consider: whether the hardware can be used without the cloud service; how the hardware and cloud service affect each other (e.g., whether the cloud service enables the hardware to 'learn' or perform its intended function better over time); whether there are additional functionalities that result from using the hardware with the cloud service; and other details of how the hardware and cloud services function and are sold.

Consider the following Illustration where an entity concludes that the connected hardware and cloud services are separately identifiable:

Illustration 5-7: Hardware sold with cloud services

Entity L enters into a contract with a customer to provide a smart home security camera bundled with cloud services, which enable the customer to view live images from the camera in an app on internet-connected devices (e.g., tablets, phones). Entity L also provides the cloud services to customers who purchase the camera through secondary markets.

Entity L concludes that the customer can benefit from each of the goods and services either on its own or together with other goods or services that are readily available. That is, each good or service is capable of being distinct under paragraph 23.21(a).

The camera is capable of being distinct because the customer can benefit from it together with the cloud services, which are a readily available resource since they can be obtained separately. Furthermore, the customer can benefit from the camera because it can be resold through secondary markets for more than scrap value.

The cloud services are capable of being distinct because the customer can benefit from them together with the camera transferred at the outset of the contract or the customer can purchase the camera separately through the secondary markets and obtain the cloud services from the entity.

Entity L then considers the factors in paragraph 23.24 and determines that the promise to transfer each good and service is distinct within the context of the contract. In reaching this conclusion, the entity notes that it does not provide a significant service of integrating the cloud services with the camera into a combined output, and the cloud services and the camera do not significantly modify or customise one another.

Entity L also determines that the camera and the cloud services are not highly interdependent or highly interrelated because it can fulfil its promise to transfer the cloud services independently from its promise to provide the camera (i.e., since customers can purchase the camera in secondary markets).

The cloud services provide only the basic functionality of connecting the camera to a personal device using Wi-Fi (instead of a traditional electrical cable). Therefore, the utility the customer can derive from the camera and the cloud services (when transferred together) is not greater than, or substantially different from, the utility the customer would receive if the camera and cloud services had been transferred separately.

As a result, Entity L identifies two performance obligations: the camera and the cloud services.

Entities will need to evaluate the specific features and functionality of the cloud services in arrangements that include connected hardware devices. Evaluating whether hardware and cloud services are separate performance obligations in arrangements for connected devices might be complex and require significant judgement when the cloud service has sophisticated features or functionality that the device cannot do independently. In these cases, there might be a high degree of interdependency between the hardware and the cloud service or a significant integration service might be present.

How we see it

To conclude that hardware and a cloud service are a single performance obligation, entities will need to demonstrate that the functionality of both the hardware and the service is significantly elevated when they are used together. Many technology entities have concluded that they have separate performance obligations because the hardware and the cloud service do not significantly affect each other and because the hardware can be sold separately from the cloud service.

Question 5-7: How would entities determine whether implementation services are distinct?

Entities will need to assess their implementation services and consider all relevant facts and circumstances to determine whether they are separate performance obligations (i.e., they are capable of being distinct and are distinct within the context of a contract, as discussed in 5.2.1 above).

Entities might include promises to provide implementation services to customers as part of their product or service contracts (i.e., the implementation activities have been determined to transfer a service to the customer, as discussed in 5.1 above). For example, these services might include training of customer personnel and data conversion.

When assessing whether implementation services are capable of being distinct, an entity first considers whether the customer can benefit from those services on their own. There is strong evidence to suggest that implementation services are capable of being distinct if third party vendors offer (or are capable of offering) implementation services for the entity's products or services, or if the customer could perform

these services on its own. This evidence would demonstrate that the implementation services provide benefit to the customer on their own (i.e., apart from the other promised products or services purchased from the entity).

If an entity concludes that the customer is not able to benefit from the implementation services on their own, the entity considers whether the customer can benefit from the services together with other readily available resources. Readily available resources include the other promised products or services from the contract if they are sold separately by the entity or if they are transferred to the customer before the implementation services. An entity disregards any contractual limitations that prevent the customer from obtaining readily available resources from a party other than the entity when making this assessment. That is, contractually restricting a customer from using another vendor to perform the installation services would not preclude an entity from determining that the implementation services are capable of being distinct.

In assessing whether the implementation services are distinct within the context of the contract, an entity needs to consider whether: the implementation services modify or customise the other promised products or services; the entity is providing a significant service of integrating the promised products or services with the implementation services into one combined output; or the entity would be able to fulfil its promise to transfer the other promised products or services in the contract independently from its promise to provide the implementation services (i.e., whether the implementation services are highly interdependent or interrelated with the other products or services). This evaluation might require judgement and is based on the facts and circumstances of the entity's contracts.

The following Illustrations depict implementation services that are distinct and are not distinct, respectively:

Illustration 5-8: Implementation services are distinct

Technology entity P enters into an arrangement with a customer to perform implementation services and to provide software as a service (SaaS) for a three-year period. The entity sells the SaaS and implementation services separately. The implementation services include changing the layout of the main dashboard for each type of user (e.g., marketing, finance) and do not alter the source code of the underlying software or add any new functionality. The implementation service is routinely performed by third parties and does not significantly modify or customise the SaaS.

Technology entity P evaluates the promised goods and services to determine which promises would be accounted for as separate performance obligations.

Technology entity P concludes that the implementation services are capable of being distinct because they can be used with the SaaS, a readily available resource, and because they can be purchased from third parties. Furthermore, the implementation services are distinct within the context of the contract for the following reasons: they are routine; they do not significantly modify or customise the SaaS; they are not integrated with the SaaS into a combined output; and they are not highly interdependent or interrelated with the SaaS since the entity can fulfil its promise to transfer the SaaS independently from its promise to provide the implementation services.

Based on this assessment, Technology entity P identifies two performance obligations: the SaaS and the implementation services.

Illustration 5-9: Implementation services are not distinct

Consider the same promised goods or services as in Illustration 5-8 above, except that the nature of the implementation services is to set up data feeds and interfaces with third-party applications and to connect the customer's SaaS account to Technology entity P's infrastructure.

Technology entity P does not sell the SaaS without the implementation services, and the customer cannot use the SaaS until the implementation services are complete, which might be up to nine months after entering into a contract. The implementation services cannot be provided by other entities because they require access to Technology entity P's systems.

Technology entity P evaluates the promised goods and services to determine which promises would be accounted for as separate performance obligations. The SaaS is capable of being distinct because it can be used together with the implementation services that are provided at the outset of the contract. However, the implementation services are not capable of being distinct because: they are not sold separately by the Technology entity P; they cannot be provided by a third party; and they do not provide benefit to the customer without SaaS (which is not a readily available resource).

Based on this assessment, Technology entity P identifies one performance obligation: the implemented SaaS (comprised of the SaaS and implementation services).

Question 5-9: Does a licence to a content library include more than one performance obligation?

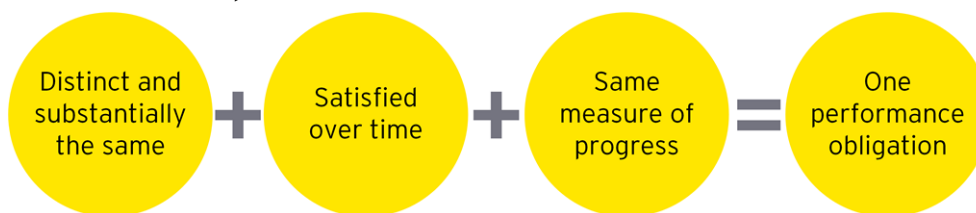
See response to Question 9-4 in 9.1.4 below.

5.2.2 Series of distinct goods or services that are substantially the same and have the same pattern of transfer

As discussed in 5 above, paragraph 23.17(b) defines, as a second type of performance obligation, a promise to transfer to the customer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer, if both of the following criteria from paragraph 23.18 are met: [FRS 102.23.17(b), FRS 102.23.18]

- Each distinct good or service in the series that the entity promises to transfer represents a performance obligation that would be satisfied over time, in accordance with paragraph 23.81 (see below and 8.1 below), if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see 8.1.4 below).

Figure 5-3: The series requirement criteria



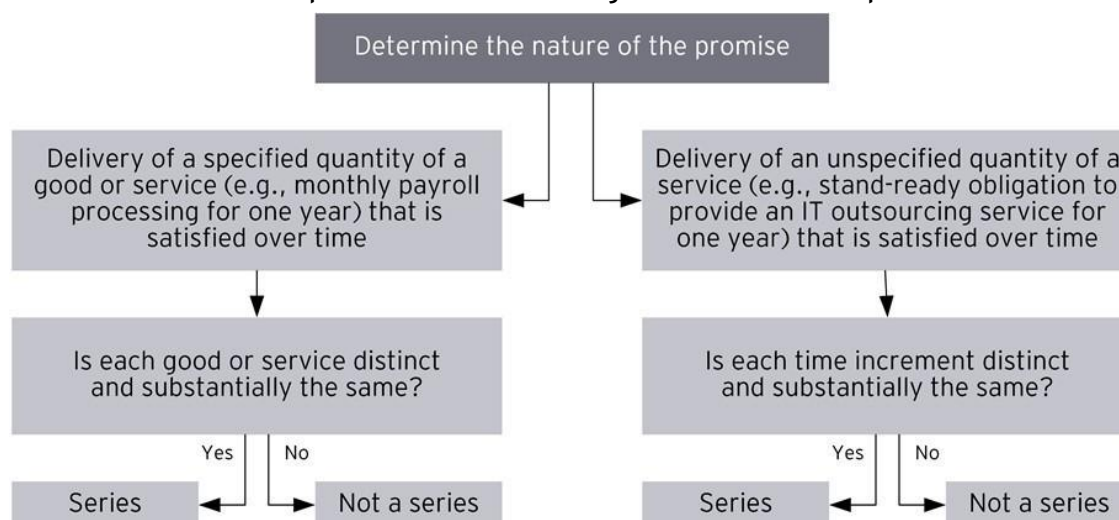
If a series of distinct goods or services meets the criteria in paragraphs 23.17(b) and 23.18 (i.e., the series requirement), an entity is required to treat that series as a single performance obligation (i.e., it is not optional). Generally, repetitive services (e.g., cleaning, transaction processing and delivering electricity) would meet the series requirement. Without the series requirement, applying the revenue model might present operational challenges because an entity would have to identify multiple distinct goods or services, allocate the transaction price to each distinct good or service on a stand-alone selling price basis and then recognise revenue when those performance obligations are satisfied. The series requirement simplifies application of the revenue model because an entity would identify a single performance obligation and allocates the transaction price to that performance obligation. It will then recognise revenue by applying a single measure of progress to that performance obligation.

Distinct goods and services that are “substantially the same”

For distinct goods or services to be accounted for as a series, one of the criteria is that they must be substantially the same. This is often the most difficult criterion for entities to assess. In addition, in its meeting related to IFRS 15 application, the TRG members generally agreed that when determining whether distinct goods or services are substantially the same, entities need to first determine the nature of their promise. This is because a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation considers whether each service is distinct and substantially the same. In contrast, if the nature of the entity’s promise is to stand ready or provide a single service for a period of time (i.e., because there is an unspecified quantity to be delivered), the evaluation considers whether each time increment (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same.¹³⁰

The following flow chart illustrates how the determination of the nature of the promise might affect whether the series requirement applies:

¹³⁰ TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

Figure 5-4: The series requirement: determining the nature of the promise

It is important to highlight that even if the underlying activities an entity performs to satisfy a promise vary significantly throughout the day and from day to day, that fact, by itself, does not mean the distinct goods or services are not substantially the same. Consider an example where the nature of the promise is to provide a daily hotel management service (i.e., an obligation to provide an unspecified quantity of a service for 20 years). Therefore, the entity evaluates whether each time increment is distinct and substantially the same. The service is comprised of activities that might vary each day (e.g., cleaning services, reservation services or property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day. Furthermore, each day of service is distinct because the management services provided on any day during the 20-year contract period are not dependent on, or interrelated with, the management services provided on any other day during the period. See Question 5-11 below for further discussion on determining the nature of an entity's promise and evaluating the 'substantially the same' criterion.

Satisfied over time

When considering the nature of the entity's promise and the applicability of the series requirement (including whether a good or service is distinct), it might be helpful for an entity to consider which over time criterion in paragraph 23.81 was met (i.e., why the entity concluded that the performance obligation is satisfied over time). As discussed further in 8.1 below, a performance obligation is satisfied over time if one of three criteria are met. For example, if a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits provided as the entity performs (i.e., the first over time criterion in paragraph 23.81(a)), that might indicate that each increment of service is capable of being distinct. If that is the case, the entity would need to evaluate whether each increment of service is separately identifiable (and substantially the same).

If a performance obligation is satisfied over time based on the other two criteria in paragraph 23.81 (i.e., (1) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or (2) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date), the nature of that promise might be to deliver a single specified good or service (e.g., a contract to construct a single piece of equipment), which would not be considered a series because the individual goods or services within that performance obligation are not distinct.

An entity's determination of whether a performance obligation is a single performance obligation comprising a series of distinct goods or services or a single performance obligation comprising goods or services that are not distinct from one another affects the accounting in the following areas: (1) allocation of variable consideration (see 7.3 below); (2) contract modifications (see 4.4 above); and (3) changes in transaction price (see 7.4 below). That is, an entity considers the underlying distinct goods or services in the contract, rather than the single performance obligation identified under the series requirement, when applying the requirements for these three areas of the model. Note that this is also consistent with the discussion in Basis for Conclusions on IFRS 15. [IFRS 15.BC115].

The following Illustration, which is based on the example included in a March 2015 TRG agenda paper¹³¹, shows how the allocation of variable consideration might differ for a single performance obligation identified under the series requirement and a single performance obligation comprising non-distinct goods and/or services:

Illustration 5-10: Allocation of variable consideration for a series versus a single performance obligation comprising non-distinct goods and/or services

Consider a five-year service contract that includes payment terms of a fixed annual fee plus a performance bonus upon completion of a milestone at the end of year two. If the entire service period is determined to be a single performance obligation comprising a series of distinct services, the entity might be able to conclude that the variable consideration (i.e., the bonus amount) is allocated directly to its efforts to perform the distinct services up to the date that the milestone is achieved (e.g., the underlying distinct services in years one and two). This could result in the entity recognising the entire bonus amount at the end of year two (when it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised – see 6.2.3 below). See Question 5-10 below for several examples of services for which it would be reasonable to conclude that they meet the series requirement.

In contrast, if the entity determines that the entire service period is a single performance obligation that is comprised of non-distinct services, the bonus would be included in the transaction price (subject to the constraint on variable consideration see 6.2.3 below) and recognised based on the measure of progress determined for the entire service period. For example, assume the bonus becomes part of the transaction price at the end of year two (when it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised – see 6.2.3 below). In that case, a portion of the bonus would be recognised at that the end of year two based on performance completed to date and a portion would be recognised as the remainder of the performance obligation is satisfied. As a result, the bonus amount would be recognised as revenue through to the end of the five-year service period.

How we see it

We believe that entities might need to apply significant judgement when determining whether a promised good or service in a contract with a customer meets the criteria to be accounted for as a series of distinct goods or services. As illustrated in Question 5-10 below, promised goods or services that meet the series criteria are not limited to a particular industry and can encompass a wide array of promised goods or services.

Frequently asked questions

Question 5-9: In order to apply the series requirement, must the goods or services be consecutively transferred?¹³²

Generally, a series of distinct goods or services need not be consecutively transferred. That is, the series requirement must be applied even when there is a gap or an overlap in an entity's transfer of goods or services, provided that the criteria in paragraph 23.18, are met. Entities might need to carefully consider whether the series requirement applies, depending on the length of the gap between an entity's transfer of goods or services.

Consider the following Illustration:

Illustration 5-11: A series in which the goods or services need not be consecutively transferred

An entity has a contract with a customer to provide a manufacturing service for the production of 24,000 units of a product over a two-year period. The units produced under the service arrangement are distinct, substantially the same and manufactured in accordance with the customer's specifications.

The entity determines that the service is satisfied over time (see 8.1 below) because the performance of the service does not create an asset with an alternative use to the entity (since the units are manufactured in accordance with the customer's specifications). Furthermore, if the contract were to be cancelled, the entity would have an enforceable right to payment for performance completed to date (cost plus a reasonable profit margin). Therefore, the criteria for the series requirement in paragraph 23.18 have been met.

¹³¹ TRG Agenda paper no. 27, *Series of Distinct Goods or Services*, dated 30 March 2015.

¹³² Based on TRG Agenda paper no. 27, *Series of Distinct Goods or Services*, dated 30 March 2015.

The conclusion is not influenced by whether the entity would perform the service evenly over the two-year period (e.g., produce 1,000 units per month). That is, the entity could produce 2,000 units in some months and none in others, but this would not be a determining factor in concluding whether the contract met the criteria to be accounted for as a series.

Question 5-10: In order to apply the series requirement, does the accounting result need to be the same as if the underlying distinct goods or services were accounted for as separate performance obligations?¹³³

Generally, the accounting result does not need to be the same. Furthermore, an entity is not required to prove that the result would be the same as if the goods or services were accounted for as separate performance obligations.

Consider the Illustration below to illustrate this point:

Illustration 5-12: A series for which the accounting result would be different if not treated as a series

An entity contracts with a customer to perform a manufacturing service that results in the production of 10 widgets. The manufacturing service will be performed over a three-year period. The contract price is £100 million and the stand-alone selling price for each widget is £10 million.

Total expected costs are £80 million. The service the entity will provide to the customer in producing each widget is substantially the same. However, the design is new, so the entity expects a decline in production costs over time. Production of the first five units is expected to cost £9 million per widget. The costs to produce the other five widgets are expected to be £7 million per widget.

For purposes of this example, the entity determines that each service that it will provide to produce one of the 10 widgets is distinct and meets the criteria to be satisfied over time, and that the same cost-based measure of progress would be used (i.e., the series requirement criteria in paragraph 23.18 are met). The following table demonstrates the difference in accounting between concluding that the series requirement applies and concluding that the contract is for 10 separate performance obligations:

(in £ millions)	Total contract	Series requirement (one performance obligation)		10 separate performance obligations	
		Units 1-5	Units 6-10	Units 1-5	Units 6-10
Revenue	100	56	44	50	50
Cost	(80)	(45)	(35)	(45)	(35)
Margin	20	11	9	5	15

Although £20 million in margin is recognised for the contract under both scenarios, there is a difference in the timing of revenue recognition (and margin) because more revenue is recognised in relation to the service to produce the first five widgets (and less in relation to its service to produce the final five widgets) when the series is accounted for as a single performance obligation using a single measure of progress towards complete satisfaction.

Also see Question 10-16 below on how the effect of learning curve costs are addressed in Section 23.

Question 5-11: In order to apply the series requirement, how does an entity consider whether a performance obligation consists of distinct goods or services that are 'substantially the same'?¹³⁴

When making the evaluation of whether goods or services are distinct and substantially the same, an entity first needs to determine the nature of the entity's promise in providing services to the customer. That is, if the nature of the promise is to deliver a specified quantity of service (e.g., monthly payroll services over a defined contract period), the evaluation considers whether each specified quantity of the underlying service is distinct and substantially the same. In contrast, if the nature of the entity's promise is to stand ready or provide a single service for a period of time (i.e., because there is an unspecified quantity to be delivered), the evaluation would consider whether each time increment (e.g., hour, day), rather than the underlying activities, is distinct and substantially the same. It could also be noted that the IASB intended that a series could consist of either specified quantities of the underlying good or service delivered (e.g., each unit of a good) or distinct time increments (e.g., an hourly service), depending on the nature of the promise. For example, paragraph BC285 of the Basis for Conclusions on IFRS 15

133 Based on TRG Agenda paper no. 27, *Series of Distinct Goods or Services*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

134 Based on TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

discusses a hotel management performance obligation that is a series of distinct days of service which clarifies the IASB did not intend to restrict a series to quantities of goods or services.

As discussed in 5.2.2 above, it is important to highlight that the underlying activities an entity performs to satisfy a performance obligation could vary significantly throughout a day and from day to day. However, this is not determinative in the assessment of whether a performance obligation consists of goods or services that are distinct and substantially the same. Consider an example where the nature of the promise is to provide a daily hotel management service (i.e., an obligation to provide an unspecified quantity of a service for 20 years). Therefore, the entity evaluates whether each time increment is distinct and substantially the same. The hotel management service comprises various activities that might vary each day (e.g., cleaning services, reservation services, property maintenance). However, the entity determines that the daily hotel management services are substantially the same because the nature of the entity's promise is the same each day and the entity is providing the same overall management service each day. Furthermore, each day of service is distinct because the management services provided on any day during the 20-year contract period are not dependent on, or interrelated with, the management services provided on any other day during the period.

Illustrated below are some examples of promised goods or services that might meet the series requirement and the analysis that supports that conclusion. The evaluation of the nature of the promise for each example is consistent with Illustration 8-1 in 8.1.1 below on monthly payroll processing.

Illustration 5-13: IT outsourcing - series provision is met

A vendor and customer execute a 10-year IT outsourcing arrangement in which the vendor continuously delivers the outsourced activities over the contract term (e.g., it provides server capacity, manages the customer's software portfolio, runs an IT help desk). The total monthly invoice is calculated based on different units consumed for the respective activities. The vendor concludes that the customer simultaneously receives and consumes the benefits provided by its services as it performs (meeting the over time recognition criterion in paragraph 23.81(a)).

The vendor first considers the nature of its promise to the customer. Because the vendor has promised to provide an unspecified quantity of activities, rather than a defined number of services, the vendor could reasonably conclude that the nature of the promise is an obligation to stand ready to provide the integrated outsourcing service each day. If the nature of the promise is the overall IT outsourcing service, each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day is separately identifiable. Also, the vendor could reasonably conclude that each day of service is substantially the same. That is, even if the individual activities that comprise the performance obligation vary from day to day, the nature of the overall promise is the same from day to day. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

Illustration 5-14: Transaction processing - series provision is met

A vendor enters into a 10-year contract with a customer to provide continuous access to its system and to process all transactions on behalf of the customer. The customer is obliged to use the vendor's system, but the ultimate quantity of transactions is unknown. The vendor concludes that the customer simultaneously receives and consumes the benefits as it performs (meeting the over time recognition criterion in paragraph 23.81(a)).

If the vendor concludes that the nature of its promise is to provide continuous access to its system, rather than process a particular quantity of transactions, it might conclude that there is a single performance obligation to stand ready to process as many transactions as the customer requires. If that is the case, it would be reasonable to conclude that there are multiple distinct time increments of the service. Each day of access to the service provided to the customer could be considered substantially the same since the customer is deriving a consistent benefit from the access each day, even if a different number of transactions are processed each day.

If the vendor concludes that the nature of the promise is the processing of each transaction (i.e., a specified quantity of transactions), each transaction processed could be considered substantially the same even if there are multiple types of transactions that generate different payments. Furthermore, each transaction processed could be a distinct service because the customer could benefit from each transaction on its own and each transaction could be separately identifiable. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

Illustration 5-15: Hotel management - series provision is met

A hotel manager (HM) enters into a 20-year contract to manage properties on behalf of a customer. HM receives monthly consideration of 1% of the monthly rental revenue, as well as reimbursement of labour costs incurred to perform the service and an annual incentive payment. HM concludes that the customer simultaneously receives and consumes the benefits of its services as it performs (meeting the over time recognition criterion in paragraph 23.81(a)).

HM considers the nature of its promise to the customer. If the nature of its promise is the overall management service (because the underlying activities are not distinct from each other), each day of service could be considered distinct because the customer can benefit from each day of service on its own and each day of service is separately identifiable.

Assuming the nature of the promise is the overall management service (i.e., an unspecified quantity of service), the service performed each day could be considered distinct and substantially the same. This is because, even if the individual activities that comprise the performance obligation vary significantly throughout the day and from day to day, the nature of the overall promise to provide the management service is the same from day to day. Accordingly, it would be reasonable for an entity to conclude that this contract meets the series requirement.

Illustration 5-16: Determining whether promised goods and services represent a series - series provision is met

A SaaS provider enters into a three-year contract with Customer X to provide access to its SaaS basic customer relationship management (CRM) application for £300,000. The contract also includes professional services that will personalise the user's interface based on the user's role. These services are sold separately from the CRM application and can be provided by third party vendors. The customer can benefit from the CRM application without the professional services, which do not significantly customise or modify the CRM application.

The SaaS provider determines that the CRM application and professional services are distinct (i.e., the CRM application and the professional services must not be combined into a single performance obligation). The two services are each capable of being distinct because Customer X can benefit from them on their own. The services are distinct within the context of the contract because they are not highly interdependent or interrelated and each service does not significantly modify or customise the other.

The SaaS provider first determines that the nature of the CRM application promise is to provide continuous access to its CRM application for the three-year period (i.e., an unspecified quantity of service). Although the activities that Customer X might be able to perform via the CRM application might vary from day to day, the overall promise is to provide continuous access to the CRM application to Customer X for a period of three years.

The SaaS provider determines that access to the CRM application represents a series of distinct services that are substantially the same and have the same pattern of transfer to Customer X. Each day of service is capable of being distinct because Customer X benefits each day from access to the CRM application. Each day is distinct within the context of the contract because there are no significant integration services, each day does not modify or customise another day and each day is not highly interdependent or interrelated. Each day of service is substantially the same because Customer X derives a consistent benefit from the access to the CRM application and has the same pattern of transfer over the term of the contract. Each distinct service represents a performance obligation that is satisfied over time and has the same measure of progress (e.g., time-elapsed). Therefore, the criteria to account for access to the CRM application as a series of distinct services (i.e., a single performance obligation) are met.

The SaaS provider also considers whether the professional services meet the criteria to be accounted for as a series. As part of this assessment, the entity considers whether each day of the professional services is distinct from the other days or whether the nature of the promise for the professional services is for a combined output from all of the days. The entity also considers the complexity of the professional services and whether the activity of each day builds on one another or if each day is substantially the same. This analysis requires judgement and is based on the facts and circumstances of the professional services performed.

Question 5-12: Can an entity choose whether to apply the series requirement?

As discussed above, if a series of distinct goods or services meets the criteria in paragraphs 23.17(b) and 23.18, an entity is required to treat that series as a single performance obligation (i.e., it is not an optional requirement). [FRS 102.23.17(b), FRS 102.23.18].

Question 5-13: Do all stand-ready obligations meet the criteria to be accounted for as a series?**How we see it**

We generally believe that stand-ready obligations (i.e., when the nature of the entity's promise is to provide an unspecified quantity of a service over time) will meet the criteria and, therefore, need to be accounted for as a series of distinct goods or services.

As discussed in Questions 5-2 and 5-3 in 5.1 above, entities might need to apply judgement to determine whether the nature of a promise to a customer is the service of standing ready to provide goods or services (i.e., a stand-ready obligation) or the delivery of the underlying goods or services (i.e., not a stand-ready obligation).

5.2.3 Examples of identifying performance obligations

Section 23 and IFRS 15 have consistent requirements when identifying performance obligations, however Section 23 does not provide examples to illustrate how requirements might be applied. IFRS 15 includes several examples that illustrate the application of the requirements for identifying performance obligations. The examples explain the judgements made to determine whether the promises to transfer goods or services are capable of being distinct and distinct within the context of the contract.

Refer to the EY publication, International GAAP® for these IFRS 15 examples and additional guidance.

5.3 Promised goods or services that are not distinct

If a promised good or service does not meet the criteria to be considered distinct, an entity is required to combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that, together, is distinct. This could result in an entity combining a good or service that is not considered distinct with another good or service that, on its own, would meet the criteria to be considered distinct (see 5.2.1 above). [FRS 102.23.25].

An entity could consider Case A and Case B within Example 10 in IFRS 15. These illustrate two examples of contracts with promised goods or services that, while capable of being distinct, are not distinct in the context of the contract because of a significant integration service that combines the inputs (the underlying goods or services) into a combined output. [IFRS 15.IE Example 10, IFRS 15.IE45-IE48C].

5.4 Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, Section 23 requires an entity to determine whether it is a principal or an agent in these transactions by evaluating the nature of its promise to the customer. For example, an entity that issues loyalty points to its customers that are redeemable for another entity's goods or services needs to assess whether it is a principal or an agent in relation to the redemption of the points.

An entity is a principal (and, therefore, records revenue on a gross basis) if it controls a promised good or service before transferring that good or service to the customer. [FRS 102.23.37, FRS 102.23.39]. An entity is an agent (and, therefore, records as revenue the net amount that it retains for its agency services) if its role is to arrange for another entity to provide the goods or services. [FRS 102.23.40].

Accordingly, for an entity to conclude that it is providing the good or service to the customer, it must first control that good or service. The entity cannot provide the good or service to a customer if the entity does not first control it. If an entity controls the good or service, the entity is a principal in the transaction. If an entity does not control the good or service before it is transferred to the customer, the entity is an agent in the transaction. It is therefore expected that an entity that itself manufactures a good or performs a service is always a principal if it transfers control of that good or service to another party. There is no need for such an entity to perform further evaluation because it transfers control of or provides its own good or service directly to its customer without the involvement of another party. For example, if an entity transfers control of a good to an intermediary that is a principal in providing that good to an end-consumer, the entity records revenue as a principal in the sale of the good to its customer (the intermediary).

An entity applies judgement in making its overall assessment of whether it is a principal or agent. Therefore, appropriate disclosures are important, in particular: (a) significant judgements in accordance with paragraph 8.6 of Section 8 *Notes to the Financial Statements*; and (b) information required by Section 23, including information about its performance obligations (see 11.4.1.D).

How we see it

Entities need to carefully evaluate whether they are acting as a principal or as an agent. As a reminder, the guidance in Section 23 focuses on control of the specified goods or services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. That is, an entity first evaluates whether it controls the specified good or service before reviewing Section 23's principal indicators. As discussed above, appropriate disclosure in accordance with Section 8 and Section 23 will be required.

As part of understanding the relationships between the parties involved in the transaction, it might be helpful to understand the flow of consideration between the parties. However, whether the entity receives consideration from one or more parties involved in the transaction on a gross or net basis is not determinative in the principal versus agent analysis.

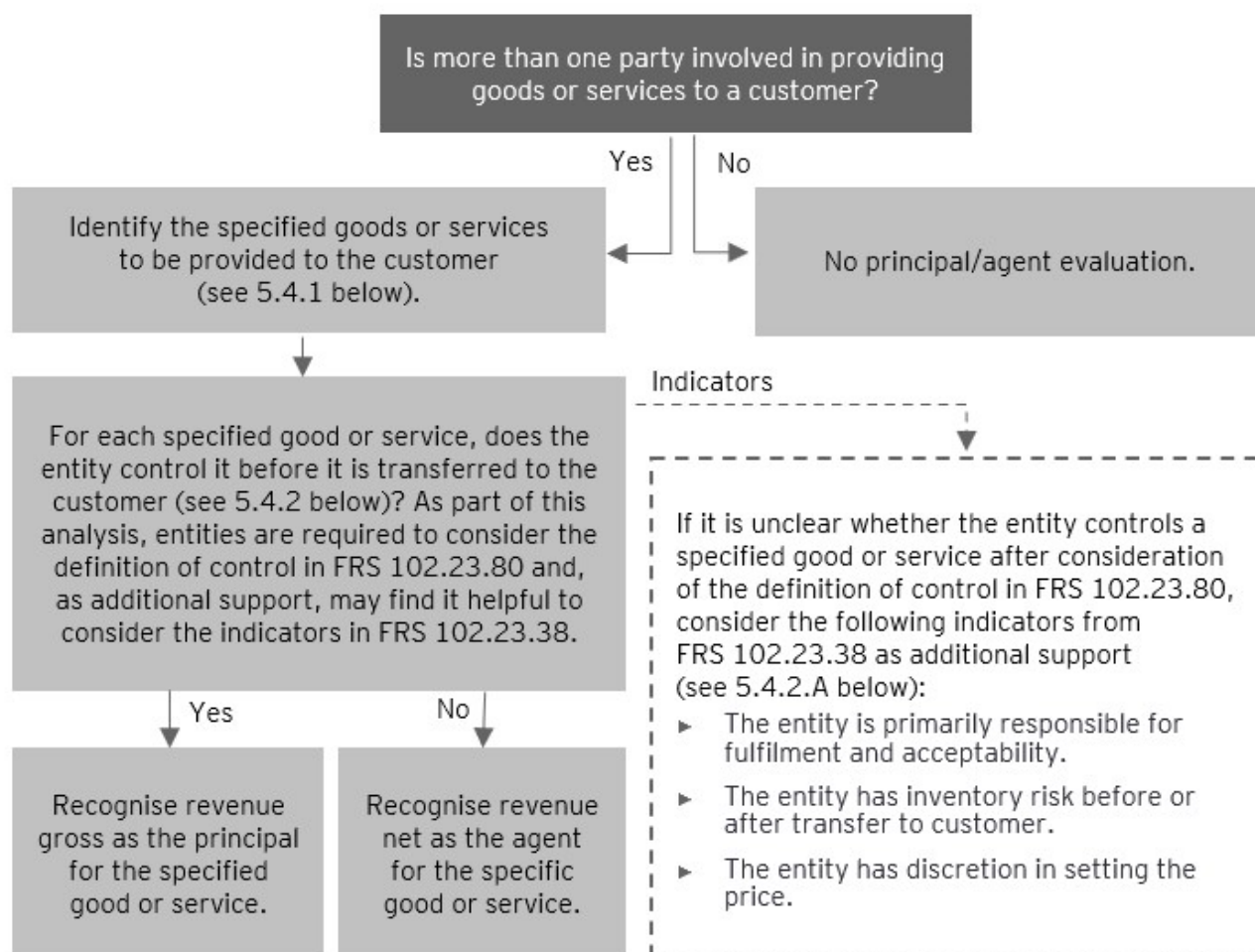
Section 23 states the overall principle for the principal versus agent evaluation, as follows: [FRS 102.23.36, FRS 102.23.37]

Extract from Section 23

23.36 When another party is involved in providing goods or services to a customer, an entity shall determine whether the nature of its promise is to provide the specified goods or services itself (ie the entity is a principal) or to arrange for those goods or services to be provided by the other party (ie the entity is an agent). A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 23.21 to 23.25). An entity shall determine whether it is a principal or an agent for each performance obligation in a contract.

The following flow chart illustrates the process for performing a principal versus agent evaluation:

Figure 5-5: Principal versus agent evaluation



How we see it

The principal versus agent guidance applies regardless of the type of transaction under evaluation or the industry in which the entity operates. Entities that: (a) do not stock inventory and might employ independent warehouses or fulfilment houses to drop-ship merchandise to customers on their behalf; or (b) offer services to be provided by an independent service provider (e.g., travel agents, magazine subscription brokers and retailers that sell goods through catalogues or that sell goods on consignment) might need to apply significant judgement when applying this guidance.

Frequently asked questions

Question 5-14: Can an entity make an accounting policy choice to report revenue from contracts with customers on a gross or net basis?

The principal versus agent assessment is not something about which an entity can make a policy choice. Entities must carefully consider the facts and circumstances of each contract to determine the appropriate accounting.

5.4.1 Identifying the specified good or service

As described in 5.4 above, when performing principal versus agent evaluation, it is important for an entity to determine the nature of its promise. [FRS 102.23.36]. Therefore, an entity must first identify the specified good or service (or unit of account for the principal versus agent evaluation) to be provided to the customer in order to determine the nature of its promise (i.e., whether it is to provide the specified goods or services to the end-consumer as a principal or to arrange for those goods or services to be provided by another party as an agent). A specified good or service is defined as “a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer”. [FRS 102.23.36]. That is, specified goods or services are the distinct goods or services (or a distinct bundle of goods or services) identified using the requirements in paragraphs 23.21 to 23.25 (see 5.2 above) that are transferred to the end-consumer. Because the specified goods or services are determined from the perspective of the end-consumer, they will not always be the same as the entity’s performance obligation - particularly when the entity is an agent.

While the definition of specified goods or services is similar to that of a performance obligation, a new term ‘specified goods or services’ is used to distinguish the principal’s performance obligation from an agent’s performance obligation because using ‘performance obligation’ would have been confusing in agency relationships. That is, an agent’s performance obligation is to arrange for goods or services to be provided by another party; providing the specified goods or services to the end-consumer is not the agent’s performance obligation. For example, consider Illustration 5-19 in 5.4.2.E below, in which an entity operates a website that enables users to purchase goods from a range of suppliers who then deliver the goods directly to the users. In this example, the entity concludes that the specified goods to be provided to the users of the website (i.e., the end-consumer) are the goods provided by the suppliers, and no other goods or services are promised to the end-consumer by the entity. The entity further concludes that it does not control the specified goods before they are transferred to the end-consumer, and it is an agent in the transaction. Its performance obligation is to arrange for the provision of goods to the end-consumer by the supplier (i.e., not the provision of the specified goods themselves).

As discussed above, a specified good or service might also be a distinct bundle of goods or services. In line with the discussion in 5.2.1.B above, if individual goods or services are not distinct from one another, they might be inputs to a combined item and each good or service might represent only a part of a single promise to the customer. Therefore, in a contract in which goods or services provided by another party are inputs to a combined item (or items), the entity would assess whether it controls the combined item (or items) before that item (or items) is transferred to the customer. If so, in determining whether it is a principal or an agent, an entity evaluates that single promise to the customer, rather than the individual inputs that make up that promise. However, in order to conclude that it controls the combined item(s), Paragraph 23.37(c) of FRS 102 (further discussed in 5.4.2 below) notes that it is likely an entity will need to conclude it performs a significant service of integrating the individual goods or services because it also controls the underlying inputs before integration.

Appropriately identifying the specified good or service to be provided is a critical step in determining whether an entity is a principal or an agent in a transaction. In many situations, especially those involving tangible goods, identifying the specified good or service is relatively straightforward. For example, if an entity is reselling laptop computers, the specified good that is transferred to the customer is a laptop computer.

However, the assessment might require significant judgement in other situations, such as those involving intangible goods or services. For example, the specified good or service might be the underlying good or service a customer ultimately wants to obtain (e.g., a flight, a meal) or a right to obtain that good or service (e.g., in the form of a ticket or voucher). It is helpful to consider the guidance provided in the Basis for Conclusions on IFRS 15 in this area. The IASB noted that when the specified good or service is a right to a good or service that will be provided by another party, the entity would determine whether its performance obligation is a promise to provide that right (and it is, therefore, a principal) or whether it is arranging for the other party to provide that right (and it is, therefore, an agent). The fact that the entity does not provide the underlying goods or services itself is not determinative. [IFRS 15.BC385O]. As well as considering the goods or services explicitly promised in the contract, an entity also needs to consider any implicit promises (see 5.1 above and Illustration 5-18 in 5.4.2 below for further discussion), which might require judgement. [FRS 102.23.19].

It might be difficult in some cases to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service. An entity could consider Example 47 in IFRS 15 which involves an airline ticket reseller. In this example, the entity pre-purchases airline tickets that it will later sell to customers. While the customer ultimately wants airline travel, the conclusion is that the specified good or service is the right to fly on a specified flight (in the form of a ticket) and not the underlying flight itself. The entity itself does not fly the plane and it cannot change the service (e.g., change the flight time or destination). However, the entity obtained the ticket prior to identifying a specific customer to purchase the ticket. As a result, the entity holds an asset (in the form of a ticket) that represents a right to fly. The entity could, therefore, transfer that right to a customer (as depicted in the example) or decide to use the right itself. [IFRS 15.IE Example 47, IFRS 15.IE239-IE243].

An entity can also consider also Example 46A in IFRS 15 which involves an office maintenance service provider. In this example, the entity concludes that the specified good or service is the underlying office maintenance service (rather than a right to that service). While the entity obtained the contract with the customer prior to engaging a third party to perform the requested services, the right to the subcontractor's services never transfers to the customer. Instead, the entity retains the right to direct the service provider. That is, the entity can direct the right to use the subcontractor's services as it chooses (e.g., to fulfil the customer contract, to fulfil another customer contract, to service its own facilities). Furthermore, the customer in this example is indifferent as to who carries out the office maintenance services. [IFRS 15.IE Example 46A, IFRS 15.IE238A-IE238G]. This is not the case in Example 47 in IFRS 15 discussed above, in which the customer wants the ticket reseller to sell one of its tickets on a specific flight.

If a contract with a customer includes more than one specified good or service, Section 23 requires that an entity must determine whether it is a principal or an agent for each performance obligation in a contract because an entity might be a principal for some specified goods or services and an agent for others.

[FRS 102.23.36]. Example 48A in IFRS 15 provides an illustration of this. [IFRS 15.IE Example 48A, IFRS 15.IE248A-IE248F]. Also consider the following Illustration:

Illustration 5-17: Entity is both a principal and an agent

A software reseller sells software licences bundled with post-contract support (PCS) and other IT solutions to end-users. The reseller has entered into contracts with several software manufacturers that provide the reseller with the right to sell licences to the software with PCS to end-users during non-cancellable periods of time in exchange for fixed fees per licence sold. The reseller can set the prices it charges end-users, but is contractually required to pay the software manufacturer the fixed fee, regardless of the price paid by end-users. The software reseller does not have a commitment to make a minimum number of purchases from the software manufacturer and does not make purchases in advance.

The software reseller is responsible for identifying which software will address the customer's needs (including the feasibility of integrating it with the customer's existing technology environment), ordering the software from the manufacturer, assisting customers if they encounter issues downloading the software (all software is provided electronically) and with other basic technical support. The software reseller is also responsible for providing refunds or remedies to the customer if the software product is not suitable for the customer's needs. The software manufacturer provides higher levels of technical support and provides PCS directly to the customer.

As part of its principal-versus-agent evaluation for these contracts, the software reseller determines that the software licence and PCS are separate specified goods or services.

When assessing control for the software licence, the reseller concludes that it controls the software licence before the licence is provided to the end-user. This is because the reseller has the right to direct the software manufacturer to provide the software to the end-user on the reseller's behalf, including the right to redirect the software to another end user (consistent with the requirements in paragraph 23.37(b), which are discussed in 5.4.2 below). As part of this assessment, the software reseller also considers the three indicators of control in Section 23 and makes the following determinations that support its overall control evaluation:

- The software reseller is responsible for fulfilling the promise to the customer and the entity takes responsibility for much of the purchasing process, as described above.
- There is no inventory risk associated with the software provided electronically.
- The software reseller has discretion to establish prices.

Conversely, the reseller concludes that it does not control the PCS before it is provided to the end-user because the software manufacturer creates the updates that it delivers electronically to end-users of the software directly through the internet and all but the most basic level of technical support will be provided by the software manufacturer. As part of this assessment, the software reseller also considers the three indicators of control in Section 23 and makes the following determinations that support its overall control evaluation:

- The software manufacturer is responsible for fulfilling the promise to the customer because, in this example, it provides the updates directly to the end-users.
- There is no inventory risk associated with the PCS provided electronically.
- The software reseller has discretion to establish prices.

The software reseller believes that the first of the indicators is the most relevant to consider in this assessment and that it supports its overall control assessment. Therefore, the software reseller concludes that it is the principal for the software licence, but is an agent for the PCS, because it does not control the PCS before it is transferred to the end-user.

How we see it

As discussed above, appropriately identifying the specified good or service to be provided to the customer is a critical step in identifying whether the nature of an entity's promise is to act as a principal or an agent. Entities need to carefully examine their contract terms and might need to apply significant judgement to determine whether the specified good or service is the underlying good or service or a right to obtain that good or service.

5.4.2 Control of the specified good or service

After identifying the specified good or service (see 5.4.1 above), the next step in determining the nature of the entity's promise (i.e., whether it is to provide the specified goods or services or to arrange for those goods or services to be provided by another party) is for the entity to determine whether the entity controls the specified good or service before it is transferred to the customer. An entity cannot provide the specified good or service to a customer (and, therefore, be a principal) unless it controls that good or service prior to its transfer. [FRS 102.23.36, FRS 102.23.37]. That is, control is the determining factor when assessing whether an entity is a principal or an agent.

In assessing whether an entity controls the specified good or service prior to transfer to the customer, an entity considers the definition of control in paragraph 23.80 that is included in Step 5 of the model (discussed further in 8 below). [FRS 102.23.80].

Extract from Section 23

23.80 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining economic benefits that may flow from, the asset.

How we see it

When evaluating the definition of control in paragraph 23.80, we believe it could be helpful for entities to consider the indicators in paragraph 23.85 (see 8.2 below) to help determine the point in time when a customer obtains control of a particular good or service (e.g., legal title, physical possession, risks and rewards of ownership).

If, after evaluating the requirement in paragraph 23.80, an entity concludes that it controls the specified good or service before it is transferred to the customer, the entity is a principal in the transaction. If the entity does not control that good or service before transfer to the customer, it is an agent.

The control principle is often easier to apply to tangible goods than to intangible goods or services because intangible goods or services generally exist only at the moment they are delivered. Therefore, Section 23 includes guidance on how the control principle applies to certain types of arrangements (including service transactions) by explaining what a principal controls before the specified good or service is transferred to the customer: [FRS 102.23.37]

Extract from Section 23

- 23.37** An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. A principal might obtain control of any one of the following:
- (a) a good or another asset from the other party that it then transfers to the customer;
 - (b) a right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf; or
 - (c) a good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.

An entity can control a service to be provided by another party when it controls the right to the specified service that will be provided to the customer. Generally, the entity then either transfers the right (in the form of an asset, such as a ticket) to its customer, in accordance with paragraph 23.37(a) (as in Example 47 in IFRS 15 involving the airline ticket reseller discussed in 5.4.1 above) or uses its right to direct the other party to provide the specified service to the customer on the entity's behalf, in accordance with paragraph 23.37(b) (as in Example 46A in IFRS 15 involving the office maintenance services discussed in 5.4.1 above).

The condition described in paragraph 23.37(a) above includes contracts in which an entity transfers to the customer a right to a future service to be provided by another party. If the specified good or service is a right to a good or service to be provided by another party, the entity evaluates whether it controls the right to the goods or services before that right is transferred to the customer (rather than whether it controls the underlying goods or services). Consider also the observation noted in the Basis for Conclusions on IFRS 15 on this matter, i.e., in assessing such rights, it is often relevant to assess whether the right is created only when it is obtained by the customer or whether the right exists before the customer obtains it. If the right does not exist before the customer obtains it, an entity would not be able to control that right before it is transferred to the customer. [IFRS 15.BC3850].

An entity could consider two examples included in IFRS 15 that illustrate this point. In Example 47 in IFRS 15 (discussed in 5.4.1 above), which involves an airline ticket reseller, the specified good or service is determined to be the right to fly on a specified flight (in the form of a ticket). One of the determining factors for the principal-agent evaluation in this example is that the entity pre-purchases the airline tickets before a specific customer is identified. Accordingly, the right existed prior to a customer obtaining it. The example concludes that the entity controls the right before it is transferred to the customer (and is, therefore, a principal). [IFRS 15.IE Example 47, IFRS 15.IE239-IE243].

In Example 48 in IFRS 15, an entity sells vouchers that entitle customers to future meals at specified restaurants selected by the customer. The specified good or service is determined to be the right to a meal (in the form of a voucher). One of the determining factors for the principal-agent evaluation is that the entity does not control the voucher (the right to a meal) at any time. It does not pre-purchase or commit itself to purchase the vouchers from the restaurants before they are sold to a customer. Instead, the entity waits to purchase the voucher until a customer requests a voucher for a particular restaurant. In addition, vouchers are created only at the time that they are transferred to a customer and do not exist before that transfer. Accordingly, the right does not exist before the customer obtains it. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers. The example concludes that the entity does not control the right before it is transferred to the customer (and is, therefore, an agent). [IFRS 15.IE Example 48, IFRS 15.IE244-IE248].

Consistent with the observation in the Basis for Conclusions on IFRS 15, determining whether an entity is a principal or an agent might be more difficult when evaluating whether a contract falls under paragraph 23.37(b). That is, it might be difficult to determine whether an entity has the ability to direct another party to provide the service on its behalf (and is, therefore, a principal) or is only arranging for the other party to provide the service (and is, therefore, an agent). As depicted in Example 46A in IFRS 15 (as discussed in 5.4.1 above), an entity could control the right to the specified service and be a principal by entering into

a contract with the subcontractor in which the entity defines the scope of service to be performed by the subcontractor on its behalf. This situation is equivalent to the entity fulfilling the contract using its own resources. Furthermore, the entity remains responsible for the satisfactory provision of the specified service in accordance with the contract with the customer. In contrast, when the specified service is provided by another party and the entity does not have the ability to direct those services, the entity typically is an agent because the entity is facilitating, rather than controlling the rights to, the service.

[IFRS 15.BC385V, IFRS 15.IE Example 46A, IFRS 15.IE238A-IE238G].

In accordance with paragraph 23.37(c), if an entity provides a significant service of integrating two or more goods or services into a combined item that is the specified good or service the customer contracted to receive, the entity controls that specified good or service before it is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which can include goods or services from other parties) and directs their use to create the combined item that is the specified good or service. The inputs would be a fulfilment cost to the entity. However, if a third party provides the significant integration service, the entity's customer for its good or services (which would be inputs to the specified good or service) is likely to be the third party.

Accordingly, when an entity assesses whether the entity controls the combined good or service before it is transferred to the end-consumer, it would be helpful to determine the nature and significance of the integration service and whether the entity first controls the inputs to the combined good or service. It might be unclear how an entity could conclude that it is a principal if the integration service is not significant or it does not control the inputs to the combined good or service.

While paragraph 23.37 provides helpful guidance, significant judgement might still be needed to determine whether the entity controls the specified good or service before it is transferred to the customer. For example, in 2021, the IFRS IC received a request regarding the determination of whether a reseller of software licences is a principal or agent. At its April 2022 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide an adequate basis for a reseller to determine this in the submitted fact pattern. Consequently, the IFRS IC decided not to add a standard-setting project to the work plan.

In considering this request, the IFRS IC noted that the assessment of control requires an entity to consider specific facts and circumstances, including the terms and conditions of the contracts between each of the parties involved. If it is unclear whether the entity controls the specified good or service, the entity would consider the indicators in paragraph B37 of IFRS 15 (which is similar to the indicators in paragraph 23.38 of IFRS 102) to assess whether it obtains control. The IFRS IC noted that part of applying judgement in the principal versus agent assessment involves "considering the relevance of the indicators to the assessment of control and the degree to which they provide evidence of control".¹³⁵

The following Illustration is based on the example from the IFRS IC agenda paper used by the IFRS IC when it discussed whether a reseller of software licences is a principal or agent in its April 2022 meeting:¹³⁶

Illustration 5-18: Determination of whether a reseller of software licences is a principal or agent

A reseller of standard software licences has a distribution agreement with a software manufacturer to sell licences to customers. The reseller has discretion in pricing the software licences. The reseller provides pre-sales advice to each customer to identify the type and number of the licences that meet the customer's needs. If the customer decides not to buy software licences, the reseller and the customer do not enter into an agreement, and the customer does not pay anything.

If the customer decides to buy the software licences, the reseller negotiates the selling price with the customer, places an order with the software manufacturer (and pays the manufacturer) and invoices the customer. The software licences are issued in the customer's name via a software portal with an activation key. If the pre-sale advice is incorrect, the customer might not accept the licences. However, the reseller cannot return unaccepted licences to the software manufacturer or sell them to another customer.

Identify the specified goods or services in the contract

The IFRS IC observed that the pre-sales advice the reseller provides is not an implicit promise in the contract. Since the reseller has already provided the advice at the time of entering into the contract with the customer, there is no further advice to be provided by the reseller after the contract inception. Therefore, the specified goods in the contract are the standard software licences as described in IFRS 15.B34A(a) (and in line with the discussion in 5.4.1 above).

¹³⁵ [IFRIC Update](#), April 2022, available on the IFRS Foundation's website.

¹³⁶ [IFRIC Update](#), April 2022, available on the IFRS Foundation's website.

Assess whether the entity controls the specified good before it is transferred to the customer

The reseller assesses whether it obtains control of the standard software licences from the software manufacturer before they are transferred to the customer. After applying paragraphs B35-B35A of OFRS 15 (or paragraph 23.37 of FRS 102), if it is unclear, the reseller considers the indicators in paragraph B37 of IFRS 15 (or paragraph 23.38 of FRS 102). The IFRS IC observed that:

- The software manufacturer is responsible for fulfilling the promise to provide the licences to the customer (IFRS 15.B37(a) or FRS 102.23.38(a)), for example, the software's functionality, issuing and activating the licences.
- The reseller is responsible for fulfilling the promise to provide the licences to the customer (IFRS 15.B37(a) or FRS 102.23.38(a)), for example, engaging with the customer before and after the software licences are provided to the customer and taking unaccepted licences.
- The reseller has no inventory risk before the licences are provided to the customer but then has inventory risk until the customer accepts the licences (IFRS 15.B37(b) or FRS 102.23.38(b)).
- The reseller has discretion in establishing the price for the software licences (IFRS 15.B37(c) or FRS 102.23.38(c)), which might be less relevant if, for example, the market has limited flexibility in establishing the price.

The reseller would apply judgement in making its overall assessment, including considering the relevance of the indicators to the assessment of control and the degree to which they provide evidence of control.

5.4.2.A Principal indicators

After considering the guidance discussed above, it still might not be clear whether an entity controls the specified good or service. Therefore, Section 23 provides three indicators of when an entity controls the specified good or service (and is, therefore, a principal): [FRS 102.23.38]

Extract from Section 23

23.38 Indicators that an entity is a principal include, but are not limited to, the following:

- (a) the entity is primarily responsible for fulfilling the promise to provide the specified good or service;
- (b) the entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (eg if the customer has a right of return); or
- (c) the entity has discretion in establishing the price for the specified good or service.

The principal indicators above are meant to support an entity's assessment of control, not to replace it. Each indicator explains how it supports the assessment of control.

Section 23 refers to the items described above as 'indicators' only. This implies, they do not override the assessment of control, are not meant to be viewed in isolation and do not constitute a separate or additional evaluation. Furthermore, they are not a checklist of criteria to be met or factors to be considered in all scenarios, i.e., considering one or more of the indicators will often be helpful and, depending on the facts and circumstances, individual indicators will be more or less relevant or persuasive to the assessment of control (which is consistent with the IFRS IC's April 2022 discussions – see 5.4.2 above).

If an entity reaches different conclusions about whether it controls the specified good or service by applying Section 23's definition of control versus the principal indicators, the entity re-evaluates its assessment, considering the facts and circumstances of its contract. This is because an entity's conclusions about control and the principal indicators need to align.

5.4.2.B Principal indicators: primarily responsible for fulfilling the promise

The first indicator that an entity is a principal, in paragraph 23.38(a), is that the entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer, which typically includes responsibility for the acceptability of the specified good or service.

How we see it

We believe that one of the reasons that the indicator in paragraph 23.38(a) supports the assessment of control of the specified good or service is because an entity generally controls a specified good or service if it is responsible for transferring control to a customer.

The terms of the contract and representations (written or otherwise) made by an entity during marketing generally provide evidence of which party is responsible for fulfilling the promise to provide the specified good or service and for the acceptability of that good or service.

It is possible that one entity might not be solely responsible for both providing the specified good or service and for the acceptability of that same good or service. For example, a reseller might sell goods or services that are provided to the customer by a supplier. However, if the customer is dissatisfied with the goods or services it receives, the reseller might be solely responsible for providing a remedy to the customer. The reseller might promote such a role during the marketing process or might agree to such a role as claims arise in order to maintain its relationship with its customer. In this situation, both the reseller and the supplier possess characteristics of this indicator. Therefore, it is likely that other indicators will need to be considered to determine which entity is the principal. However, if the reseller is responsible for providing a remedy to a dissatisfied customer but can then pursue a claim against the supplier to recoup any remedies it provides, that might indicate that the reseller is not ultimately responsible for the acceptability of the specified good or service.

5.4.2.C Principal indicators: inventory risk

The second indicator that an entity is a principal, in paragraph 23.38(b), is that the entity has inventory risk (before the specified good or service is transferred to the customer or upon customer return). Inventory risk is the risk normally taken by an entity that acquires inventory in the hope of reselling it at a profit. Inventory risk exists if a reseller obtains (or commits to obtain) the specified good or service before it is ordered by a customer. Inventory risk also exists if a customer has a right of return and the reseller will take back the specified good or service if the customer exercises that right.

This indicator supports the assessment of control of the specified good or service because when an entity obtains (or commits to obtain) the specified good or service before it has contracted with a customer, it is likely that the entity has the ability to direct the use of and obtain substantially all of the remaining benefits from the good or service. For example, inventory risk can exist in a customer arrangement involving the provision of services if an entity is obliged to compensate the individual service provider(s) for work performed, regardless of whether the customer accepts that work. However, this indicator often does not apply to intangible goods or services.

Factors might exist that mitigate a reseller's inventory risk. For example, a reseller's inventory risk might be significantly reduced or eliminated if it has the right to return to the supplier goods it cannot sell or goods that are returned by customers. Another example is if a reseller receives inventory price protection from the supplier. In these cases, the inventory risk indicator might be less relevant or persuasive to the assessment of control.

5.4.2.D Principal indicators: pricing discretion

The third principal indicator, in paragraph 23.38(c), is that the entity has discretion in establishing the price of the specified good or service. Reasonable latitude, within economic constraints, to establish the price with a customer for the product or service might indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits (i.e., the entity controls the specified good or service). However, because an agent might also have discretion in establishing the price of the specified good or service, the facts and circumstances of the transaction need to be carefully evaluated.

5.4.2.E Principal indicators: examples

Illustration 5-19 below shows how an entity might conclude that it is an agent:

Illustration 5-19: Entity is an agent

An entity operates a website that provides a marketplace for customers to purchase goods from a variety of suppliers who deliver the goods directly to the customers. The entity's website facilitates customer payments to suppliers at prices that are set by the suppliers. The entity requires payment from customers before orders are processed and all orders are non-refundable. The entity has no further obligations to the customers after arranging for the products to be provided to them; the entity is not responsible for the acceptability of goods provided to customers.

First, the entity evaluates the specified goods and concludes that there are no other goods or services provided to the customer except for those provided directly by the suppliers. Next, the entity considers whether it controls the specified goods before they are transferred to the customers. Since the entity does not at any time have the ability to direct the use of the goods transferred to the customers, the entity concludes

that it does not control the specified goods before they are transferred. As part of this assessment, the entity considers the three indicators of control in Section 23 and makes the following determinations that support its overall control evaluation:

- The suppliers are responsible for fulfilling the promise to the customer and the entity does not take responsibility for the acceptability of the goods.
- The entity does not have inventory risk because it does not obtain the goods at any time.
- The entity does not have discretion to establish prices because they are set by the suppliers.

The entity concludes that it is an agent for the goods sold through its website because the nature of its performance obligation is to arrange for goods to be provided to the customers.

In contrast, consider the following Illustration of an entity that concludes it is acting as a principal:

Illustration 5-20: Entity is a principal

An entity operates a website that provides a marketplace for customers to purchase digital content. The entity has entered into contracts with suppliers that provide it with the right to sell the digital content during a non-cancellable period of time in exchange for a fixed fee per unit of content. The entity can set the price for the content to be sold to customers on its website. The entity is contractually required to pay the supplier a fixed price or rate for any digital content it sells to its customers and that price or rate is unaffected by the price paid by the end-consumers. The entity is responsible for assisting customers if they encounter issues downloading the content or with the user experience, and customers do not interact with the suppliers.

The entity first evaluates the specified goods and concludes that the digital content is the only specified good or service. Next, the entity considers whether it controls the digital content before it is transferred to the customer. The entity concludes that it controls the specified goods before they are transferred because it has entered into a non-cancellable distribution agreement that permits the entity to sell the digital content to its customers. This conclusion differs from the entity's conclusion in Illustration 5-19 above because that entity provided a platform to connect suppliers to customers and did not have the ability to sell the suppliers' goods. As part of this assessment, the entity also considers the three indicators of control in Section 23 and makes the following determinations that support its overall control evaluation:

- The entity is responsible for fulfilling the promise to the customer and the entity takes responsibility for the acceptability of the digital content.
- There is no inventory risk associated with digital content.
- The entity has discretion to establish prices.

The entity concludes that it is a principal for the digital content sold through its website because it controls the content before it is transferred to the customer.

5.4.3 Recognising revenue as principal or agent

The determination of whether the entity is acting as a principal or an agent affects the amount of revenue the entity recognises. When the entity is the principal in the arrangement, the revenue recognised is the gross amount to which the entity expects to be entitled in exchange for the specified good or service transferred as it satisfies its performance obligation. [FRS 102.23.39]. When the entity is the agent, the performance obligation is to arrange for the specified goods or services to be provided by another party. The revenue recognised upon satisfaction of its performance obligation is the fee or commission to which the agent expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. [FRS 102.23.40]. The agent's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

After an entity determines whether it is the principal or the agent and the amount of gross or net revenue that would be recognised, the entity recognises revenue when or as it satisfies its performance obligation. An entity satisfies its performance obligation by transferring control of the specified good or service underlying the performance obligation, either at a point in time or over time (as discussed in 8 below). That is, a principal would recognise revenue when (or as) it transfers the specified good or service to the customer. An agent would recognise revenue when its performance obligation to arrange for the specified good or service is complete.

It is also worth considering the observations noted in the Basis for Conclusions on IFRS 15 relating to this matter. The IASB noted that, in some contracts in which the entity is the agent, control of specified goods or services promised by the agent might transfer before the customer receives related goods or services from the principal. For example, an entity might satisfy its promise to provide customers with loyalty points when those points are transferred to the customer if:

- The entity's promise is to provide loyalty points to customers when the customer purchases goods or services from the entity.
- The points entitle the customers to future discounted purchases with a third party (i.e., the points represent a material right to a future discount).
- The entity determines that it is an agent (i.e., its promise is to arrange for the customers to be provided with points) and the entity does not control those points (i.e., the specified good or service) before they are transferred to the customer.

In contrast, if the points entitle the customers to future goods or services to be provided by the entity, the entity might conclude it is not an agent. This is because the entity's promise is to provide those future goods or services and, therefore, the entity controls both the points and the future goods or services before they are transferred to the customer. In these cases, the entity's performance obligation might only be satisfied when the future goods or services are provided.

In other cases, the points might entitle customers to choose between future goods or services provided by either the entity or a third party. For example, many airlines allow loyalty programme members to redeem loyalty points for goods or services provided by a partner (e.g., travel on another airline, hotel accommodation). In this situation, the nature of the entity's performance obligation might not be known until the customer makes its choice. That is, until the customer has chosen the goods or services to be provided (and, therefore, whether the entity or the third party will provide those goods or services), the entity is obliged to stand ready to deliver goods or services. Therefore, the entity might not satisfy its performance obligation until it either delivers the goods or services or is no longer obliged to stand ready. If the customer subsequently chooses to receive the goods or services from a third party, the entity would need to consider whether it was acting as an agent and would, therefore, only recognise revenue for a fee or commission that it received for arranging the ultimate transaction between the customer and the third party. [IFRS 15.BC383, IFRS 15.BC384, IFRS 15.BC385].

How we see it

The above discussion illustrates that control of specified goods or services promised by an agent might transfer before the customer receives related goods or services from the principal. An entity needs to assess each loyalty programme in accordance with the principles of the principal versus agent guidance to determine if revenue would be reported on a gross or net basis.

In addition, if an entity that was initially the principal in a transaction transfers to another entity its obligation to provide the specified goods or services to the customer, the entity does not continue to recognise revenue as a principal. Instead, after the transfer of its obligation, the entity evaluates whether it is acting as an agent and would recognise as revenue the net amount of consideration that the entity retains in accordance with paragraph 23.40. This is consistent with the guidance in provided in IFRS 15.B36. [IFRS 15.B38].

5.4.4 Examples of principal versus agent considerations

IFRS 15 and Section 23 have consistent principal versus agent guidance, however Section 23 does not provide examples to illustrate how such guidance might be applied. IFRS 15 includes six examples that illustrate the application of principal versus agent guidance. Refer to the EY publication, International GAAP® for these examples and additional guidance.

Frequently asked questions

Question 5-15: How would an entity determine whether it is a principal or an agent in a transaction for a specified good for which it only takes title momentarily or never has physical possession?

An entity's determination of whether it is a principal or an agent in a transaction for a specified good for which it only takes title momentarily or never has physical possession requires significant judgement and careful consideration of the facts and circumstances. Entities might enter into contracts with third-party vendors (the vendors) to provide goods or services to be sold through their sales channels to their customers. In these arrangements, the entity might take legal title to the good only momentarily before the good is transferred to the customer, such as in scan-based trading or 'flash title' contracts (e.g., vendor is responsible for stocking, rotating and otherwise managing the product until the final point of sale). Alternatively, the entity might never take physical possession or legal title to the good (e.g., 'drop shipment arrangements' when goods are shipped directly from a vendor to the customer). In these situations, the entity needs to carefully evaluate whether it obtains control of the specified good and, therefore, is the principal in the transaction with the end-consumer.

How we see it

When evaluating the control principle and the principal indicators provided in Section 23, we believe some questions an entity might consider when making this judgement could include the questions listed below.

- Does the entity take title to the goods at any point in the order-to-delivery process? If not, why?
- Is the vendor the party that the customer will hold responsible for the acceptability of the product (e.g., handling of complaints and returns)? If so, why?
- Does the entity have a return-to-vendor agreement with the vendor or have a history of returning goods to the vendor after a customer returns the good(s)? If so, why?
- Does the vendor have discretion in establishing the price for the goods (e.g., setting the floor or ceiling)? If so, why?
- Is the vendor responsible for the risk of loss or damage (e.g., shrinkage) while the goods are in the entity's store? If so, why?
- Does the vendor have the contractual right to take back the goods delivered to the entity and, if so, has the vendor exercised that right in situations other than when the goods were at the end of their useful lives?
- Can the entity move goods between their stores or relocate goods within their stores without first obtaining permission from the vendor? If not, why?
- Does the entity have any further obligation to the customer after remitting the customer's order to the vendor? If not, why?
- Once a customer order is placed, can the entity direct the product to another entity or prevent the product from being transferred to the customer? If not, why?

Understanding the business purpose and rationale for the contractual terms between the vendor and the entity might help the entity assess whether it controls the specified goods prior to the transfer to the end-consumer and is, therefore, the principal in the sale to the end-consumer.

Question 5-16: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes) under FRS 102 (i.e., as revenue or as a reduction of costs)?¹³⁷

Section 23 is generally clear that any amounts not collected on behalf of third parties would be included in the transaction price (i.e., revenue). As discussed in 6 below, paragraph 23.41 states that "the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (eg some sales taxes)". Therefore, if the amounts were earned by the entity in fulfilling its performance obligations, the amounts are included in the transaction price and recorded as revenue.

¹³⁷ Based on TRG Agenda paper no. 2, *Gross versus Net Revenue: Amounts Billed to Customers*, dated 18 July 2014 and TRG Agenda paper no. 5, *July 2014 Meeting - Summary of Issues Discussed and Next Steps*, originally dated 31 October 2014, reissued 18 March 2015.

Shipping and handling

The appropriate presentation of amounts billed to customers for shipping and handling activities would depend on whether the entity is a principal or an agent in the shipping arrangement (see Question 11-8 in 11.3 below for further discussion on presentation of shipping and handling costs incurred by the entity).

Expense or cost reimbursements

Many service providers routinely incur incidental expenses, commonly referred to as 'out-of-pocket' expenses, in the course of conducting their normal operations. Those expenses often include, but are not limited to, airfare, other travel-related costs (such as car rentals and hotel accommodation) and telecommunications charges. The entity (i.e., the service provider) and the customer might agree that the customer will reimburse the entity for the actual amount of such expenses incurred. Alternatively, the parties might negotiate a single fixed fee that is intended to compensate the service provider for both professional services rendered and out-of-pocket expenses incurred.

Out-of-pocket expenses are often costs incurred by an entity in fulfilling its performance obligation(s) (i.e., the out-of-pocket expenses are fulfilment costs) and do not transfer a good or service to the customer. In these situations, reimbursement for such costs generally is included in the entity's estimate of the transaction price and recognised as revenue when (or as) the performance obligation(s) is (are) satisfied, even if the entity is reimbursed at 'cost' (i.e., at zero margin). Alternatively, if an entity concludes that the costs *do* transfer a good or service to the customer, it considers the principal-versus-agent guidance when determining whether reimbursement amounts received from its customer need to be recorded on a gross or net basis.

In some cases, it might be appropriate to include the reimbursement in the transaction price and recognise that amount as revenue when the applicable expense is incurred. That is, an entity might not have to estimate out-of-pocket expenses in its determination of the transaction price at contract inception. This could be the case in the following situations:

- The entity is an agent as it relates to the specified good or service identified (see 5.4 above). That is, in cases in which the entity is an agent and the reimbursement is equal to the cost, the net effect on revenue would be zero and, therefore, no estimation would be required.
- The variable consideration is constrained (see 6.2.3 below). That is, if a portion of the transaction price related to reimbursements of out-of-pocket expenses is constrained, an entity would not include an estimate in the transaction price for that amount until it becomes highly probable that the entity will be entitled to the cumulative amount of revenue recognised (see 6.2.3 below), which might be when the underlying out-of-pocket expenses are incurred in some cases. For example, an entity might not be able to make reliable estimates of expenses and the related reimbursements that the entity will be entitled to due to a lack of historical evidence.
- The variable consideration relates specifically to a performance obligation or a distinct good or service in a series and the entity meets the variable consideration exception (see 7.3 below).
- The entity qualifies to apply the 'right to invoice' practical expedient (see 8.1.4.B below).
- The entity applies a 'costs incurred' measure of progress when recognising revenue for over time performance obligations (see 8.1.4 below). That is, if an entity selects a 'costs incurred' method, the timing of the costs being incurred and the revenue recognition associated with those costs would align.

Taxes or other assessments

This would generally require entities to evaluate taxes collected in all jurisdictions in which they operate to determine whether a tax is levied on the entity or the customer. That is, whether the entity is liable for the tax (regardless of whether it can pass that cost onto its customers) or the customer is liable, and the entity would be collecting the tax on behalf of the tax authority. Assume an entity sets the price for a good at £99, which includes an amount equivalent to the sales tax of £9:

- If the tax is levied on the entity (i.e., the entity is liable for the tax), the £9 charged to the customer is because the entity is able to increase its prices to cover the sales tax (its own cost). Therefore, £9 is actually part of the transaction price that the entity earns from the customer in exchange for fulfilling its performance obligation(s). That is, £99 is the transaction price (i.e., revenue) and the entity would recognise an expense of £9 when it is liable for the tax.
- If the tax is levied on the customer (i.e., the entity is collecting the tax on behalf of the tax authority), the transaction price would be £90. This is because the sales tax of £9 is being collected by the entity on behalf of the tax authority. Furthermore, the entity would not incur any costs in respect of the tax, since it is the customer who is liable, rather than the entity.

Also, an entity would generally apply the principal versus agent guidance when it is not clear whether the amounts are collected on behalf of third parties. This could result in amounts billed to a customer being recorded as an offset to costs incurred (i.e., on a net basis). Because sales or similar taxes are an obligation to a tax authority, rather than a good or service promised to a customer, the principal versus agent guidance is applied by analogy and judgement might, therefore, be needed.

Determining whether an entity is a principal (i.e., directly liable for the tax obligation) or an agent (i.e., collecting the tax on behalf of the tax authority) in relation to such taxes will depend on the specific facts and circumstances, including the intention and underlying characteristics of the tax in the particular jurisdiction. The basis on which the tax is calculated might be informative (e.g., the sales price, units sold or consumed, units produced, imported or exported). However, the measurement point will not, in and of itself, determine the economic nature of the tax. Tax authorities might simply utilise a basis that is at a convenient point in the process and is easy to verify.

One or more of the following indicators might indicate that the entity is the principal in relation to taxes and other assessments remitted to governmental authorities:

- *The entity is primarily responsible for fulfilling the tax obligation* - Entities might be responsible for a particular tax assessment regardless of whether they choose to seek full or partial reimbursement of that assessment through billings to their customers. In other jurisdictions, the customer could be responsible for payment of sales taxes even though the tax authority in that jurisdiction might require the entity to collect the tax from the customer and remit the entire amount to the tax authority. In that context, the customer might be responsible for remitting the tax to the appropriate authority if the entity does not collect the tax.
- *The entity has latitude with respect to the amount charged to the customer* - If the entity is able to make its own decision about whether and how it recovers the tax from its customers, it might be the principal. For example, entities that are required to collect sales tax from customers are required to do so at the amount owed to the tax authority and remit that amount to the tax authority, while other entities make their own decision about whether and how they recover the costs from their customers.
- *The amount retained by the entity is not fixed* - If the entity is required to remit what it collects from the customer and its retention is fixed (at zero), it might indicate it is an agent. Conversely, the entity might be a principal if its margins on the tax are not fixed and the selling price represents a business decision about the price that customers are willing to pay for the goods or services.
- *The entity has credit risk* - An entity would have credit risk if it is solely responsible for payment of the full tax or other assessment amount, regardless of whether it collects any amounts it has billed to its customers.

In addition to the above indicators, while it might vary depending on the nature of the sales (or similar) tax, it might not be clear whether those amounts represent consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer. That is, the amount billed to the customer in respect of the tax might not relate to the entity's performance in satisfying a performance obligation. This might be evident in circumstances when the price of the good or service varies among jurisdictions by the statutorily mandated tax. For example, when a good is sold over the internet, a sales tax amount is added (or not added) at time of checkout based on where the customer resides. In addition, in some jurisdictions, certain types of entities might not be required to pay sales tax for certain products, while other types of entities are required to pay sales tax for the same products. Since the price variation in those examples is entirely attributable to the tax (not to any incremental performance), one might conclude that the tax amount should not be part of the transaction price (i.e., excluded from revenue).

Question 5-17: How does an entity allocate the transaction price in a contract with multiple performance obligations in which the entity acts as both a principal and an agent?

See response to Question 7-8 in 7.2 below.

5.5 Consignment arrangements

Section 23 provides specific guidance for a promise to deliver goods on a consignment basis to other parties. See 8.4 below.

5.6 Customer options for additional goods or services

Many sales contracts give customers the option to acquire additional goods or services. These additional goods or services might be priced at a discount or might even be free of charge. [FRS 102.23.31]. Options to acquire additional goods or services at a discount can come in many forms, including sales incentives, volume-tiered pricing structures, customer award credits (e.g., frequent flyer points) or contract renewal options (e.g., waiver of certain fees, reduced future rates). [FRS 102.23.32]. See the Questions that follow this section, which discuss many of these different types of customer options.

When an entity grants a customer the option to acquire additional goods or services, that option is only a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract. [FRS 102.23.31]. For example, granting a customer the option to acquire additional goods or services at a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market would represent an option that provides a material right to the customer. See Question 5-22 below for further discussion on the evaluation of class of customer.

If the option provides a material right to the customer, the customer has, in effect, paid the entity in advance for future goods or services. As such, the entity recognises revenue when those future goods or services are transferred or when the option expires. [FRS 102.23.33]. Effectively, an entity is required to identify and account for options that customers are paying for (often implicitly) as part of the current transaction. See 7.1.5 below for a discussion of the measurement of customer options that are separate performance obligations.

Section 23 does not provide any further guidance as to what constitutes a 'material' right. However, Section 23 requires that an option to purchase additional goods or services at a price that would reflect their stand-alone selling prices does not provide a material right to the customer and does not give rise to a separate performance obligation. [FRS 102.23.31]. Instead, this is treated as a marketing offer. This is the case even if the customer has obtained the option only as a result of entering into a previous contract. It follows that an entity that has made a marketing offer accounts for it only when the customer exercises the option to purchase the additional goods or services.

However, an option to purchase additional goods or services in the future at the current stand-alone selling price could be a material right if prices are highly likely to significantly increase. This could also be the case if a renewal option at the current stand-alone selling price is offered for an extended period of time and the stand-alone selling price for the product is highly likely to significantly increase, depending on the facts and circumstances of the contract. This is because the customer is being offered a discount on future goods or services compared to what others will have to pay in the future as a result of entering into the previous contract.

How we see it

Significant judgement might be required to determine whether a customer option represents a material right. This determination is important because it affects the accounting and disclosures for the contract at inception and throughout the life of the contract.

Section 23's requirements for accounting for customer options for additional goods or services are aligned with the requirements in IFRS 15. However, unlike IFRS 15, Section 23 does not provide examples to illustrate how such guidance might be applied.

Illustration 5-21 below, which is based on Example 49 in IFRS 15, illustrates the determination of whether an option represents a material right (see 7.1.5 below for a discussion of the measurement of options that are separate performance obligations): [IFRS 15.IE Example 49, IFRS 15.IE250-IE253]

Illustration 5-21: Option that provides the customer with a material right (discount voucher)

An entity enters into a contract for the sale of Product A for £100. As part of the contract, the entity gives the customer a 40% discount voucher for any future purchases up to £100 in the next 30 days. The entity intends to offer a 10% discount on all sales during the next 30 days as part of a seasonal promotion. The 10% discount cannot be used in addition to the 40% discount voucher.

Because all customers will receive a 10% discount on purchases during the next 30 days, the only discount that provides the customer with a material right is the discount that is incremental to that 10% (i.e., the additional 30% discount). The entity accounts for the promise to provide the incremental discount as a performance obligation in the contract for the sale of Product A.

To estimate the stand-alone selling price of the discount voucher in accordance with paragraph 23.71 (see 7.1.5 below), the entity estimates an 80% likelihood that a customer will redeem the voucher and that a customer will, on average, purchase £50 of additional products. Consequently, the entity's estimated stand-alone selling price of the discount voucher is £12 (£50 average purchase price of additional products × 30% incremental discount × 80% likelihood of exercising the option). The stand-alone selling prices of Product A and the discount voucher and the resulting allocation of the £100 transaction price are as follows:

Performance obligations	Stand-alone selling price	
		£
Product A	100	
Discount voucher	12	
Total	112	
	Allocated transaction price	
Product A	89	(£100 ÷ £112 × £100)
Discount voucher	11	(£12 ÷ £112 × £100)
Total	100	

The entity allocates £89 to Product A and recognises revenue for Product A when control transfers. The entity allocates £11 to the discount voucher and recognises revenue for the voucher when the customer redeems it for goods or services or when it expires.

Evaluating whether an option provides a material right might be more complex when the stand-alone selling price of the good or service is highly variable, as illustrated below:

Illustration 5-22: Evaluating a customer option when the stand-alone selling price is highly variable

A technology entity enters into a contract with a customer for a perpetual licence of a software, with one year of post-contract support (PCS). The contract also includes an option to purchase additional licences of the software at 40% off the list price.

The entity does not sell the software separately, but it sells PCS separately in the form of renewals that are consistently priced at 20% of the net licence fee. Assume that the technology entity uses the residual method to estimate the stand-alone selling price of the perpetual licence for the software (see 7.1.2 below). Also assume that the price the technology entity charges for the bundle of the perpetual licence and PCS is highly variable. That is because the price the technology entity charges to customers in the same class and same market as the customer who have not made prior purchases ranges from the list price to a discounted price of up to 70% off the list price for the bundle. Assume that the entity has appropriately stratified its contracts/customers to evaluate the range of discounts and has a sufficient amount of transactions to support that this is the range of discounts it offers.

Since the 40% discount the technology entity offered to the customer is within the range of discounts it typically offers to customers in the same class as the customer, the technology entity concludes that this option does not represent a material right.

While the customer option is determined not to be a material right in this example, that might not always be the case. An entity would need to evaluate all customer options, even those for which the price of the good or service that is subject to the option is highly variable and for which the residual approach was used.

Frequently asked questions

Question 5-18: Would entities consider only the current transaction or would they consider past and future transactions with the same customer when determining whether an option for additional goods or services provides the customer with a material right?¹³⁸

Entities would generally consider all relevant transactions with a customer (i.e., current, past and future transactions), including those that provide accumulating incentives, such as loyalty programmes, when determining whether an option represents a material right. That is, the evaluation is not solely performed in relation to the current transaction.

Question 5-19: Is the material right evaluation solely a quantitative evaluation or does the evaluation also consider qualitative factors?¹³⁹

The evaluation generally considers both quantitative and qualitative factors that would be known to the entity (e.g., what a new customer would pay for the same service, the availability and pricing of competitors' service alternatives, whether the average customer life indicates that the fee provides an incentive for customers to remain beyond the stated contract term, whether the right accumulates). This is because a customer's perspective on what constitutes a 'material right' might consider qualitative factors. This is consistent with the notion that when identifying promised goods or services in Step 2, an entity considers reasonable expectations of the customer that the entity will transfer a good or service to it (see 5.1 above).

Question 5-20: How would an entity distinguish between a contract that contains an option to purchase additional goods or services and a contract that includes variable consideration (see 6.2 below) based on a variable quantity (e.g., a usage-based fee)?¹⁴⁰

Entities have found it challenging to distinguish between a contract that includes customer options to purchase additional goods or services and one that includes variable consideration based on a variable quantity (e.g., a usage-based fee). This is because, under both types of contracts, the ultimate quantity of goods or services to be transferred to the customer is often unknown at contract inception. This determination generally requires judgement and consideration of the facts and circumstances.

This determination is important because it affects the accounting for the contract at inception and throughout the life of the contract, as well as disclosures. If an entity concludes that a customer option for additional goods or services provides a material right, the option itself is deemed to be a performance obligation in the contract, but the underlying goods or services are not accounted for until the option is exercised (as discussed below in Question 5-21 below). As a result, the entity is required to allocate a portion of the transaction price to the material right at contract inception and to recognise that revenue when or as the option is exercised or the option expires. If an entity, instead, concludes that an option for additional goods or services is not a material right, there is no accounting for the option and no accounting for the underlying optional goods or services until those subsequent purchases occur.

However, if the contract includes variable consideration (rather than a customer option), an entity has to estimate at contract inception the variable consideration expected over the life of the contract and update that estimate each reporting period (subject to the constraint on variable consideration) (see 6.2 below). There are also more disclosures required for variable consideration (e.g., the requirement to disclose the remaining transaction price for unsatisfied performance obligations) (see 11.4.1.D below) than for options that are not determined to be material rights.

The first step (in determining whether a contract involving variable quantities of goods or services are accounted for as a contract containing customer options or variable consideration) is for the entity to determine the nature of its promise in providing goods or services to the customer and the rights and obligations of each party.

In a contract in which the variable quantity of goods or services results in variable consideration, the nature of the entity's promise is to transfer to the customer an overall service. In providing this overall service, an entity might perform individual tasks or activities. At contract inception, the entity is presently obliged by the terms and conditions of the contract to transfer all promised goods or services

¹³⁸ Based on TRG Agenda paper no. 6, *Customer options for additional goods and services and non-refundable upfront fees*, dated 31 October 2014, and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

¹³⁹ Based on TRG Agenda paper no. 6, *Customer options for additional goods and services and non-refundable upfront fees*, dated 31 October 2014, and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

¹⁴⁰ Based on TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

provided under the contract and the customer is obliged to pay for those promised goods or services. This is because the customer entered into a contract that obliges the entity to transfer those goods or services. The customer's subsequent actions to utilise the service affect the measurement of revenue (in the form of variable consideration), but do not oblige the entity to provide additional distinct goods or services beyond those promised in the contract.

For example, consider a contract between a transaction processor and a customer in which the processor will process all of the customer's transactions in exchange for a fee paid for each transaction processed. The ultimate quantity of transactions that will be processed is not known. The nature of the entity's promise is to provide the customer with continuous access to the processing platform so that submitted transactions are processed. By entering into the contract, the customer has made a purchasing decision that obliges the entity to provide continuous access to the transaction processing platform. The consideration paid by the customer results from events (i.e., additional transactions being submitted for processing to the processor) that occur after (or as) the entity transfers the payment processing service. The customer's actions do not oblige the processor to provide additional distinct goods or services because the processor is already obliged (starting at contract inception) to process all transactions submitted to it.

Another example of contracts that might include variable consideration relates to certain IT outsourcing contracts. Under this type of contract (similar to the transaction processing contract, discussed above), the entity provides continuous delivery of a service over the contract term and the amount of service provided is variable.

Illustration 5-23: Variable consideration (IT outsourcing arrangement)

An entity enters into a 10-year IT outsourcing arrangement with a customer in which it provides continuous delivery of outsourced activities over the contract term. The entity provides server capacity, manages the customer's software portfolio and runs an IT help desk. The total monthly invoice is calculated based on the units consumed for each activity. For example, the billings might be based on millions of instructions per second of computing power, the number of software applications used or the number of employees supported. The price per unit differs for each type of activity.

At contract inception, it is unknown how many outsourced activities the entity will perform for the customer throughout the life of the contract. The question that arises is whether the customer makes optional purchases when it sends activities to the entity to be performed or whether its use of the service affects the measurement of revenue (in the form of variable consideration).

It is likely that this contract contains variable consideration because of the nature of the entity's promise. The customer is paying for the entity to stand ready to perform in an outsourcing capacity on any given day. The customer does not make a separate purchasing decision each time it sends a unit for processing. Instead, the customer made its purchasing decision when it entered into the outsourcing contract with the entity. Therefore, the customer's actions to use the service also do not oblige the entity to provide any additional distinct goods or services.

In contrast, when an entity provides a customer option, the nature of its promise is to provide the quantity of goods or services specified in the contract, if any, and a right for the customer to choose the amount of additional distinct goods or services the customer will purchase. That is, the entity is not obliged to provide any additional distinct goods or services until the customer exercises the option. The customer has a contractual right that allows it to choose the amount of additional distinct goods or services to purchase, but the customer has to make a separate purchasing decision to obtain those additional distinct goods or services. Prior to the customer's exercise of that right, the entity is not obliged to provide (nor does it have a right to consideration for transferring) those goods or services.

Since an option that is a marketing offer is considered a new contract if it is exercised, an analogy to the contract modification requirements in paragraphs 23.15 to 23.16 (see 4.4 above) could be helpful when an entity is distinguishing between optional purchases and variable consideration. For a modification to be considered a separate contract, one of the criteria is that the modification results in the addition of promised goods or services that are distinct. Similarly, the exercise of a customer option would typically result in the addition of promised goods or services that are distinct.

The following Illustration is an example of a contract that includes a customer option (rather than variable consideration).

Illustration 5-24: Customer option that is not a material right

Entity B enters into a contract to provide 100 widgets to Customer Y in return for consideration of £10 per widget. Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at the stand-alone selling price of £10 per widget. Therefore, the quantity that might be purchased by Customer Y is variable.

While the quantity of widgets that might be purchased is variable, the transaction price for the existing contract is fixed at £1,000 [100 widgets x £10 per widget].

That is, the transaction price only includes the consideration for the 100 widgets specified in the contract and the customer's decision to purchase additional widgets is an option. While Entity B might be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option. In this example, the option is accounted for as a separate contract because there is no material right, since the pricing of the option is at the stand-alone selling price of the widgets.

Contrast the above Illustration with another contract that includes a customer option that is determined to be a material right:

Illustration 5-25: Customer option that is a material right

Entity B enters into a contract to provide 100 widgets to Customer Y at £10 per widget (which is the widget's stand-alone selling price at contract inception). Each widget is a distinct good transferred at a point in time. The contract also gives Customer Y the right to purchase additional widgets at £9 per widget. Therefore, the quantity that might be purchased by Customer Y is variable.

While the quantity of widgets that might be purchased is variable, the transaction price for the existing contract is fixed at £1,000 [100 widgets x £10 per widget]. That is, the transaction price only includes the consideration for the 100 widgets specified in the contract, and the customer's decision to purchase additional widgets is an option. While Entity B might be required to deliver additional widgets in the future, Entity B is not legally obligated to provide the additional widgets until Customer Y exercises the option.

Entity B determines that Customer Y obtained a discount on future widgets because £9 per widget is lower than the stand-alone selling price of each widget at contract inception (i.e., £10 per widget), as well as being lower than the expected stand-alone selling price at renewal. In this example, the option is accounted for as a material right.

The following Illustration is an example of a contract in which the variable quantity of goods or services includes a customer option:

Illustration 5-26: Customer option

A supplier enters into a five-year master supply arrangement in which the supplier is obliged to produce and sell parts to a customer at the customer's request. That is, the supplier is not obliged to transfer any parts until the customer submits a purchase order. In addition, the customer is not obliged to purchase any parts; however, it is highly likely it will do so because the part is required to manufacture the customer's product and it is not practical to obtain parts from multiple suppliers. Each part is determined to be a distinct good that transfers to the customer at a point in time.

The nature of the promise in this example is the delivery of parts (and not a service of standing ready to produce and sell parts). That is, the contract provides the customer with a right to choose the quantity of additional distinct goods (i.e., it provides a customer option), rather than a right to use the services for which control to the customer has (or is currently being) transferred (such as in the transaction processor example above). Similarly, the supplier is not obliged to transfer any parts until the customer submits the purchase order (another important factor in distinguishing a customer option from variable consideration). In contrast, in certain other fact patterns, the supplier is obliged to make the promised services available to the customer without any additional decisions made by the customer.

The above example can be contrasted with other contracts that might include a stand-ready obligation (e.g., a customer's use of a health club). When the customer submits a purchase order under the master supply arrangement, it is contracting for a specific number of distinct goods, which creates new performance obligations for the supplier. In contrast, a customer using services in a health club is using services that the health club is already obliged to provide under the present contract. That is, there are no new obligations arising from the customer's usage.

The following Illustration is an example of a contract in which the variable quantity of goods or services results in variable consideration:

Illustration 5-27: Variable consideration (variable quantities of goods or services)

Entity A enters into a contract to provide equipment to Customer X. The equipment is a single performance obligation transferred at a point in time. Entity A charges Customer X based on its usage of the equipment at a fixed rate per unit of consumption. The contract has no minimum payment guarantees. Customer X is not contractually obliged to use the equipment. However, Entity A is contractually obliged to transfer the equipment to Customer X.

The usage of the equipment by Customer X is a variable quantity that affects the amount of consideration owed to Entity A. It does not affect Entity A's performance obligation, which is to transfer the piece of equipment. That is, Entity A has performed by transferring the distinct good. Customer X's actions, which result in payment to Entity A, occur after the equipment has been transferred and do not require Entity A to provide additional goods or services.

Question 5-21: When, if ever, would an entity consider the goods or services underlying a customer option as a separate performance obligation?¹⁴¹

Generally, an entity does not need to identify the additional goods or services underlying the option as promised goods or services (or performance obligations) if there are no contractual penalties (e.g., termination fees, monetary penalties for not meeting contractual minimums), even if it believes that it is virtually certain that a customer will exercise its option for additional goods or services. Only the option is assessed to determine whether it represents a material right (and accounted for as a performance obligation). As a result, any consideration that would be received in return for optional goods or services is not included in the transaction price at contract inception. The following Illustration is an example of a contract in which it is virtually certain that a customer will exercise its option for additional goods or services:

Illustration 5-28: Customer option with no contractual penalties

An entity sells equipment and consumables, both of which are determined to be distinct goods that are recognised at a point in time. The stand-alone selling price of the equipment and each consumable is £10,000 and £100, respectively. The equipment costs £8,000 and each consumable costs £60. The entity sells the equipment for £6,000 (i.e., at a 40% discount on its stand-alone selling price) with a customer option to purchase each consumable for £100 (i.e., equal to its stand-alone selling price). There are no contractual minimums, but the entity estimates the customer will purchase 200 parts over the next two years. This is an exclusive contract in which the customer cannot purchase the consumables from any other vendors during the contract term.

Generally, the consumables underlying each option would not be considered part of the contract. Furthermore, the option does not represent a material right because it is priced at the stand-alone selling price for the consumable. This is the case even though the customer is compelled to exercise its option for the consumables because the equipment cannot function without the consumables and the contract includes an exclusivity clause that requires the customer to acquire the consumables only from the entity. Accordingly, the transaction price is £6,000 and it is entirely attributable to the equipment. This would result in a loss for the entity of £2,000 when it transfers control of the equipment to the customer.

However, contractual minimums might represent fixed consideration in a contract, even if the contract also contains optional purchases. For example, an MSA might set minimum purchase quantities that the entity is obliged to provide, but any quantities above the minimum might require the customer to make a separate purchasing decision (i.e., exercise a customer option). If contractual penalties exist (e.g., termination fees, monetary penalties assessed) for not meeting contractual minimums, it might be appropriate to include some or all of the goods or services underlying customer options as part of the contract at inception. This is because the penalty effectively creates a minimum purchase obligation for the goods or services that would be purchased if the penalty were enforced.

Illustration 5-29: Customer option with contractual penalties

Consider the same facts as in Illustration 5-28 above, except that the customer will incur a penalty if it does not purchase at least 200 consumables. That is, the customer will be required to repay some or all of the £4,000 discount provided on the equipment. Per the contract terms, the penalty decreases as each consumable is purchased at a rate of £20 per consumable.

The penalty is substantive and it effectively creates a minimum purchase obligation. As a result, the entity concludes that the minimum number of consumables required to avoid the penalty would be evidence of enforceable rights and obligations. The entity would then calculate the transaction price as £26,000 [(200 consumables x £100/consumable) + £6,000 (the selling price of the equipment)]. Furthermore, if the customer failed to purchase 200 consumables, the entity accounts for the resulting penalty as a contract modification.

Question 5-22: How does an entity consider the class of customer when evaluating whether a customer option is a material right?¹⁴²

Generally, an entity considers 'class of customer' when determining whether a customer option to acquire additional goods or services represents a material right. When making this evaluation, they agreed that an entity first determines whether the customer option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar customer independent of a prior contract with the entity? If the pricing is independent, the option is considered a marketing offer and there is no material right. Also, it is likely that the determination will require an entity to exercise significant judgement and consider all facts and circumstances. In addition, a volume rebate or discount that is provided prospectively to all customers within a class of customers might also provide a material right. See Question 5-23 below for additional discussion.

Paragraph 23.31 states that when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right that the customer would not receive without entering into the contract. [FRS 102.23.31]. This is consistent with IFRS 15, however, IFRS 15 provided an example i.e., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that region or market. [IFRS 15.B40]. Furthermore, paragraph 23.33 states that an option to purchase additional goods or services at their stand-alone selling prices does not provide a material right and does not give rise to a separate performance obligation. [FRS 102.23.31]. This is also consistent with IFRS 15, and IFRS 15 clarifies that in such cases, the entity has instead made a marketing offer. [IFRS 15.B41].

These requirements are intended to make clear that a customer option to acquire additional goods or services would not give rise to a material right if a customer could execute a separate contract to obtain the goods or services at the same price. That is, customer options that would exist independently of an existing contract with a customer do not constitute performance obligations in that existing contract.

The following Illustration provides an application of the above discussion:

Illustration 5-30: Class of customer evaluation

Retailer owns and operates several electronic stores and currently provides customers who purchase a 50-inch television with a coupon for 50% off the purchase of a stereo system. The coupon must be redeemed at one of Retailer's stores and is valid for one year. Retailer has never offered a discount of this magnitude to a customer that does not purchase a television (or another item of similar value).

Customer A purchases a 50-inch television from Retailer. At the time of purchase, Customer A receives a coupon for 50% off a stereo system. In evaluating whether the 50% discount provided to Customer A exists independently of its existing contract to purchase a television, Retailer needs to compare the discount offered to Customer A (50%) with the discount typically offered to other customers independent of a prior contract (purchase) with Retailer. For customers that do not purchase a 50-inch television, the only promotion Retailer is running on the stereo system is offering a 5% off coupon to all customers walking into the store. It would not be appropriate for Retailer to compare the discount offered to Customer A with a discount offered to another customer that also purchased a 50-inch television. This is because the objective of the requirements in paragraphs 23.31 to 23.33 is to determine whether a customer option exists independently of an existing contract with a customer.

Retailer determines that the discount offered to Customer A is not comparable to the discount typically offered to customers without a prior contract (purchase). Rather, Customer A is receiving an incremental discount that it would not have received had it not entered into a contract to purchase a 50-inch television. The incremental discount provided to Customer A represents a material right.

Question 5-23: Are volume rebates and/or discounts on goods or services accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?**How we see it**

We believe the appropriate accounting for volume rebates and/or discounts depends on whether the rebate or discount programme is applied retrospectively (variable consideration) or prospectively (a customer option).

¹⁴¹ Based on TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

¹⁴² Based on FASB TRG Agenda paper no. 54, *Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right*, dated 18 April 2016.

Generally, if a volume rebate or discount is applied prospectively, we believe the rebate or discount would be accounted for as a customer option (not variable consideration). This is because the consideration for the goods or services in the present contract is not contingent upon or affected by any future purchases. Rather, the discounts available from the rebate programme affect the price of future purchases. Entities need to evaluate whether the volume rebate or discount provides the customer with an option to purchase goods or services in the future at a discount that represents a material right (and is, therefore, accounted for as a performance obligation) (see Question 5-24 below). In addition, a volume rebate or discount that is provided prospectively to all customers within a class of customer might also provide a material right. The fact that other customers receive the same volume rebate or discount is not relevant to the assessment if those customers similarly must first make purchases at a higher price in order to receive a right to discount on purchases in the future. That is, consistent with the guidance in Question 5-24 below, an entity does not compare discounts given to other customers who receive a similar volume-based discount. Rather, the entity must evaluate whether the option exists independently of an existing contract with the customer.

However, we believe a volume rebate or discount that is applied retrospectively is accounted for as variable consideration (see 6.2 below). This is because the final price of each good or service sold depends upon the customer's total purchases that are subject to the rebate programme. That is, the consideration is contingent upon the occurrence or non-occurrence of future events. This view is consistent with Illustration 6-1 in 6.2.1 below).

Entities must keep in mind that they need to evaluate whether contract terms, other than those specific to the rebate or discount programme, create variable consideration that needs to be separately evaluated (e.g., if the goods subject to the rebate programme are also sold with a right of return).

Question 5-24: How does an entity consider whether prospective volume discounts determined to be customer options are material rights?¹⁴³

In making this evaluation, similar to the discussion in Question 5-22 and Question 5-23 above, an entity would first evaluate whether the option exists independently of the existing contract. That is, would the entity offer the same pricing to a similar high-volume customer independent of a prior contract with the entity? If yes, it indicates that the volume discount is not a material right, as it is not incremental to the discount typically offered to a similar high-volume customer. If the entity typically charges a higher price to a similar customer, it might indicate that the volume discount is a material right as the discount is incremental.

Consider the following Illustration:

Illustration 5-31: Volume discounts

Entity enters into a long-term master supply arrangement with Customer A to provide an unspecified volume of non-customised parts. The price of the parts in subsequent years is dependent upon Customer A's purchases in the current year. That is, Entity charges Customer A £1.00 per part in year one and if Customer A purchases more than 100,000 parts, the year two price will be £0.90 per part.

When determining whether the contract between Entity and Customer A includes a material right, Entity first evaluates whether the option provided to Customer A exists independently of the existing contract. To do this, Entity compares the discount offered to Customer A with the discount typically offered to a similar high-volume customer that receives a discount independent of a prior contract with Entity. Such a similar customer could be Customer B who places a single order with Entity for 105,000 parts. Comparing the price offered to Customer A in year two with offers to other customers that also receive pricing that is contingent on prior purchases would not help Entity determine whether Customer A would have been offered the year two price had it not entered into the original contract.

Volume discounts or tiered pricing can make an entity's assessment of whether a customer option to purchase additional goods or services is a material right more complex. It is likely that this assessment will require significant judgement, as illustrated below:

¹⁴³ Based on FASB TRG Agenda paper no. 54, *Considering Class of Customer When Evaluating Whether a Customer Option Gives Rise to a Material Right*, dated 18 April 2016.

Illustration 5-32: Evaluating a customer option with volume discounts

Semi-conductor Entity S sells microchips for use in cell phones. The entity executes a contract with a customer to sell one million units of microchip M for £0.50 each (or £500,000). The contract provides the right for the customer to purchase an additional 200,000 microchips for £0.40 each.

The entity concludes that it has provided the customer with an option to purchase the additional microchips since the entity is not obligated to provide the additional goods until the customer makes a purchasing decision. Furthermore, the volume discount is applied prospectively and does not affect the transaction price in the original contract.

Scenario A

For microchip M, Semi-conductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first one million microchips at £0.50 each, the second million at £0.40 each and any additional amounts at £0.35 each.

Semi-conductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount it typically offers to a similar high-volume customer that receives a discount without having had a prior contract. In other words, the entity compares the pricing in this contract to the pricing it typically offers to customers that purchase between one million and two million units of microchip M without having made any prior purchases.

The entity has sold, and continues to sell, the same volume of microchip M at the same price to other customers in the same class of customer who have not made prior purchases (i.e., similar customers pay £0.50 each for the first one million microchips and £0.40 each for the second million). That is, the price offered to the customer in the option exists independently of the existing contract. Therefore, Semi-conductor Entity S concludes that it has not provided the customer with a material right.

Scenario B

For microchip M, Semi-conductor Entity S provides volume discounts as part of its standard pricing practices and typically prices the first three million microchips at £0.50 each and any additional amounts at £0.30 each.

Semi-conductor Entity S considers whether the option provides the customer with a material right. To make this evaluation, the entity compares the discount offered in this option with the discount it typically offers to a similar high-volume customer that receives a discount without having had a prior contract.

For similar high-volume customers of the same customer class who have not made prior purchases, the entity typically does not provide this pricing (e.g., similar customers would pay £0.50 per microchip for all of the 1.2 million microchips). Therefore, the entity concludes that it has provided the customer with a material right.

Question 5-25: How would an entity consider whether a renewal option is a material right?

An entity assesses whether a renewal option represents a material right in the same manner as other customer options discussed above. That is, an entity would determine whether the customer renewal option would be offered at the same price to a similar class of customer, independent of a prior contract with the entity. Customer renewal options might be explicitly included in the original contract or, as discussed in 6.8 below, the existence of a non-refundable upfront fee might indicate that the contract includes a renewal option for future goods or services (e.g., if the customer renews the contract without the payment of an additional upfront fee).

As discussed above, paragraph 23.31 specifies that if a customer has the option to purchase additional goods or services (e.g., by exercising a renewal option) at a price that would reflect the stand-alone selling prices of those goods or services, the renewal option would not provide a material right and does not give rise to a separate performance obligation. [FRS 102.23.31]. Determining the stand-alone selling price of a renewal option might require significant judgement. For example, a renewal option offered at the current stand-alone selling price might or might not be determined to be a material right. That is, if the pricing for the goods and services are expected to remain stable, it would be appropriate for a renewal option offered at a current stand-alone selling price to be considered a marketing offer. In contrast, a renewal option at the current stand-alone selling price could be a material right if, for example, prices are highly likely to significantly increase or the renewal option is offered for an extended period of time.

Illustration 7-5 in 7.1.5 below describes the accounting for a renewal option that is a material right. That example also includes guidance on how to allocate a portion of the transaction price to the material right, which is further discussed in 7.1.5 below.

Question 5-26: How would an entity consider whether a loyalty or reward programme is a material right?

Entities frequently offer loyalty or reward programmes under which customers accumulate points that they can redeem for 'free' or discounted products or services. Under paragraphs 23.31 to 23.33, an entity typically concludes that such a loyalty or reward programme provides a material right to customers that they would not receive without entering into a contract. This is because the customer effectively pays in advance for the right to obtain a future good or service (e.g., travel, upgrades, products) or a discount on that good or service.

This is also consistent with the discussion in Questions 5-18 and 5-19 above, that entities need to consider all relevant transactions with a customer (i.e., current, past and future transactions) and both quantitative and qualitative factors, including those that provide accumulating incentives, when determining whether an option represents a material right. Illustration 8-16 in 8.9 below) illustrates the accounting for a loyalty programme.

Question 5-27: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?¹⁴⁴

Generally, it is reasonable for an entity to account for the exercise of a material right as either a contract modification or as a continuation of the existing contract (i.e., a change in the transaction price). It is not generally considered appropriate to account for the exercise of a material right as variable consideration.

Under the approach that treats the exercise of a material right as a contract modification (i.e., because there is a change in the scope and/or price of a contract), an entity follows the contract modification requirements in paragraphs 23.13 to 23.16 (see 4.4 above).

Under the second approach, which treats the exercise of a material right as a continuation of the existing contract (i.e., because the customer decided to purchase additional goods or services contemplated in the original contract), an entity would update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise, in accordance with the requirements for changes in the transaction price included in paragraphs 23.75 to 23.77 – see 7.4 below.

Under these requirements, changes in the total transaction price are generally allocated to the separate performance obligations on the same basis as the initial allocation. However, unlike Section 23, IFRS 15 provides further guidance and specifies criteria which an entity could consider when allocating changes in transaction price under the second approach. Under IFRS 15.89, an entity allocates a change in the transaction price entirely to one or more, but not all, performance obligations if the criteria in paragraph 85 of IFRS 15 are met. [IFRS 15.89]. These criteria are that the additional consideration specifically relates to the entity's efforts to satisfy the performance obligation(s) and that allocating the additional consideration entirely to one or more, but not all, performance obligation(s) is consistent with IFRS 15's allocation objective (which is consistent with the overall revenue recognition and allocation objective of Section 23 – see 7 below). The additional consideration received for the exercise of the option is likely to meet the criteria to be allocated directly to the performance obligation(s) underlying the material right. Revenue would be recognised when (or as) the performance obligation(s) is (are) satisfied. [IFRS 15.85].

Consider the following Illustration:

Illustration 5-33: Exercise of a material right under the requirements for changes in the transaction price

Entity enters into a contract with Customer to provide two years of Service A for £100 and includes an option for Customer to purchase two years of Service B for £300. The stand-alone selling prices of Services A and B are £100 and £400, respectively. Entity concludes that the option represents a material right and its estimate of the stand-alone selling price of the option is £33. Entity allocates the £100 transaction price to each performance obligation as follows:

	Transaction price	Stand-alone selling price	%	Allocation
Service A		£100	75%	£75
Option		£33	25%	£25
Totals	£100	£133	100%	£100

Upon executing the contract, Customer pays £100 and Entity begins transferring Service A to Customer. The consideration of £75 that is allocated to Service A is recognised over the two-year service period. The consideration of £25 that is allocated to the option is deferred until Service B is transferred to the customer or the option expires.

Six months after executing the contract, Customer exercises the option to purchase two years of Service B for £300. Following the requirements for changes in the transaction price, the consideration of £300 related to Service B is added to the amount previously allocated to the option to purchase Service B (i.e., £300 + £25 = £325). This is recognised as revenue over the two-year period in which Service B is transferred. Entity is able to allocate the additional consideration received for the exercise of the option to Service B because it specifically relates to Entity's efforts to satisfy the performance obligation and the allocation in this manner is consistent with Section 23's overall revenue recognition objective (see 7 and 7.3 below).

Since more than one approach would be acceptable, an entity needs to consider which approach is most appropriate, based on the facts and circumstances, and consistently apply that approach to similar contracts.

Question 5-28: Is an entity required to evaluate whether a customer option that provides a material right includes any effects of time value of money? If so, how would entities perform this evaluation?

Generally, an entity has to evaluate whether a material right includes effect of time value of money (see 6.5 below) in the same way that it evaluates for any other performance obligation. This evaluation requires judgement and consideration of the facts and circumstances.¹⁴⁵

Accordingly, the requirement relating to adjustment and recognition of the effects of time of value of money, including the policy choice as discussed in 6.5 below, applies to customer option that provides a material right.

Question 5-29: How would revenue be recognised for customer options for additional goods or services that represent a material right but do not have an expiration date (i.e., can an entity recognise breakage for these options)?

Paragraph 23.33 states that an entity recognises revenue allocated to options that are material rights when the future goods or services resulting from the option are transferred or when the option expires. [FRS 102.23.33]. However, in some cases, options might be perpetual and not have an expiration date. For example, loyalty points likely provide a material right to a customer and, sometimes, these points do not expire.

How we see it

We believe an entity might apply the requirements in Section 23 on customers' unexercised rights (or breakage), which are discussed in 8.9 below (i.e., paragraphs 23.129 to 23.130) to customer options that represent a material right but do not have an expiry date. That is, we believe it is appropriate for revenue allocated to a customer option that does not expire to be recognised at the earlier of when the future goods or services, resulting from the option, are transferred or, if the goods or services are not transferred, when the likelihood of the customer exercising the option becomes remote.

5.7 Sale of products with a right of return

An entity might provide its customers with a right to return a transferred product. A right of return might be contractual, an implicit right that exists due to the entity's customary business practice or a combination of both (e.g., an entity has a stated return period, but generally accepts returns over a longer period). A customer exercising its right to return a product might receive a full or partial refund, a credit that can be applied to amounts owed, a different product in exchange or any combination of these items. [FRS 102.23.51].

¹⁴⁴ Based on TRG Agenda paper no. 32, *Accounting for a Customer's Exercise of a Material Right*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

¹⁴⁵ Based on TRG Agenda paper no. 32, *Accounting for a Customer's Exercise of a Material Right*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

Offering a right of return in a sales agreement obliges the selling entity to stand ready to accept any returned product during the return period. As clarified in IFRS 15 such an obligation to stand ready to accept a returned product does not represent a performance obligation in addition to the obligation to provide a refund. [IFRS 15.B22]. Instead, the IASB concluded that an entity makes an uncertain number of sales when it provides goods with a return right. That is, until the right of return expires, the entity is not certain how many sales will fail. Therefore, the IASB concluded that an entity does not recognise revenue for sales that are expected to fail as a result of the customer exercising its right to return the goods. [IFRS 15.BC364]. Instead, the potential for customer returns needs to be considered when an entity estimates the transaction price because potential returns are a component of variable consideration. [FRS 102.23.51-23.57]. This concept is discussed further in 6.4 below.

Paragraph 23.52 clarifies that exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one colour or size for another) are not considered returns for the purposes of applying Section 23. [FRS 102.23.52]. Furthermore, contracts in which a customer might return a defective product in exchange for a functioning product need to be evaluated in accordance with the requirements on warranties included in Section 23. [FRS 102.23.57]. See further discussion on warranties in 10.1 below.

6 Step 3 – Determine the transaction price

When (or as) an entity satisfies a performance obligation, it recognises revenue at the amount of the transaction price (which excludes constrained estimates of variable consideration – see 6.2.3 below) that is allocated to that performance obligation.

Section 23 provides the following requirements for determining the transaction price: [FRS 102.23.41, FRS 102.23.42]

Extract from Section 23

- 23.41** An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which the entity expects to be entitled in exchange for transferring goods or services promised to a customer, excluding amounts collected on behalf of third parties (eg some sales taxes).
- 23.42** For the purposes of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer in accordance with the existing contract and that the contract will not be cancelled, modified or renewed.

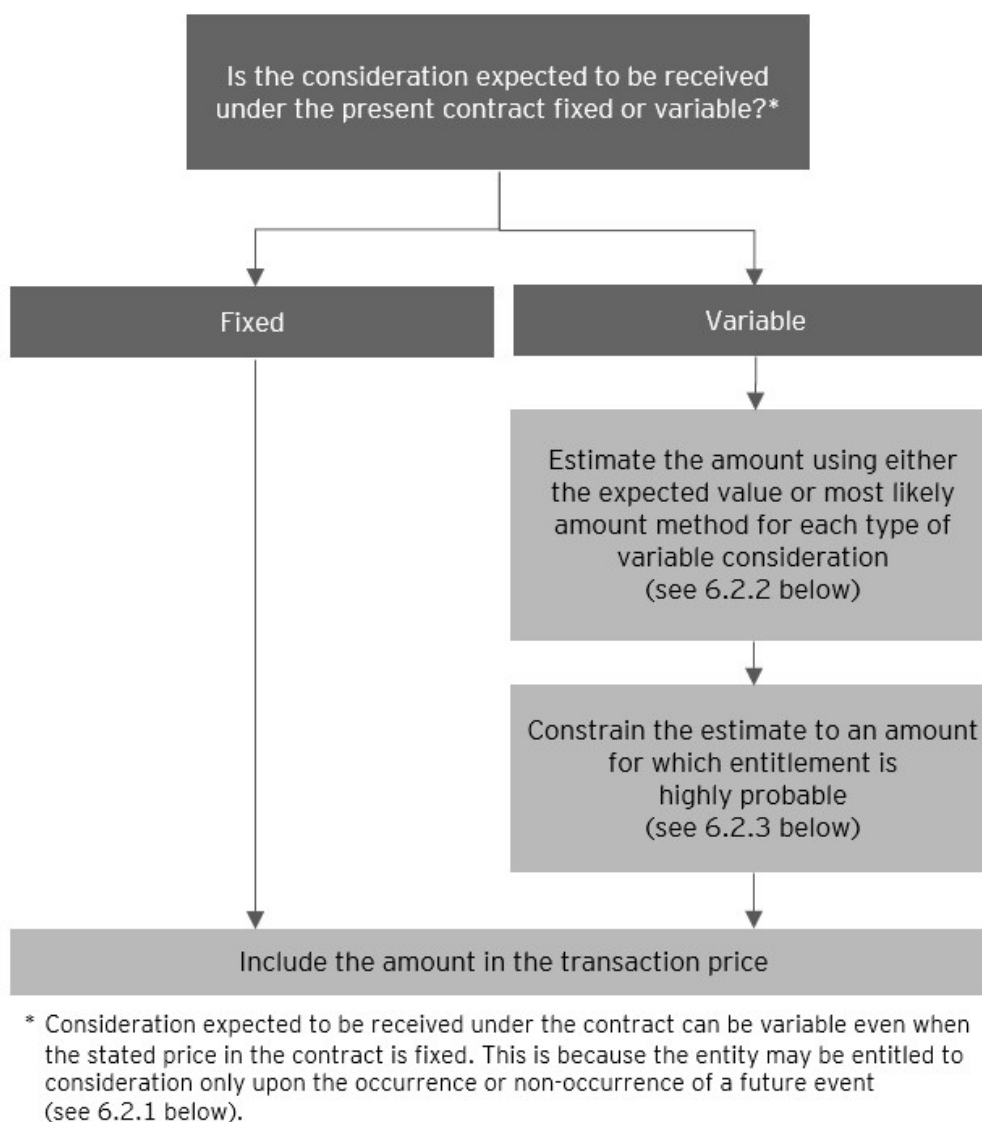
The transaction price is based on the amount to which the entity expects to be 'entitled'. This is meant to reflect the amount to which the entity has rights under the present contract (see 4.2 above on contract enforceability and termination clauses). That is, the transaction price does not include estimates of consideration resulting from future change orders for additional goods or services. The amount to which the entity expects to be entitled also excludes amounts collected on behalf of another party, such as sales taxes. It is also worth noting that in the Basis for Conclusions on IFRS 15, the IASB decided that the transaction price would not include the effects of the customer's credit risk, unless the contract includes a significant financing component (see 6.5 below). [IFRS 15.BC185].

Entities might have rights under the present contract to amounts that are to be paid by parties other than the customer and, if so, these amounts would be included in the transaction price. For example, in the healthcare industry, an entity might be entitled under the present contract to payments from the patient, insurance companies and/or government organisations. Similarly, an entity might also receive a payment from a manufacturer, as a result of the manufacturer issuing coupons or rebates directly to the entity's customer. If that is the case, the total amount to which the entity expects to be entitled needs to be included in the transaction price, regardless of the source. Note that this is consistent with the clarification in the Basis for Conclusions on IFRS 15. [IFRS 15.BC187].

Determining the transaction price is an important step in applying Section 23 because this amount is allocated to the identified performance obligations and is recognised as revenue when (or as) those performance obligations are satisfied. In many cases, the transaction price is readily determinable because the entity receives payment when it transfers promised goods or services and the price is fixed (e.g., a restaurant's sale of food with a no refund policy). Determining the transaction price is more challenging when the consideration is variable, when payment is received at a time that differs from when the entity provides the promised goods or services or when payment is in a form other than cash. Consideration paid or payable by the entity to the customer might also affect the determination of the transaction price.

Figure 6-1 illustrates how an entity would determine the transaction price if the consideration to be received is fixed or variable:

Figure 6-1: Fixed versus variable consideration



Frequently asked questions

Question 6-1: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes under the revenue standards (i.e., as revenue or as a reduction of costs)?

See response to Question 5-16 in 5.4.4 above.

6.1 Presentation of sales (and other similar) taxes

Various types of taxes based on the production, use, consumption or sale of goods and services are common in many jurisdictions (e.g., taxes levied on tobacco, alcohol, gasoline, sugar). Sales and excise taxes are those levied by taxing authorities on the sales of goods or services. Although various names are used for these taxes, sales taxes generally refer to taxes levied on the purchasers of the goods or services and excise taxes refer to those levied on the sellers of goods or services. Significant variations exist in how these taxes are calculated and administered and the regulations might differ significantly from one country to another. In some cases, these taxes are collected by an entity from a customer on behalf of the tax authorities while, in other cases, the entity is directly liable for the tax obligation.

Section 23 includes a general principle that an entity determines the transaction price exclusive of amounts collected on behalf of third parties (e.g., some sales taxes). [FRS 102.23.41]. However, in practice, there could be multiple interpretations regarding whether certain items that are billed to customers need to be presented as revenue or as a reduction of costs. Examples of such amounts include shipping and handling fees, reimbursements of out-of-pocket expenses and taxes or other assessments collected and remitted to government authorities. See Question 5-16 in 5.4.4 above.

6.2 Variable consideration

The transaction price reflects an entity's expectations about the consideration to which it will be entitled to receive from the customer. Section 23 provides the following requirements for determining whether consideration is variable and, if so, how it would be treated under the model: *[FRS 102.23.43]*

Extract from Section 23

23.43 If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer. If the consideration promised in a contract includes a variable amount (eg because of some discounts, rebates, refunds, penalties or performance bonuses), an entity shall estimate the variable amount in the transaction price that reflects the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer, determined in accordance with paragraphs 23.44 to 23.50.

The requirements on variable consideration are discussed in more detail below.

6.2.1 Forms of variable consideration

As described in 6.2 above, 'variable consideration' broadly includes discounts, rebates, refunds, penalties and performance bonuses (e.g., meeting specified performance conditions where there is uncertainty about the outcome). *[FRS 102.23.43]*. The examples in IFRS 15 also include price concessions, credits and other incentives given to entity's customer. *[IFRS 15.51]*. Variable consideration can result from explicit terms in a contract to which the parties to the contract agreed or can be implied by an entity's past business practices or intentions under the contract. It is important for entities to appropriately identify the different instances of variable consideration included in a contract because the second step of estimating variable consideration requires entities to apply a constraint (as discussed further in 6.2.3 below) to all variable consideration.

Consideration can be variable even when the stated price in the contract is fixed. This is because the entity might be entitled to consideration only upon the occurrence or non-occurrence of a future event. For example, Section 23's description of variable consideration includes amounts resulting from variability due to customer refunds or returns. As a result, a contract to provide a customer with 100 widgets at a fixed price per widget would be considered to include a variable component if the customer has the right to return the widgets (see 6.2 below).

In many transactions, entities have variable consideration as a result of rebates and/or discounts on the price of products or services they provide to customers once the customers meet specific volume thresholds. Illustration 6-1 below, which is based on Example 24 in IFRS 15, is an example relating to volume discounts: *[IFRS 15.IE Example 24, IFRS 15.IE124-IE128]*

Illustration 6-1: Volume discount incentive

An entity enters into a contract with a customer on 1 January 20X6 to sell Product A for £100 per unit. If the customer purchases more than 1,000 units of Product A in a calendar year, the contract specifies that the price per unit is retrospectively reduced to £90 per unit. Consequently, the consideration in the contract is variable.

For the first quarter ended 31 March 20X6, the entity sells 75 units of Product A to the customer. The entity estimates that the customer's purchases will not exceed the 1,000-unit threshold required for the volume discount in the calendar year.

The entity considers the requirements in paragraph 23.46 on constraining estimates of variable consideration (see 6.2.3 below). The entity determines that it has significant experience with this product and with the purchasing pattern of the entity. Thus, the entity concludes that it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised (i.e., £100 per unit) when the uncertainty is resolved (i.e., when the total amount of purchases is known). Consequently, the entity recognises revenue of £7,500 (75 units × £100 per unit) for the quarter ended 31 March 20X6.

In May 20X6, the entity's customer acquires another company and in the second quarter ended 30 June 20X6 the entity sells an additional 500 units of Product A to the customer. In the light of the new fact, the entity estimates that the customer's purchases will exceed the 1,000-unit threshold for the calendar year and therefore it will be required to retrospectively reduce the price per unit to £90.

Consequently, the entity recognises revenue of £44,250 for the quarter ended 30 June 20X6. That amount is calculated from £45,000 for the sale of 500 units (500 units × £90 per unit) less the change in transaction price of £750 (75 units × £10 price reduction) for the reduction of revenue relating to units sold for the quarter ended 31 March 20X6 (see FRS 102.23.75-23.76 - see 7.4 below).

How we see it

Section 23 requires an entity to disclose significant payment terms (including whether the consideration amount is variable). Section 8 requires additional disclosures about an entity's key sources of estimation uncertainties and use of significant judgements. This might include any significant judgements used in determining the transaction price such as information about methods, inputs and assumptions used to estimate variable consideration and assess whether the estimate is constrained.

As a result, entities might need to explain the different forms of variable consideration included in their contracts with customers. Entities, therefore, need to carefully consider and identify all forms of variable consideration when they determine the transaction price for their customer contracts and review their disclosures to verify that they meet the disclosure requirements in Section 23 and Section 8 (see 11.4 below for further discussion of disclosure requirements).

Frequently asked questions

Question 6-2: Are volume rebates and/or discounts on goods or services accounted for as variable consideration or as customer options to acquire additional goods or services at a discount?

See response to Question 5-23 in 5.6 above.

Question 6-3: How would an entity distinguish between a contract that contains an option to purchase additional goods or services and a contract that includes variable consideration based on a variable quantity (e.g., a usage-based fee)?

See response to Question 5-20 in 5.6 above.

Question 6-4: Are liquidated damages, penalties or compensation from other similar clauses accounted for as variable consideration or as warranties under Section 23?

How we see it

Most liquidated damages, penalties and similar payments are accounted for as variable consideration. However, in limited situations, we believe that amounts that are based on the actual performance of a delivered good or service could be considered similar to warranty payments (e.g., in situations in which an entity pays the customer's direct costs to remedy a defect).

Some contracts provide for liquidated damages, penalties or other damages if an entity fails to deliver future goods or services or if the goods or services fail to meet certain specifications. Section 23 includes 'penalties' as an example of variable consideration. [FRS 102.23.43]. That is, a promised consideration in a contract can be variable if the right to receive the consideration is contingent on the occurrence or non-occurrence of a future event (e.g., the contract specifies that an entity pays a penalty if it fails to perform according to the agreed upon terms).

Penalties and other clauses that are considered similar to warranty provisions would be accounted for as:

(a) Consideration paid or payable to a customer (which might be variable consideration, see 6.7 below)

Or

(b) An assurance-type or service-type warranty (see 10.1 below on warranties)

Cash fines or penalties paid to a customer would generally be accounted for under the requirements on consideration payable to a customer. However, we believe there might be situations in which it is appropriate to account for cash payments to a customer as an assurance-type warranty (e.g., an entity's direct reimbursement to the customer for costs paid by the customer to a third party for repair of a product).

Question 6-5: If a contract includes an undefined quantity of outputs, but the contractual rate per unit is fixed, is the consideration variable?¹⁴⁶

Generally, if a contract includes an unknown quantity of tasks, throughout the contract period, for which the entity has enforceable rights and obligations (i.e., the unknown quantity of tasks is not an option to purchase additional goods or services, as described in Question 5-20 in 5.6 above) and the consideration received is contingent upon the quantity completed, the total transaction price would be variable. This is because the contract has a range of possible transaction prices and the ultimate consideration depends on the occurrence or non-occurrence of a future event (e.g., customer usage), even though the rate per unit is fixed.

¹⁴⁶ Based on TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

An entity would need to consider contractual minimums (or other clauses) that would make some or all of the consideration fixed.

Question 6-6: If a contract is denominated in a currency other than that of the entity's functional currency, would changes in the contract price due to exchange rate fluctuations be accounted for as variable consideration?

Changes to the contract price due to exchange rate fluctuations are a consequence of entering into a contract that is denominated in a foreign currency.

How we see it

The variability resulting from changes in foreign exchange rates relates to the form of the consideration (i.e., it is in a currency other than the entity's functional currency), rather than as a result of a contractual term like a discount or rebate or one that depends on the occurrence or non-occurrence of a future event. As such, we believe that it would not be considered variable consideration when determining the transaction price.

Such variability might, instead, need to be accounted for in accordance with Section 12 if it is a separable embedded derivative. Otherwise, an entity would account for this variability in accordance with Section 30 *Foreign Currency Translation*.

Also, when consideration denominated in a foreign currency is recognised in advance of the associated revenue, an entity could conclude that the appropriate application of Section 30 is to measure the revenue using the exchange rate at the date the advanced receipt is recognised, normally the payment date. This is consistent with the guidance in IFRIC 22 *Foreign Currency Transactions and Advance Consideration* on determining the date of the transaction for the purpose of determining the exchange rate to use in translating deposits or progress payments where these deposits or progress payments are recognised as non-monetary items (see Chapter 32 at 3.4.10). [FRS 102.10.6, IFRIC 22.8].

Question 6-7: How would an entity account for price protection or price matching clauses included in a contract with a customer?

How we see it

Consideration subject to price protection or price matching clauses that require an entity to refund a portion of the consideration to the customer in certain situations must be accounted for as variable consideration under Section 23. That is, we believe that, if an entity is required to retrospectively apply lower prices to previous purchases made by a customer (or has a past business practice of doing so, even if the contractual terms would only require prospective application), the consideration would be accounted for as variable consideration.

Examples include contracts between an entity and a customer that provide, either as a matter of formal agreement or due to an entity's business practices, that the entity will refund or provide a credit equal to a portion of the original purchase price towards future purchases if the entity subsequently reduces its price for a previously delivered product and the customer still has inventory of that product on hand. An entity might also offer to match a competitor's price and provide a refund of the difference, if the customer finds the same product offered by one of the entity's competitors for a lower price during a specified period of time following the sale.

Contracts with customers also might contain 'most favoured nation' or 'most favoured customer' clauses under which the entity guarantees that the price of any products sold to the customer after contract inception will be the lowest price the entity offers to any other customer. How consideration from such contracts would be accounted for under Section 23 depends on the terms of the clause (i.e., whether the price protection is offered prospectively or retrospectively).

How we see it

We believe that clauses that require an entity to prospectively provide a customer with its best prices on any purchases of products after the execution of a contract have no effect on the revenue recognised for goods or services already transferred to the customer (i.e., the consideration would not be accounted for as variable consideration).

However, if an entity is required to retrospectively apply lower prices to previous purchases made by a customer (or has a past business practice of doing so even if the written contractual terms would only require prospective application), we believe the contract includes a form of price protection and the consideration subject to this provision would be accounted for as variable consideration, as discussed above.

We note that these clauses might be present in arrangements with governmental agencies. For example, an entity might be required to monitor discounts given to comparable customers during the contract period and to refund the difference between what was paid by the government and the price granted to comparable commercial customers.

Question 6-8: Do early payment (or prompt payment) discounts represent a form of variable consideration?

Contracts with customers might include a discount for early payment (or 'prompt payment' discount) under which the customer can pay less than an invoice's stated amount if the payment is made within a certain period of time. For example, a customer might receive a 2% discount if the payment is made within 15 days of receipt (if payment is otherwise due within 45 days of receipt).

How we see it

Because the amount of consideration to be received by the entity would vary depending on whether the customer takes advantage of the discount, we believe the transaction price is variable.

Question 6-9: How does an entity account for a dispute related to a contract accounted for in accordance with Section 23 that might result in consideration received or receivable from a customer?

A dispute related to a contract accounted for in accordance with Section 23 might result in consideration received or receivable from a customer. Disputes might involve third-party arbitration or litigation proceedings, or they might not (e.g., a resolution negotiated only between the entity and the customer).

For settlements (or potential settlements) received or receivable from a customer, an entity needs to apply judgement to determine the appropriate accounting based on a thorough analysis of facts and circumstances. For example, if the entity receives (or expects to receive) consideration from its customer as part of a settlement related to a contract accounted for in accordance with Section 23, the payment might represent variable consideration to which the entity is entitled based on its performance under that contract. The requirements for estimating and constraining variable consideration in Section 23 would apply.

An entity will also need to determine whether the settlement with the customer represents a contract modification, (see 4.4 above, including Question 4-13). This would be the case if the settlement results in a change in the scope and/or price of a contract that either creates new or changes existing enforceable rights and obligations of the parties. Judgement might also be required to distinguish between a contract modification and a change in the estimated transaction price due to variable consideration, as discussed in Question 4-15 in 4.4 above.

If a dispute arises, but the payment or anticipated payment was not contemplated in the original contract and the settlement does not yet represent a contract modification, the requirements for contingent assets in Section 21 (see Chapter 24) might apply until there is a contract modification under Section 23.

For settlements (or potential settlements) from litigation or disputes that result in consideration paid or payable to a customer, please see response to Question 6-26 in 6.7.2 below.

6.2.1.A Implicit price concessions

Section 23 requires an entity to consider not only the terms of the contract, but also its customary business practices to determine the transaction price. [FRS 102.23.41].

For some contracts, the stated price has easily identifiable variable components. However, for other contracts, the consideration might be variable because the facts and circumstances indicate that the entity might accept a lower price than the amount stated in the contract (i.e., it expects to provide an implicit price concession). This could be a result of the customer having a valid expectation that the entity will reduce its price based on the entity's customary business practices, published policies or statements made by the entity.

An implicit price concession could also result from other facts and circumstances indicating that the entity intended to offer a price concession to the customer when it entered into the contract. For example, an entity might accept a lower price than the amount stated in the contract to develop or enhance a customer relationship or because the incremental cost of providing the service to the customer is not significant and the consideration it expects to collect provides a sufficient margin.

An entity deducts from its contract price any estimated price concessions to derive the transaction price at contract inception (i.e., the amount the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer). The Section 23 collectability assessment is then performed on the transaction price (see 4.1.5 above). An entity also has to assess any contract assets or trade receivables arising from a Section 23 contract under the credit loss model in Section 11 (see Chapter 13).

Illustration 6-2 below, which is based on Example 2 in IFRS 15, is an example of when an implicit price concession exists and, as a result, the transaction price is not the amount stated in the contract: [IFRS 15.IE Example 2, IFRS 15.IE7-IE9]

Illustration 6-2: Consideration is not the stated price - implicit price concession

Example 2-Consideration is not the stated price - implicit price concession

An entity sells 1,000 units of a prescription drug to a customer for promised consideration of £1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

When assessing whether the criterion in paragraph 23.7(e) of FRS 102 is met (see 4.1.5 above), the entity also considers paragraph 23.41 (and could also consider IFRS 15.52(b)). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not £1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to £400,000.

The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty, it is probable that it will collect £400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 23.7(e) is met based on an estimate of variable consideration of £400,000. In addition, on the basis of an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 23.7 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the requirements in Section 23.

Variable consideration might also result where payment terms in a contract are deferred beyond normal business terms and any resulting uncertainty about whether the entity will be willing to accept a lower payment amount in the future. That is, an entity has to evaluate whether such payment terms represent an implied price concession because the entity does not intend to collect all amounts due in future periods. Offering payment terms beyond the normal business terms constitutes a financing transaction (see 6.5 below).

6.2.1.B Variable consideration versus credit risk

As discussed in 4.1.5 above, entities need to determine at contract inception whether they expect to collect a lower amount of consideration than the amount stated in the contract. In some cases, it might be difficult to determine whether the entity has implicitly offered a price concession (i.e., variable consideration) or whether the entity has chosen to accept the risk of the customer defaulting on the contractually agreed consideration (i.e., impairment losses under Section 11, see Chapter 13). Section 23 does not have guidance to assist in distinguishing between price concessions (recognised as variable consideration, within revenue) and a credit loss to be accounted for as an impairment loss under Section 11 (i.e., outside of revenue). Therefore, entities need to consider all relevant facts and circumstances when analysing situations in which an entity is willing to accept a lower price than the amount stated in the contract.

How we see it

We believe the following factors might suggest that the entity has implicitly offered a price concession to the customer:

- The entity has an established business practice that indicates it is willing to accept consideration less than its contractually stated prices. For example, an entity routinely accepts reduced payments on services for which it earns high margins, indicating that it is willing to accept an amount of consideration that is less than the contract price.
- The entity has a history of not enforcing its contractual rights to promised consideration in similar contracts under similar circumstances such that customers expect the entity to offer price concessions. For example, the customer has a valid expectation that the entity is willing to accept a lower amount of consideration than the contractually stated price based on its past experience with the entity.
- The entity is willing to enter into a contract with a customer even though facts and circumstances indicate that the customer intends to pay an amount of consideration that is less than the contractually stated price. For example, the entity willingly enters into a contract expecting that it will receive less than the stated contract price, implicitly reducing the transaction price to the expected lesser consideration.

Appropriately distinguishing between price concessions (i.e., reductions of revenue) and customer credit risk (i.e., impairment loss) for collectability concerns, that were known at contract inception, is also important because it affects whether a valid contract exists (see 4.1.5 above). If an entity determines at contract inception that a contract includes a price concession (i.e., variable consideration), the estimated amount of the concession is reflected in the transaction price (i.e., as a reduction of the stated contract price). As shown in Illustration 6-2 in 6.2.1.A above, entities might estimate a transaction price that is significantly lower than the stated invoice or contractual amount, but still consider the difference between those amounts to be variable consideration (e.g., a price concession), rather than a collectability issue that would result in credit losses.

After the entity has determined the amount to assess for collectability under paragraph 23.7(e), it also has to apply the requirements in Section 11 to account for any credit losses for the receivable (or contract asset) that is recorded (i.e., after consideration of any variable consideration, such as an implicit price concession). Also, it presents any resulting impairment loss as an expense under Section 11 (i.e., not as a reduction of the transaction price). This is illustrated in Illustration 4-3 included in Question 4-4 in 4.1.5.B above.

After contract inception, entities need to update both their estimate of variable consideration under Section 23 (see 6.2.4 below) and their assessment of credit losses under Section 11, respectively, at the end of each reporting period. When the amount an entity expects to collect changes after contract inception, the entity might need to exercise significant judgement to determine whether that change is due to: (1) a change in estimate of the variable consideration identified at contract inception (and, therefore, would be accounted for as a change in the transaction price, as discussed in 7.4 below); or (2) an identifiable credit event (e.g., a known or expected decline in a customer's operations, a known or expected bankruptcy filing or other financial reorganisation or the request for a concession on payment terms due to economic reasons) that would trigger a credit loss to be accounted for as an impairment loss under Section 11 (i.e., outside revenue). It is likely that this determination will require entities to establish policies to differentiate between price concessions and customer credit events, both at contract inception and as facts and circumstances change over the life of the contract. Such assessments could, for example, be needed during a pandemic or following a natural disaster because customers' ability and intent to pay might be affected and/or entities might be more willing to accept partial payment or extended payment terms. Importantly, if the parties need to change the terms of contracts with existing customers as a result, entities need to determine whether there is a contract modification (see 4.4 above).

When making this evaluation, the entity needs to consider the facts and circumstances that led to its change in expectation about the amount it expects to collect. For example, if an entity that had contemplated an implicit price concession at contract inception decides to increase the amount of the concession it is willing to provide to further enhance the relationship with its customer, it might conclude that this is variable consideration. Therefore, it would be a reduction of the transaction price, i.e., revenue. In contrast, if the entity determines it will collect less consideration than it originally estimated due to its customer filing for bankruptcy, it is likely the entity would conclude that this is an impairment loss to be accounted for outside of Section 23 (i.e., there would be no adjustment to revenue).

An entity might also need to make the following assessments when evaluating changes in expectations about the amount it expects to collect after contract inception:

- Reassess collectability of the remaining contract consideration if the entity concludes that the change in expectation is due to a significant change in facts and circumstances (see Question 4-5 in 4.1.5.B above).
- Consider whether the change in expectation is due to a contract modification. A contract modification is defined in Section 23 as “a change in the scope or price (or both) of a contract that is approved by the parties to the contract”. [FRS 102.23.13]. See 4.4 above for further discussion on contract modifications.
- Consider whether the change in expectation indicates that the entity needs to assess related capitalised costs to obtain or fulfil a contract for impairment (see 10.3 below).

How we see it

Determining, at contract inception, whether an entity has implicitly offered a price concession (i.e., variable consideration) or whether it has accepted the risk that a customer might default on the contractually agreed-upon consideration (i.e., impairment losses) might require significant judgement. The entity needs to consider its specific facts and circumstances, including its customary business practices and any other indicators about whether it intended at contract inception to offer a price concession to the customer.

Entities might also need to apply judgement when determining whether a change in the amount it expects to collect after contract inception is due to a change in an estimate of variable consideration (and, therefore, needs to be accounted for as change in transaction price) or due to a change in customer's credit risks that would be accounted for as impairment loss.

6.2.2 Estimating variable consideration

If a contract with a customer includes variable consideration, paragraph 23.43 (see 6.2 above) states that “an entity shall estimate the variable amount in the transaction price that reflects the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer”. Entities are generally required to estimate variable consideration at contract inception and at the end of each reporting period (see 6.2.4 below for reassessment requirements). In Question 6-10 below, we discuss limited situations in which the estimation of variable consideration might not be required.

Variable consideration generally needs to be estimated, instead of waiting for the variable consideration to be received or known with a high degree of certainty (e.g., upon receipt of a report from a customer detailing the amount of revenue due to the entity). For example, it would not be acceptable for entities that sell their products through distributors or resellers to wait until the end-sale has occurred if the only uncertainty is the variability in the pricing. This is because Section 23 requires an entity to estimate the variable consideration (the end-sales price in our example) based on the information available, taking into consideration the effect of the constraint on variable consideration (see 6.2.3 below), unless one of the limited situations discussed in Question 6-10 below occurs.

An entity is required to first estimate variable consideration using either the ‘expected value’ or the ‘most likely amount’ method, as described in Section 23: [FRS 102.23.44, FRS 102.23.45]

Extract from Section 23

- 23.44** An entity shall first estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:
- (a) The expected value - the expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
 - (b) The most likely amount - the most likely amount is the single most likely amount in a range of possible consideration amounts (ie the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (eg an entity either achieves a performance bonus or does not).

23.45 An entity shall apply one method consistently throughout the contract when estimating the amount of variable consideration. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for the goods or services promised to the customer.

An entity is required to choose between the expected value method and the most likely amount method, selecting the method which better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a 'free choice'. Rather, an entity must select the method that is best suited, based on the specific facts and circumstances of the contract. [FRS 102.23.44].

A contract might contain different types of variable consideration. As such, it might be appropriate for an entity to use different methods (i.e., expected value or most likely amount) for estimating different types of variable consideration within a single contract. However, an entity applies the selected method consistently to each type of variable consideration throughout the contract term and updates the estimated variable consideration at the end of each reporting period. [FRS 102.23.45]. Once it selects a method, an entity is required to apply that method consistently for similar types of variable consideration in similar types of contracts. [FRS 102.23.5].

Entities determine the expected value of variable consideration using the sum of probability-weighted amounts in a range of possible amounts under the contract. To do this, an entity identifies the possible outcomes of a contract and the probabilities of those outcomes. Accordingly, the expected value method is likely to better predict expected consideration when an entity has a large number of contracts with similar characteristics. [FRS 102.23.44(a)]. This method might also better predict consideration when an entity has a single contract with a large number of possible outcomes. Under IFRS 15, the IASB clarified that an entity preparing an expected value calculation is not required to consider all possible outcomes, even if the entity has extensive data and can identify many possible outcomes. Instead, the IASB noted in the Basis for Conclusions on IFRS 15 that, in many cases, a limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value. [IFRS 15.BC201].

Illustration 6-3: Estimating the transaction price using the expected value method

Entity A enters into contracts with customers to construct commercial buildings. The contracts include similar terms and conditions and contain a fixed fee plus variable consideration for a performance bonus related to the timing of Entity A's completion of the construction. Based on Entity A's historical experience, the expected bonus amounts and associated probabilities for achieving each bonus are, as follows:

Bonus amount	Probability of outcome
£0	25%
£100,000	50%
£150,000	25%

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled because it has a large number of contracts that have characteristics that are similar to the new contract. Under the expected value method, Entity A estimates variable consideration of £87,500, as follows:

Bonus amount (a)	Probability of outcome (b)	Expected value amount (a × b)
£0	25%	£0
£100,000	50%	£50,000
£150,000	25%	£37,500
Total		£87,500

Entity A needs to consider the effect of applying the constraint on variable consideration (see 6.2.3 below).

Entities determine the most likely amount of variable consideration using the single most likely amount in a range of possible consideration amounts. The most likely amount method might be the better predictor when the entity expects to be entitled to one of two possible amounts. For example, a contract in which an entity is entitled to receive all or none of a specified performance bonus, but not a portion of that bonus. [FRS 102.23.44(b)].

Illustration 6-4: Estimating the transaction price using the most likely amount

Entity A enters into a six-month advertising campaign agreement (£500,000 fixed fee) that also includes a potential £100,000 performance bonus linked to certain goals. Entity A estimates that it is 90% likely to receive the entire performance bonus and 10% likely to receive none of the bonus.

Because of the binary nature of the outcome (i.e., the entity will either receive the performance bonus or not receive it), Entity A determines that the most likely amount method is the better predictor of the amount to which it expects to be entitled. Because it is 90% probable that Entity A will receive the £100,000 performance bonus, Entity A estimates the most likely amount it will receive is £600,000 (i.e., £500,000 fixed fee plus the entire £100,000 bonus).

However, Entity A also needs to consider the effect of applying the constraint on variable consideration (see 6.2.3 below) and determine whether it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised if it includes the entire £100,000 performance bonus in the transaction price.

Section 23 noted that the information that an entity uses to estimate the amount of variable consideration, under either the expected value method and the most likely amount method, would typically be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for the goods or services promised to the customer. [FRS 102.23.45]. Under IFRS 15 when applying either of these estimation methods, an entity considers all information (historical, current and forecast) that is reasonably available to the entity. Some stakeholders questioned whether an entity would be applying the portfolio approach practical expedient in paragraph 4 of IFRS 15 (which is similar to paragraph 23.6 of FRS 102 - see 4.3.1 above) when considering evidence from other, similar contracts to develop an estimate of variable consideration using an expected value method. This question was discussed in July 2015 TRG meeting for purposes of IFRS 15 application.¹⁴⁷ We consider that the TRG discussion on this question is relevant in applying the related Section 23 requirements.

The TRG members generally agreed that an entity would not be applying the portfolio approach practical expedient, if it used a portfolio of data from its historical experience with similar customers and/or contracts. The TRG members noted that an entity could choose to apply the portfolio approach practical expedient, but would not be required to do so. Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the revenue standard to an individual contract. The TRG agenda paper noted that using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

¹⁴⁷ TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

Frequently asked questions

Question 6-10: Are there any situations in which an entity would not have to estimate variable consideration at contract inception under Section 23?

An entity would not have to estimate variable consideration at the inception of a contract in the following situations:

- **Variable consideration allocation exception** - When the terms of a variable payment relate to an entity's efforts to satisfy a specific part of a contract (i.e., one or more, but not all, performance obligations or distinct goods or services promised in a series) and allocating the consideration to this specific part is consistent with the Section 23's overall allocation objectives, Section 23 requires variable consideration to be allocated entirely to that specific part of a contract. As a result, variable consideration would not be estimated for the purpose of recognising revenue. For example, an entity that provides a series of distinct hotel management services and receives a variable fee based on a fixed percentage of rental revenue would need to allocate the percentage of monthly rental revenue entirely to the period in which the consideration is earned if this allocation exception is applied. See 7.3 below for further discussion of the variable consideration allocation exception.
- **The 'right to invoice' practical expedient** - When an entity recognises revenue over time, the right to invoice practical expedient allows it to recognise revenue as invoiced, if the entity's right to payment is for an amount that corresponds directly with the value to the customer of the entity's performance to date. For example, an entity would not be required to estimate the variable consideration for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service rendered, provided that fixed amount reflects the value to the customer. See 8.1.4.B below for further discussion of the right to invoice practical expedient.
- **Recognition constraint for sales-based and usage-based royalties related to licences of intellectual property** - Section 23 provides explicit guidance for recognising consideration from sales-based and usage-based royalties provided in exchange for licences of intellectual property. Under Section 23, an entity must not apply the requirements on estimating, constraining and updating estimates of variable consideration to such sales-based or usage-based royalties. Instead, Section 23 states that an entity recognises sales-based and usage-based royalties as revenue at the later of when: (1) the subsequent sales or usage occurs; or (2) the performance obligation to which some, or all, of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied). In many cases, using this guidance results in the same pattern of revenue recognition as fully constraining the estimate of variable consideration associated with the future royalty stream. However, in cases where an entity is required to allocate sales-based or usage-based royalties to separate performance obligations in a contract, it might need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations. See 9.5 below for further discussion about sales-based and usage-based royalties related to licences of intellectual property.

6.2.3 Constraining estimates of variable consideration

Before an entity can include any amount of variable consideration in the transaction price, it must consider whether the amount of variable consideration is required to be constrained. This ensures that there is sufficient certainty that the amounts recognised would faithfully depict the consideration to which an entity expects to be entitled in exchange for the goods or services transferred to a customer and that the estimates are robust and result in useful information. Accordingly, an entity includes estimates of variable consideration in revenue only when the entity has a 'high degree of confidence' that it will be entitled to the cumulative amount of revenue in the subsequent reporting period.

Therefore, as the following extract from Section 23 states, the constraint is aimed at preventing the over-recognition of revenue (i.e., Section 23 focuses on probability of entitlement): [FRS 102.23.46]

Extract from Section 23

- 23.46** An entity shall include in the transaction price an amount of variable consideration estimated in accordance with paragraph 23.44 only to the extent that it is highly probable that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved.

Note that Section 23 has a different model for consideration in the form of a sales-based or usage-based royalty provided in exchange for a licence of intellectual property, when the licence of intellectual property is the sole or predominant item to which the royalty relates. [FRS 102.23.48]. See 9.5 below for further discussion about sales-based and usage-based royalties related to licences of intellectual property.

To include variable consideration in the estimated transaction price, the entity has to conclude that it is 'highly probable' that the entity will be entitled to the cumulative amount of revenue in future periods once the uncertainty related to the variable consideration is resolved. For the purpose of this analysis, the meaning of the term 'highly probable' is defined as "significantly more likely than probable" and 'probable' is defined as "more likely than not". [FRS 102 Appendix I]. These definitions are consistent with existing definitions in adopted IFRS.

Consequently, an entity's analysis to determine whether its estimate of variable consideration must be constrained is largely qualitative. That is, an entity needs to use judgement to evaluate whether it has met the objective of the constraint (i.e., it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved). In applying the judgement, the entity must consider the likelihood of entitlement to cumulative revenue.

An entity must carefully evaluate the factors that could decrease the likelihood of its entitlement to the cumulative amount of revenue in the subsequent periods. The factors described in IFRS 15 could be considered when applying Section 23 constraint guidance: [IFRS 15.57]

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., volatility in a market, judgement or actions of third parties, weather conditions, high risk of obsolescence of the promised good or service).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) of similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

Assessing the likelihood of an entitlement to cumulative amount of revenue requires significant judgement. Entities want to ensure they adequately document the basis for their conclusions. The presence of any one of the indicators described above does not necessarily mean that a decrease in the likelihood of an entitlement will occur if the variable consideration is included in the transaction price. Under IFRS 15, these are included as 'factors', rather than 'criteria', to signal that the list of items to consider is not a checklist for which all items need to be met. In addition, the factors provided are not meant to be an all-inclusive list and entities might need to consider additional factors that are relevant to their facts and circumstances.

The following Illustration, which is based on Example 2 in FRC's FRS 102 Factsheet 10,¹⁴⁸ shows application of variable consideration constraint under Section 23:

Illustration 6-5: Variable consideration constraint

Entity B agrees to carry out a service for a customer. The contract (which is not part of a portfolio of similar contracts, and so is accounted for as an individual contract) has a single performance obligation that is satisfied over time and the transaction price consists of a £50,000 fixed element and a £25,000 variable element to which Entity B will be entitled if it meets specified performance criteria.

At the end of the first reporting period, Entity B measures its progress towards completion of the performance obligation at 90%. Entity B also assesses that the most likely amount of variable consideration it will be entitled to is the full amount, because it is more likely than not to achieve the performance criteria.

Entity B therefore initially estimates the amount of variable consideration to which it will be entitled at £25,000, which gives a total transaction price of £75,000. Using that transaction price would suggest that Entity B would recognise £67,500 as revenue (90% of £75,000) at the end of the first reporting period. However, Entity B must also consider the variable consideration constraint.

¹⁴⁸ [FRS 102 Factsheet 10 Revenue](#) from *Contracts with Customers*, FRC, issued on 27 November 2024 Section 2 The five-step revenue recognition model, Step 3 - Determine the transaction price, page 11.

In this example, Entity B considers that even though meeting the performance criteria is the most likely outcome, that outcome is not highly probable. If Entity B did not meet the performance criteria, then at the end of the contract it would be entitled only to £50,000 of consideration. Therefore, Entity B constrains the estimate of variable consideration included in the transaction price to zero and recognises £45,000 of revenue at the end of the first reporting period (90% of £50,000).

In the subsequent reporting period, the entity's progress towards complete satisfaction of the performance obligation reaches 100%. If Entity B has not achieved the performance criteria it recognises a further £5,000 as revenue (£50,000 of cumulative revenue). If Entity B has achieved the performance criteria it recognises a further £30,000 as revenue (£75,000 of cumulative revenue).

There are some types of variable consideration that are frequently included in contracts that have significant uncertainties. It is likely to be more difficult for an entity to assert its entitlement to cumulative amount of revenue is highly probable. Examples of the types of variable consideration include, but are not limited to, the following:

- Payments contingent on regulatory approval (e.g., regulatory approval of a new drug)
- Long-term commodity supply arrangements that are settled based on market prices at the future delivery date
- Contingency fees based on litigation or regulatory outcomes (e.g., fees based on the positive outcome of litigation or the settlement of claims with government agencies)

In some situations, it is appropriate for an entity to include in the transaction price an estimate of variable consideration that is not a possible outcome of an individual contract. The TRG discussed this topic in July 2015 using an example from the TRG agenda paper no. 38 for purposes of IFRS 15 application.¹⁴⁹ The following Illustration is based on that example, which we consider relevant in applying the related Section 23 requirements:

Illustration 6-6: Estimating variable consideration using the expected value method

Entity A develops websites for customers. The contracts include similar terms and conditions and contain a fixed fee, plus variable consideration for a performance bonus related to the timing of Entity A completing the website. Based on Entity A's historical experience, the bonus amounts and associated probabilities for achieving each bonus are, as follows:

Bonus amount	Probability of outcome
£0	15%
£50	40%
£100	45%

Entity A determines that using the expected value method would better predict the amount of consideration to which it will be entitled than using the most likely amount method because it has a large number of contracts that have characteristics that are similar to the new contract.

Under the expected value method, Entity A estimates variable consideration of £65,000 [$(£0 \times 15\%) + (£50,000 \times 40\%) + (£100,000 \times 45\%)$]. Entity A must then consider the effect of applying the constraint on variable consideration. To do this, Entity A considers the factors that could reduce the likelihood of its entitlement to the cumulative amount of revenue in the future, including those factors described above. Entity A concludes that it has relevant historical experience with similar types of contracts and that the amount of consideration is not highly susceptible to factors outside of its influence.

In determining whether the entity would include £50,000 or £65,000 in the transaction price, when an entity has concluded that the expected value approach is the appropriate method to estimate variable consideration, the constraint is also applied based on the expected value method. That is, the entity is not required to switch from an expected value method to a most likely amount for purposes of applying the constraint. As a result, if an entity applies the expected value method for a particular contract, the estimated transaction price might not be a possible outcome in an individual contract. Therefore, the entity could conclude that, in this example, £65,000 is the appropriate estimate of variable consideration to include in the transaction price. It is important to note that in this example, the entity had concluded that none of the factors described above or any other factors indicate a likelihood that the entity would not receive the cumulative amount of revenue it is entitled to in the future.

¹⁴⁹ TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

When an entity uses the expected value method and determines that the estimated amount of variable consideration is not a possible outcome in the individual contract, the entity must still consider the constraint on variable consideration. Depending on the facts and circumstances of each contract, an entity might need to constrain its estimate of variable consideration, even though it has used an expected value method, if there are factors (including those described above) which indicate a likelihood of decreasing an entity's entitlement to revenue. However, using the expected value method and considering probability-weighted amounts sometimes achieve the objective of the constraint on variable consideration. When an entity estimates the transaction price using the expected value method, the entity reduces the probability of entitlement to cumulative amount of revenue because the estimate does not include all of the potential consideration due to the probability weighting of the outcomes. In some cases, the entity does not need to constrain the estimate of variable consideration if the factors, including those described above, do not indicate a likelihood of decreasing the entity's entitlement to cumulative amount of revenue in the future.

FRS 102 aims to be simpler than adopted IFRS. Accordingly, the FRC included a rewording of the constraint on estimates of variable consideration so it is easier to understand but generally has the same effect as applying the IFRS 15 requirement for constraining variable consideration. [FRS 102.BC.B23.7]. Whilst the requirement in Section 23 is reworded for simplification, it is worth noting that it has resulted in a requirement (see discussion below) that is expressed differently to that in IFRS 15 which could, in some instances, result in an entity recognising different amounts of variable consideration in a reporting period in similar circumstances.

An entity's analysis to determine whether its estimate of variable consideration must be constrained is largely qualitative under Section 23 and IFRS 15. However, under IFRS 15, the requirement in constraining variable consideration is to include in the transaction price some or all of an amount of estimated variable consideration, only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. An entity needs to consider both the likelihood and magnitude of a revenue reversal to apply the constraint under IFRS 15; i.e., the constraint is based on the probability of a reversal (likelihood of reversal) of an amount that is 'significant' relative to the cumulative revenue recognised for the contract (magnitude of reversal). [IFRS 15.56, IFRS 15.57]. In contrast, Section 23 only requires an entity to consider the likelihood of entitlement to the estimated cumulative amount of revenue recognised, when the uncertainty associated with the variable consideration is subsequently resolved.

Consequently, an entity might be expected to recognise some amounts of revenue earlier under IFRS 15 compared to Section 23 in instances where it is highly probable that some (but not a significant) amounts of revenue will reverse in the future.

Frequently asked questions

Question 6-11: Is an entity required to follow a two-step approach to estimate variable consideration (i.e., first estimate the variable consideration and then apply the constraint to that estimate)?

An entity is not required to strictly follow a two-step process (i.e., first estimate the variable consideration and then apply the constraint to that estimate) if its internal processes incorporate the principles of both steps in a single step. Note that this is consistent with the observation in the Basis for Conclusions on IFRS 15. [IFRS 15.BC215]. For example, if an entity already had a single process to estimate expected returns when calculating revenue from the sale of goods in a manner consistent with the objectives of applying the constraint, the entity would not need to estimate the transaction price and then separately apply the constraint.

Also, as discussed above, applying the expected value method, which requires an entity to consider probability-weighted amounts, might sometimes achieve the objective of the constraint on variable consideration. That is, in developing its estimate of the transaction price in accordance with the expected value method, an entity reduces the probability of entitlement to cumulative amount of revenue and might not need to further constrain its estimate of variable consideration. However, to meet the objective of the constraint, the entity's estimated transaction price would need to incorporate its expectations of the possible consideration amounts (e.g., products not expected to be returned) at a level at which it is highly probable that including the estimate of variable consideration in the transaction price would not impact the entity's entitlement to cumulative amount of revenue in the future (i.e., such that it is highly probable that additional returns above the estimated amount would not reduce the entity's entitlement to cumulative amount of revenue in the future).¹⁵⁰

¹⁵⁰ Based on TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

Question 6-12: How does an entity apply the constraint on variable consideration to milestone payments?

An entity might need to apply significant judgement to determine whether and, if so, how much of a milestone payment is constrained. Assuming the payment is not subject to the sales-based or usage-based royalty recognition constraint (see 9.5 below), a milestone payment is a form of variable consideration that needs to be estimated and included in the transaction price, subject to the variable consideration constraint.

Milestone payments are often binary (i.e., the entity will either achieve the target or desired outcome and become entitled to the milestone payment or not). In these situations, entities generally conclude that the most likely amount method is the better predictor of the amount to which it expects to be entitled. The entity will then consider the constraint on variable consideration to determine whether it is highly probable that an entity will be entitled to the cumulative amount of revenue recognised when the uncertainties related to the milestone payments have been resolved.

How we see it

Applying the constraint to milestone payments often requires significant judgement, especially when uncertainty exists about the underlying activities necessary to meet the target or desired outcome that entitle the entity to the milestone payment. Entities need to analyse the facts and circumstances of each milestone payment and consider all information (historical, current and forecast) that is reasonably available to them to assess whether the revenue needs to be constrained. In addition, there could be external factors that affect an entity's assessment of the contract and the probability of entitlement to milestone payments. For example, we expect entities to conclude in many instances that milestone payments contingent on regulatory approval (e.g., regulatory approval of a new drug) are constrained, preventing them from recognising these payments until the uncertainty associated with the payments is resolved.

Consider the following Illustration:

Illustration 6-7: Milestone payments

Biotech enters into an arrangement with Pharma under which Biotech provides a licence to a product candidate that is starting phase II clinical studies and performs research and development services for a specified period of time. Assume that these two promises are determined to be distinct. Biotech receives an upfront payment upon execution of the arrangement and is entitled to receive milestone payments upon: (1) enrolment of a specified number of patients in a phase II clinical study; (2) completion of phase III clinical studies, (3) regulatory approval in the UK; and (4) regulatory approval in the European Union.

Under Section 23, Biotech includes in the transaction price the upfront payment and its estimate of the milestone payments it expects to receive. The amount of consideration that Biotech would include in the transaction price is restricted to amounts for which it is highly probable that the entity will be entitled to the cumulative amount of revenue when the associated uncertainty is subsequently resolved.

The milestone for patient enrolment only has two possible outcomes (e.g., Biotech enrolls or does not enrol the specified number of patients). Therefore, Biotech determines that the most likely amount method is the better predictor of the milestone payment. It then determines that it can include the amount associated with the enrolment milestone in the transaction price because it is highly probable that doing so will not reduce the likelihood of its entitlement to such amount (see discussion further above), based on its prior experience with enrolling participants in similar studies and clinical trial results on the product candidate to date.

Due to the significant uncertainty associated with the other future events that would result in milestone payments, however, Biotech initially determines that it cannot include these amounts in the transaction price (i.e., the other milestone payments are fully constrained at contract inception). At the end of each reporting period, Biotech updates its assessment of whether the milestone payments are constrained.

The evaluation of the constraint considers the probability of entitlement (i.e., achieving the target or desired outcome). There are many variables that need to be factored into this assessment. Thus, entities need to carefully evaluate each milestone to determine when it is appropriate to include the milestone in the transaction price.

As discussed in 6.2.4 below, an entity is required to update its estimate of variable consideration (including any amounts that are constrained) at the end of each reporting period to reflect its revised expectations of the amount of consideration to which it expects to be entitled. For example, an entity might initially conclude that a milestone payment is constrained and, therefore, exclude it from the transaction price. However, in a later reporting period, when reassessing the amount of variable consideration that must be included in the transaction price, the entity might conclude a milestone payment is no longer constrained even though the target or desired outcome has not been achieved. That is, based on new information, an entity might conclude that it expects to achieve the target or desired outcome and, therefore, concludes that it is now highly probable that the entity will be entitled to the cumulative amount of revenue when the associated uncertainty is subsequently resolved.

6.2.4 Reassessment of variable consideration

At the end of each reporting period, an entity updates the estimate of variable consideration included in the transaction price to reflect any relevant changes in circumstances. [FRS 102.23.47]. That is, when a contract includes variable consideration, an entity needs to update its estimate of the transaction price throughout the term of the contract to depict conditions that exist at the end of each reporting period. This involves updating the estimate of the variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled, considering uncertainties that are resolved or new information that is gained about remaining uncertainties. The entity accounts for changes in the transaction price in accordance with paragraphs 23.75 to 23.77. [FRS 102.23.47]. As discussed in 6.2.3 above, conclusions about amounts that could result in an entitlement to the cumulative amount of revenue recognised might change as an entity satisfies a performance obligation. See 7.4 below for a discussion of allocating changes in the transaction price after contract inception.

In some cases, an estimate of variable consideration made at the end of an accounting period could be affected by information that arises after the end of the reporting period, but before the release of the financial statements. In these cases, the entity applies the guidance in accounting for subsequent events provided in Section 32 *Events after the End of the Reporting Period* (see Chapter 34).

Frequently asked questions

Question 6-13: How would an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

See response to Question 4-15 in 4.4 above.

6.3 Refund liabilities

An entity might receive consideration that it will need to refund to the customer in the future because the consideration is not an amount to which the entity ultimately will be entitled under the contract. If an entity expects to refund some or all of that consideration, the amounts received (or receivable) need to be recorded as refund liabilities. [FRS 102.23.49].

A refund liability is measured at the amount of consideration received (or receivable) to which the entity does not expect to be entitled (i.e., amounts not included in the transaction price). An entity is required to update its estimates of refund liabilities (and the corresponding change in the transaction price) at the end of each reporting period. An entity accounts for changes in the estimate of the transaction price by applying paragraphs 23.75 to 23.77 – see discussion in 7.4 below [FRS 102.23.49]. Section 23 also notes that, if a refund liability relates to a sale with a right of return, an entity applies the specific guidance for sale with a right of return. [FRS 102.23.50].

While the most common form of refund liabilities is related to sale with a right of return (see 6.4 below), the refund liability requirements also apply when an entity expects that it will need to refund consideration received due to poor customer satisfaction with a service provided (i.e., there was no good delivered or returned). For example, the terms of a fixed-price service contract might require a customer to pay upfront and could provide the customer with a full refund of the amount paid if the customer is dissatisfied with the service at any time. [FRS 102.23.49]. The refund liability requirements also apply if an entity expects to have to provide retrospective price reductions to a customer (e.g., if a customer reaches a certain threshold of purchases, the unit price is retrospectively adjusted).

Frequently asked questions

Question 6-14: Is a refund liability a contract liability (and, thus, subject to the presentation and disclosure requirements of a contract liability)?

See response to Question 11-4 in 11.1.5 below.

6.4 Rights of return

Section 23 notes that, in some contracts, an entity might transfer control of a product to a customer but grant the customer a right of return. In return, the customer might receive a full or partial refund of any consideration paid; a credit that can be applied against amounts owed, or that will be owed, to the entity; another product in exchange; or any combination thereof. [FRS 102.23.51]. As discussed in 5.7 above, IFRS 15 clarifies that a right of return does not represent a separate performance obligation. [IFRS 15.B22]. Instead, a right of return affects the transaction price and the amount of revenue an entity can recognise for satisfied performance obligations. In other words, rights of return create variability in the transaction price.

Under Section 23, rights of return do not include exchanges by customers of one product for another of the same type, quality, condition and price (e.g., one colour or size for another). [FRS 102.23.52]. Nor do rights of return include situations where a customer might return a defective product in exchange for a functioning product; these are, instead, evaluated in accordance with the guidance on warranties (see 10.1 below). [FRS 102.23.57].

Section 23 provides the following guidance to determine how rights of return would be treated: [IFRS 15.B21]

Extract from Section 23

- 23.53** To account for revenue for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise the following:
- (a) revenue only for products expected not to be returned;
 - (b) a refund liability for consideration received (or receivable) for products expected to be returned; and
 - (c) a refund asset, classified as inventory, for products expected to be returned (and corresponding adjustment to cost of sales).

Under Section 23, an entity estimates the transaction price and applies the constraint to the estimated transaction price to determine the amount of consideration to which the entity expects to be entitled. In doing so, it considers the products expected to be returned in order to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity recognises revenue based on the amount to which it expects to be entitled through to the end of the return period (considering expected product returns). An entity does not recognise the portion of the revenue subject to the constraint until the amount is no longer constrained, which could be at the end of the return period. The entity recognises the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration (see 6.3 above). [FRS 102.23.54]. Subsequently, at the end of each reporting period, the entity updates its assessment of amounts for which it expects to be entitled. [FRS 102.23.56(a)].

As part of updating its estimate, an entity must update its assessment of expected returns and the related refund liabilities. This remeasurement is performed at the end of each reporting period and reflects any changes in assumptions about expected returns. Any adjustments made to the estimate result in a corresponding adjustment to amounts recognised as revenue for the satisfied performance obligations (e.g., if the entity expected the number of returns to be lower than originally estimated, it would have to increase the amount of revenue recognised and decrease the refund liability). [FRS 102.23.56(a)].

Finally, when customers exercise their rights of return, the entity might receive the returned product in a saleable or repairable condition. Under Section 23, at the time of the initial sale (i.e., when recognition of revenue is deferred due to the anticipated return), the entity recognises a refund asset (and adjusts the cost of goods sold) for its right to recover the goods returned by the customer. [FRS 102.23.53]. The entity initially measures this asset at the former carrying amount of the inventory, less any expected costs to recover the goods, including any potential decreases in the value of the returned goods (e.g., because of damage, obsolescence or declining selling prices). The consideration of potential decreases in value of the returned products is important because the returned products might not be in the same condition they were in when they were sold (e.g., due to damage or use) and this helps to ensure that the value of the refund asset is not impaired. [FRS 102.23.55].

The following table provides a summary of what an entity initially recognises in relation to a right of return in accordance with the requirements in Section 23 (also see Illustration 6-8 below).

Figure 6-2: Rights of return

Revenue	The amount to which the entity expects to be entitled through to the end of the return period (considering expected product returns)
Cost of sales	The carrying amount of goods transferred, less the refund asset
Refund liability	The amount received or receivable that is expected to be returned
Refund asset	The former carrying amount of the inventory the entity expects to recover (i.e., goods expected to be returned by the customer), less any expected costs to recover the goods, including potential decreases in the value of the returned goods

Along with remeasuring the refund liability at the end of each reporting period (as discussed above), the entity updates the measurement of the refund asset recorded (with adjustments in cost of sales) for any revisions to its expected level of returns, as well as any additional potential decreases in the value of the returned products. [FRS 102.23.56(b)]. Because paragraph 23.56 of FRS 102 includes specific remeasurement requirements for the refund asset, an entity applies those requirements, rather than other impairment models (e.g., inventory). Section 23 also requires the refund asset to be classified as inventory. [FRS 102.23.53]. Consequently, refund liability is presented separately from the refund asset (i.e., on a gross basis, rather than a net basis).

Illustration 6-8 below, which is based on Example 22 in IFRS 15, is an example of accounting for a sale with a right of return: [IFRS 15.IE Example 22, IFRS 15.IE110-IE115]

Illustration 6-8: Right of return

An entity enters into 100 contracts with customers. Each contract includes the sale of one product for £100 (100 total products × £100 = £10,000 total consideration). Cash is received when control of a product transfers. The entity's customary business practice is to allow a customer to return any unused product within 30 days and receive a full refund. The entity's cost of each product is £60.

The entity applies the requirements in Section 23 to the portfolio of 100 contracts because it reasonably expects that, in accordance with FRS 102.23.6 (see 4.3.1 above), the effects on the financial statements from applying these requirements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio.

Because the contract allows a customer to return the products, the consideration received from the customer is variable. To estimate the variable consideration to which the entity will be entitled, the entity decides to use the expected value method in paragraph 23.44(a) (see 6.2.2 above) because it is the method that the entity expects to better predict the amount of consideration to which it will be entitled. Using the expected value method, the entity estimates that 97 products will not be returned.

The entity also considers the requirements in paragraph 23.46 (see 6.2.3 above) on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of £9,700 (£100 × 97 products not expected to be returned) can be included in the transaction price.

The entity assesses the factors which might not support the entity's entitlement to revenue, including considerations of the factors in IFRS 15 (see 6.2.3 above), and determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (i.e., the 30-day return period). Thus, the entity concludes that it is highly probable that a reversal in the cumulative amount of revenue recognised (i.e., CU9,700) will not occur as the uncertainty is resolved (i.e., over the return period) - which supports a high degree of entitlement to such revenue.

The entity estimates that the costs of recovering the products will be immaterial and expects that the returned products can be resold at a profit.

Upon transfer of control of the 100 products, the entity does not recognise revenue for the three products that it expects to be returned. Consequently, in accordance with paragraphs 23.50 and 23.53, the entity recognises the following:

- (a) revenue of £9,700 (£100 × 97 products not expected to be returned)
- (b) a refund liability of £300 (£100 refund × 3 products expected to be returned)

And

- (c) a refund asset of £180 (£60 × 3 products for its right to recover products from customers on settling the refund liability)

The following journal entries illustrate how the entity would account for the above transaction, when the products are transferred to the customer:

Dr	Cash	£10,000 ^(a)	
	Cr Revenue		£9,700 ^(b)
	Cr Refund liability		£300 ^(c)
Dr	Cost of sales	£5,820 ^(d)	
Dr	Refund asset	£180 ^(e)	
	Cr Inventory		£6,000 ^(f)

(a) £100 × 100 products transferred

(b) £100 × 97 products not expected to be returned

(c) £100 refund × 3 products expected to be returned

(d) £60 × 97 products not expected to be returned

(e) £60 × 3 products for its right to recover products from customers on settling the refund liability

(f) £60 × 100 products

Frequently asked questions

Question 6-15: Is an entity applying the portfolio approach practical expedient when accounting for rights of return?¹⁵¹

Illustration 6-8 above states that the entity is using the portfolio approach practical expedient in paragraph 23.6 (see 4.3.1 above) to calculate its estimate of returns. Use of this practical expedient requires an entity to assert that it does not expect the use of the expedient to differ materially from applying the standard to an individual contract.

However, an entity can, but would not be required to, apply the portfolio approach practical expedient to estimate variable consideration for expected returns using the expected value method. Similar to the discussion in 6.2.2 above on estimating variable consideration, an entity can consider evidence from other, similar contracts to develop an estimate of variable consideration using the expected value method without applying the portfolio approach practical expedient. In order to estimate variable consideration in a contract, an entity frequently makes judgements considering its historical experience with other, similar contracts. Considering historical experience does not necessarily mean the entity is applying the portfolio approach practical expedient.

We expect that entities often use the expected value method to estimate variable consideration related to returns because doing so would likely better predict the amount of consideration to which the entities will be entitled. This is despite the fact that there are two potential outcomes for each contract from the variability of product returns: the product either will be returned or will not be returned. That is, the revenue for each contract ultimately either will be 100% or will be 0% of the total contract value (assuming returns create the only variability in the contract). However, entities might conclude that the expected value is the appropriate method for estimating variable consideration because they have a large number of contracts with similar characteristics. Using a portfolio of data is not equivalent to using the portfolio approach practical expedient, so entities that use the expected value method to estimate variable consideration for returns would not be required to assert that the outcome from the portfolio is not expected to materially differ from an assessment of individual contracts.

Question 6-16: How does an entity account for restocking fees for goods that are expected to be returned?¹⁵²

Entities sometimes charge customers a 'restocking fee' when a product is returned. This fee might be levied by entities to compensate them for the costs of repackaging, shipping and/or reselling the item at a lower price to another customer. Section 23 is not clear about the accounting for such restocking fees and related costs.

¹⁵¹ Based on TRG Agenda paper no. 38, *Portfolio Practical Expedient and Application of Variable Consideration Constraint*, dated 13 July 2015.

¹⁵² Based on TRG Agenda paper no. 35, *Accounting for Restocking Fees and Related Costs*, dated 13 July 2015.

Restocking fees for goods that are expected to be returned would be included in the estimate of the transaction price at contract inception and recorded as revenue when (or as) control of the good transfers. That is, selling a product subject to a restocking fee if it is returned is not different from providing a partial return right and must be accounted for similarly.

Consider the following Illustration:

Illustration 6-9: Restocking fees

Entity A enters into a contract with a customer to sell 10 widgets for £100 each. The customer has the right to return the widgets, but, if it does so, it will be charged a 10% restocking fee (or £10 per returned widget). The entity estimates that 10% of all widgets that are sold will be returned. Upon transfer of control of the 10 widgets, the entity will recognise revenue of £910 [(9 widgets not expected to be returned x £100 selling price) + (1 widget expected to be returned x £10 restocking fee)]. A refund liability of £90 will also be recorded [1 widget expected to be returned x (£100 selling price - £10 restocking fee)].

Question 6-17: How does an entity account for restocking costs related to expected returns (e.g., shipping or repackaging costs)?¹⁵³

Restocking costs (e.g., shipping and repackaging costs) would be recorded as a reduction of the amount of the refund asset when (or as) control of the good is transferred to the customer. This accounting treatment is consistent with the requirement in paragraph 23.55 that the refund asset be initially measured at the former carrying amount of the inventory, less any expected costs to recover the goods (e.g., restocking costs). [FRS 102.23.55].

Question 6-18: How can an entity evaluate a conditional call option to repurchase an asset?

See response to Question 8-24 in 8.3.1 below.

Question 6-19: Does an entity account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item) as a right of return or an assurance-type warranty?

See response to Question 10-3 in 10.1.1 below.

6.5 Time value of money

For some transactions, the receipt of the consideration does not match the timing of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

Section 23 states the following in relation to the effects of time value of money arising from a contract: [FRS 102.23.58, FRS 102.23.59, FRS 102.23.60]

Extract from Section 23

- 23.58** If payment is deferred beyond normal business terms or is financed (by the entity) at a rate of interest that is not market rate, the arrangement constitutes a financing transaction (see paragraphs 11.13 and 12.7). An entity shall adjust the promised amount of consideration for the effects of the time value of money and recognise the interest revenue in accordance with Section 11 or Section 12. The entity shall present interest revenue separately from revenue from contracts with customers.
- 23.59** If payment is received in advance, an entity may adjust the promised amount of consideration for the effects of the time value of money and recognise the resulting interest expense in accordance with Section 11 or Section 12.
- 23.60** An entity need not adjust the promised amount of consideration for the effects of the time value of money if the entity expects, at contract inception, that the period between when the entity transfers the good or service promised to a customer and when the customer pays for that good or service will be 12 months or less (see paragraph 11.13A(c)).

¹⁵³ Based on TRG Agenda paper no. 35, *Accounting for Restocking Fees and Related Costs*, dated 13 July 2015.

A revenue contract that includes a financing component comprise two transactions. The first one being a transaction for the sale of goods and/or services and the second one being a financing transaction. Accordingly, subject to the policy choice and/or practical expedient available (see 6.5.1 and 6.5.2 below), entities would adjust the amount of promised consideration for the effects of time value of money if the arrangement constitutes a financing transaction. [FRS 102.23.58].

When the arrangement constitutes a financing transaction, i.e., when the payment for goods or services is deferred beyond normal business terms or the sale is financed at a below-market rate of interest, the trade debtor or contract asset is measured at the present value of the future cash inflows discounted at the market rate of interest for a similar receivable (see Chapter 13 at 5.2.2). [FRS 102.11.13, FRS 102.23.58, FRS 102.23.59]. See 11.1 below for further discussions on contract assets.

Adjusting the promised amount of consideration for the effects of time value of money results in entities recognising as revenue the present value of future cash receipts attributed to the underlying goods or services at the time of transfer. The FRC also observed that in practice, an entity could use the current cash selling price for the goods or services sold on an arm's length basis as an estimate for the present value of the future payments. However, if there is no cash sale alternative or the cash selling price is the same as the price when buying on credit, the entity must calculate the present value of the future cash flows.¹⁵⁴

6.5.1 Practical expedient

As a practical expedient, an entity is not required to adjust the promised amount of consideration for the effects of a financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. This practical expedient is consistent with paragraph 11.13A(c) which allows an entity to initially measure financing transactions at the transaction price (i.e., a trade receivable or contract asset when, at contract inception, payment is expected within 12 months or less from when the entity transfers the good or service could be measured initially at transaction price). [FRS 102.11.13A(c), FRS 102.23.60].

In applying the practical expedient, it is important to note that if the period between when the entity transfers a promised good or service to a customer and the customer pays for that good or service is more than one year, the entity must account for the entire financing component. That is, an entity cannot exclude the first 12 months of the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service from the calculation of the potential adjustment to the transaction price.

Entities might need to apply judgement to determine whether the practical expedient applies to some contracts. For example, Section 23 does not specify whether entities must assess the period between payment and performance at the contract level or at the performance obligation level. However, see Question 6-20 in 6.5.3 below for a discussion of how an entity might consider whether the practical expedient applies to contracts with a single payment stream for multiple performance obligations.

If an entity uses the practical expedient, it applies the expedient consistently to similar contracts in similar circumstances. [FRS 102.23.5]. Use of this practical expedient is also required to be disclosed (see 11.4.4 below).

Note that Section 23 does not discuss situations in which expectations change after contract inception regarding the timing difference between the receipt of consideration and the transfer of goods and services to the customer (e.g., a change in the timing of delivery).

How we see it

As discussed above, Section 23 includes a practical expedient that allows an entity to not adjust the promised amount of consideration for the effects of the time value of money if the entity expects, at contract inception, that the period between transfer to, and payment from, the customer will be less than one year. To the extent this period of time changes and extends beyond one year (due to events unknown at contract inception), we believe an entity would not be required to reconsider the use of this expedient because the guidance does not contemplate updating this assessment after contract inception.

¹⁵⁴ [FRS 102 Factsheet 4 Financial Instruments](#), FRC, issued on 27 November 2024, Appendix - Financing transactions, The sale of goods or services on deferred payment terms, page 18.

If an entity has accounted for a financing component at contract inception and the expected timing of the transfer of goods or services then changes, it is important to understand the reason for the expectation change. For example, if the change to the delivery date was part of a larger contract modification that changed the scope and/or price of the contract, the entity would need to apply the contract modification requirements (see 4.4 above for further discussion on accounting for contract modifications). If the change to the delivery date was at the entity's discretion or was due to circumstances that were not foreseen at contract inception, Section 23 does not specify how an entity would account for that change and an entity needs to use judgement to determine the appropriate accounting treatment.

6.5.2 Existence of a financing transaction

Absent the use of the practical expedient (see 6.5.1 above) or accounting policy choice not to adjust the effects of time value of money on payments received in advance (see 6.5.2.A below), to determine whether a financing component exists, Section 23 requires an entity to assess whether the payment is deferred beyond normal business terms or is financed at a rate of interest that is not market rate. If so, the arrangement constitutes a financing transaction. This is consistent with the requirements in paragraphs 11.13 and 12.7. Accordingly, an entity needs to adjust the promised amount of consideration for the effects of the time value of money and subsequently recognise the interest revenue and/or interest expense in accordance with Section 11 or Section 12. [FRS 102.23.58, FRS 102.23.59].

For further discussion and illustration relating to accounting for financing transactions, see Chapter 13 at 5.2.2.

Section 23 specifies when the time value of money should be adjusted for (i.e., a financing transaction exists if payment is deferred beyond normal business terms or is financed at a rate of interest that is not market rate). [FRS 102.23.58]. It does not refer to the term 'financing component' or 'significant financing component'. In contrast, under IFRS 15, an entity considers all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract (i.e., only transactions with a 'significant' financing component in the context of the contract under IFRS 15 are adjusted for the effects of the time value of money). The factors to be considered include: (a) the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and (b) the combined effect of the expected length of time between the transfer of the goods or services and the receipt of consideration and the prevailing market interest rates. [IFRS 15.61]. The assessment of significance is made at the individual contract level – this requires application of judgement.

In addition, even if conditions in a contract would otherwise indicate that a significant financing component exists, IFRS 15 also includes several situations which do not provide the customer or the entity with a significant benefit of financing, and therefore, no adjustment for a financing component is required. [IFRS 15.62]. However, Section 23 does not include similar provisions which could preclude accounting for the effects of the time value of money.

IFRS 15 also provides a practical expedient similar to the practical expedient discussed in 6.5.1 above. However, unlike in Section 23, there is no accounting policy choice available under IFRS 15 or an overall exemption from accounting for the effects of a significant financing component arising from advance payments (see 6.5.2.A below). [IFRS 15.60].

6.5.2.A Advance payments

Where an entity requires advance payments from a customer, ignoring the effects of such advance payments could skew the amount and timing of revenue recognised if the advance payment is significant and the purpose of the payment is to provide the entity with financing. For example, an entity might require a customer to make advance payments to avoid obtaining the financing from a third party. If the entity obtained third-party financing, it would likely charge the customer additional amounts to cover the finance costs incurred. Accordingly, the entity's revenue must be consistent regardless of whether it receives the significant financing benefit from a customer or from a third party because, in either scenario, the entity's performance is the same.

Nevertheless, Section 23 offers a policy choice for payments made by the customer in advance of the entity providing the promised goods or services: it can choose whether to adjust the promised amount of consideration for the effects of the time value of money and recognise the resulting interest expense in accordance with Section 11 or Section 12. [FRS 102.23.59]. If the entity chooses not to adjust the promised consideration for the effects of the time value of money, the amount received by the entity is recognised as contract liability (see 11.1 below).

If the entity chooses to adjust the promised amount of consideration for the effects of time value of money for payments received in advance, the practical expedient offered by Section 23 could still be applied. The use of the practical expedient in paragraph 23.60 does not specifically exclude the effects of time value of money on payments received in advance. Instead, it only provides the condition that needs to be met in order to use the practical expedient. That is, at contract inception, the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service must be one year or less (see 6.5.1 above).

6.5.3 Examples of financing components

Illustration 6-10 below, which is based on Example 26 in IFRS 15, illustrates a contract that contains a financing component because payment is deferred beyond normal business terms: [IFRS 15.IE Example 26, IFRS 15.IE135-IE140]

Illustration 6-10: Financing component and right of return

An entity sells a product to a customer for £121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.

The entity's normal business term is cash on delivery. If the product was sold under the normal business terms, the product would have been sold for £100. The entity's cost of the product is £80. Sales taxes are ignored in this example.

The entity does not recognise revenue when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is highly probable that a reversal in the amount of cumulative revenue recognised will not occur which supports the entity's entitlement to the revenue in accordance with paragraph 23.46 (see 6.2.3 above). Consequently, revenue is recognised after three months when the right of return lapses.

The contract includes a financing component, in accordance with paragraph 23.58 (see 6.5.2 above). This is because payment is deferred beyond normal business terms.

The contract includes an implicit interest rate of 10% (i.e., the interest rate that over 24 months discounts the promised consideration of £121 to the selling price of £100 under normal business terms). The entity evaluates the rate and concludes that it is commensurate with the market rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception.

The following journal entries illustrate how the entity accounts for this contract in accordance with paragraphs 23.51 to 23.57 (see 6.4 above).

(a) When the product is transferred to the customer, in accordance with paragraph 23.51:

Refund asset (for right to recover product to be returned)	£80 ⁽¹⁾	
Inventory		£80

(1) This example does not consider expected costs to recover the asset.

(b) During the three-month right of return period, no interest is recognised in line with the discussion in 6.5.2 above because no contract asset or receivable has been recognised.

(c) When the right of return lapses (the product is not returned):

Receivable	£100 ⁽²⁾	
Revenue		£100
Cost of sales	£80	
Refund asset		£80

(2) The receivable recognised would be measured in accordance with Section 11. This example assumes there is no material difference between the fair value of the receivable at contract inception and the fair value of the receivable when it is recognised at the time the right of return lapses. In addition, this example does not consider the impairment accounting for the receivable.

Until the entity receives the cash payment from the customer, interest revenue would be recognised in accordance with Section 11. In determining the effective interest rate in accordance with Section 11, the entity would consider the remaining contractual term.

Illustration 6-11 below, which is based on Example 29 in IFRS 15, illustrates a contract with an advance payment from the customer that the entity concludes constitutes a financing transaction. It also illustrates a situation in which the implicit interest rate does not reflect the interest rate that would be used in a separate financing transaction between the entity and its customer at contract inception, as follows:

[IFRS 15.IE Example 29, IFRS 15.IE148-IE151]

Illustration 6-11: Advance payment and assessment of discount rate

An entity enters into a contract with a customer to sell an asset. Control of the asset will transfer to the customer in two years (i.e., the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options: payment of £5,000 in two years when the customer obtains control of the asset or payment of £4,000 when the contract is signed. The customer elects to pay £4,000 when the contract is signed.

The entity concludes that the contract contains a financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market. The entity's accounting policy is to adjust the effects of the time value of money on payments received in advance.

The interest rate implicit in the transaction is 11.8%, which is the interest rate necessary to make the two alternative payment options economically equivalent. However, the entity determines that, in accordance with paragraph 11.13, the rate that must be used in adjusting the promised consideration is 6%, which is the market rate of interest for a similar debt instrument.

The following journal entries illustrate how the entity would account for the financing component:

- (a) Recognise a contract liability for the £4,000 payment received at contract inception:

Cash	£4,000	
	Contract liability	£4,000

- (b) During the two years from contract inception until the transfer of the asset, the entity adjusts the promised amount of consideration (in accordance with FRS 102.23.59) and accretes the contract liability by recognising interest on £4,000 at 6% for two years:

Interest expense	CU494 ^(a)	
	Contract liability	CU494

(a) £494 = CU4,000 contract liability × (6% interest per year for two years).

- (c) Recognise revenue for the transfer of the asset:

Contract liability	£4,494	
	Revenue	£4,494

Frequently asked questions

Question 6-20: How do entities consider whether the practical expedient on adjusting for the effects of time value of money applies to contracts with a single payment stream for multiple performance obligations?¹⁵⁵

As discussed in 6.5.1 above, Section 23 includes a practical expedient that allows an entity not to adjust the promised consideration in a contract for the effects of time value of money if the period between the customer's payment and the entity's transfer of the goods or services is one year or less. [FRS 102.23.60]. Depending on the facts and circumstances, generally, entities could either apply an approach of allocating any consideration received:

- (1) To the earliest good or service delivered
- Or
- (2) Proportionately between the goods or services

For example, a telecommunications entity enters into a two-year contract to provide a device at contract inception and related data services over 24 months in exchange for 24 equal monthly instalments. The entity concludes that the device and services are each distinct. The promised amount of consideration (combined amount for device and services) is £2,400 payable in 24 monthly instalments of £100. Assume the transaction price is allocated to the device (£500) and services (£1,900 [£79 per month]).

¹⁵⁵ Based on TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015 and TRG Agenda paper no. 34, March 2015 Meeting - Summary of Issues Discussed and Next Steps, dated 13 July 2015.

The example also assumes that the arrangement includes a financing component, and that the entity transfers the device first and recognises revenue for £500. Each month the entity transfers the services and recognises revenue for £79.

Under approach (1) above, an entity would be allowed to apply the practical expedient because the period between transfer of the good or service and customer payment would be less than one year for both the device and the related services. This is because, in the example provided, the device would be 'paid off' after five months. The entity also notes that any given month of service will be settled in less than 12 months under this approach. For example, services delivered in month 1 will be fully paid in month 6, services delivered in month 2 will be fully paid in month 7, etc.

Under approach (2) above, an entity would not be able to apply the practical expedient because the device would be deemed to be paid off over the full 24 months (i.e., greater than one year). Each month, £79 of the cash is allocated to service and £21 cash is allocated to the device. The amount related to the service receivable is fully settled at the end of each month. The entity will, however, receive the full amount outstanding on the handset only over 24 months (£21 per month for 24 months).

Approach (2) above would be appropriate in circumstances similar to the example above, when the cash payment is not directly tied to the earliest good or service delivered in a contract. Approach (1) would be appropriate when the cash payment is directly tied to the earliest good or service delivered in a contract. However, it might be difficult to tie a cash payment directly to a good or service because cash is fungible. Accordingly, judgement is required based on the facts and circumstances.

Question 6-21: How does an entity allocate the effects of time value of money when there are multiple performance obligations in a contract?¹⁵⁶

Section 23 is clear that, when determining the transaction price in Step 3 of the model, the effect of financing is excluded from the transaction price prior to the allocation of the transaction price to performance obligations (which occurs in Step 4). However, it might be reasonable for an entity to attribute a financing component to one or more, but not all, of the performance obligations in the contract. In doing so, the entity would analogise to the exceptions for allocating variable consideration and/or discounts to one or more (but not all) performance obligations, if the basis for allocation depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract (see 7.3 below). However, attribution of a financing component to one (or some) of the performance obligations requires the use of judgement, especially because cash is fungible.

Question 6-22: Is an entity required to evaluate whether a customer option that provides a material right includes any effects of time value of money? If so, how would entities perform this evaluation?

See response to Question 5-28 in 5.6 above.

6.5.4 Financial statement presentation of the effects of the time value of money

As discussed in 6.5 above, when a financing component exists in a contract, the transaction price is adjusted so that the amount recognised as revenue is the present value of future cash receipts (or, when applicable, 'cash selling price') attributed to the underlying goods or services at the time of transfer. Essentially, a contract with a customer that has a financing component would be separated into a revenue component (for the notional cash selling price) and a loan component (for the effect of the deferred or advance payment terms). Consequently, the accounting for accounts receivable arising from a contract that has a financing component must be comparable to the accounting for a loan with the same features.

The amount allocated to the financing component must be presented separately from revenue recognised from contracts with customers. An entity is required to present interest revenue separately from revenue from contracts with customers in the income statement. [FRS 102.23.58]. It also follows that interest expense is presented separately from revenue from contracts with customers. The financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears). The interest income or expense is recognised over the financing period using the effective interest method described in Section 11 (see Chapter 13 at 6.2).

¹⁵⁶ Based on TRG Agenda paper no. 30, *Significant Financing Components*, dated 30 March 2015 and TRG Agenda paper no. 34, March 2015 Meeting - Summary of Issues Discussed and Next Steps, dated 13 July 2015.

As discussed in 11.1 below, a contract asset (or receivable) or contract liability is generated (and presented on the balance sheet) when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. As shown in the Illustrations in 6.5.3 above, interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer. For example, Illustration 6-10 in 6.5.3 above illustrates a situation in which an entity transfers control of a good to a customer, but the customer is not required to pay for the good until two years after delivery. The contract includes a financing component. Furthermore, the customer has the right to return the good for 90 days. The product is new and the entity does not have historical evidence of returns activity. Therefore, the entity is not able to recognise revenue (or a contract asset or receivable) upon delivery because it cannot assert that it is highly probable that the entity will be entitled to the cumulative amount of revenue in the future (i.e., it cannot assert that it is highly probable that the product will not be returned). Accordingly, during the 90-day return period, the entity also cannot record interest income. However, as depicted in the example, once the return period lapses, the entity can record revenue and a receivable, as well as begin to recognise interest income.

The above discussion is consistent with IFRS 15 which requires an entity to present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Also, under IFRS 15, interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised in accounting for a contract with a customer. [IFRS 15.65]. The IASB noted in the Basis for Conclusions on IFRS 15 that the requirement in paragraph 65 of IFRS 15 does not preclude an entity from presenting interest income as revenue when interest income represents income from an entity's ordinary activities (see 3.1.3 above), which might be the case for banks and other entities with similar types of operations. [IFRS 15.BC247]. See also further discussion in Question 11-7 in 11.2 below.

Although there are two components within the contract when there is a financing component (i.e., the revenue component and the financing component), it is only in the case of deferred payment terms that there are two cash flow components. In that case, the revenue component cash flows are classified as cash flows from operating activities, and the cash flows related to the financing component are classified consistent with the entity's choice to present cash flows from interest received in accordance with Section 7 *Statement of Cash Flows* (i.e., as cash flows from operating or investing activities). [FRS 102.7.15]. If the customer pays in advance, the sum of the cash amount and the accrued interest represent revenue, and thus there is only one cash flow component. Accordingly, the cash received is classified as cash flows from operating activities. See Chapter 7 at 3.3 for further discussion.

Impairment losses on receivables, with or without a financing component, are presented in line with the general requirements of Section 5 *Statement of Comprehensive Income and Income Statement* (see Chapter 6 at 5) and disclosed in accordance with Section 11 or Section 12 (see Chapter 13). However, Section 23 makes it clear that such amounts are disclosed separately from impairment losses from other contracts (see 11.2 below). [FRS 102.23.133(b)].

How we see it

We believe entities might need to expend additional effort to track impairment losses on assets arising from contracts that are within the scope of Section 23 separately from impairment losses on assets arising from other contracts. Entities need to ensure that they have the appropriate systems, internal controls, policies and procedures in place to collect and separately present this information.

6.6 Non-cash consideration

Customer consideration might be in the form of goods, services or other non-cash consideration (e.g., PP&E, a financial instrument). When an entity (i.e., the seller or vendor) receives, or expects to receive, non-cash consideration, the fair value of the non-cash consideration is included in the transaction price. [FRS 102.23.61].

It is likely that an entity will apply the requirements of Section 2A *Fair Value Measurement* or Section 26 when measuring the fair value of any non-cash consideration. If an entity cannot reasonably estimate the fair value of non-cash consideration, it measures the non-cash consideration indirectly by reference to the stand-alone selling price of the promised goods or services. [FRS 102.23.61]. Significant judgement and consideration of specific facts and circumstances might be required in such situations (e.g., advertising barter transactions, see 6.6.2 below for further discussion on barter transactions).

For contracts with both non-cash consideration and cash consideration, an entity needs to measure the fair value of the non-cash consideration and look to other requirements within Section 23 to account for the cash consideration. For example, for a contract in which an entity receives non-cash consideration and a sales-based royalty, the entity would measure the fair value of the non-cash consideration and refer to the requirements within Section 23 for the sales-based royalties.

Note that IFRS 15 provides further guidance (as discussed below) when dealing with non-cash consideration which an entity reporting under FRS 102 could consider.

The fair value of non-cash consideration might change both because of the form of consideration (e.g., a change in the price of a share an entity is entitled to receive from a customer) and for reasons other than the form of consideration (e.g., a change in the exercise price of a share option because of the entity's performance). Under IFRS 15, if an entity's entitlement to non-cash consideration promised by a customer is variable for reasons other than the form of consideration (i.e., there is uncertainty as to whether the entity receives the non-cash consideration if a future event occurs or does not occur), the entity considers the constraint on variable consideration. [IFRS 15.68].

In some transactions, a customer contributes goods or services, such as equipment or labour, to facilitate the fulfilment of the contract. Under IFRS 15, if the entity obtains control of the contributed goods or services, it would consider them non-cash consideration and account for that consideration as described above. [IFRS 15.69]. Assessing whether the entity obtains control of the contributed goods or services by the customer might require judgement.

Note that any assets recognised as a result of non-cash consideration are accounted for in accordance with other sections of FRS 102 (e.g., Section 17).

Illustration 6-12 below, which is based on Example 31 in IFRS 15, is an example of a transaction for which non-cash consideration is received in exchange for services provided: [IFRS 15.IE Example 31, IFRS 15.IE156-IE158]

Illustration 6-12: Entitlement to non-cash consideration

An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on 1 January 20X6 and work begins immediately. The entity concludes that the service is a single performance obligation in accordance with paragraph 23.17(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service.

The entity measures its progress towards complete satisfaction of the performance obligation as each week of service is complete. To determine the transaction price (and the amount of revenue to be recognised), the entity measures the fair value of 100 shares that are received upon completion of each weekly service. The entity does not reflect any subsequent changes in the fair value of the shares received (or receivable) in revenue (see 6.6.1 below).

6.6.1 Non-cash consideration application considerations

One of the application issues related to accounting for non-cash consideration is about the date to use when measuring the fair value of non-cash consideration for inclusion within the transaction price. In addition, the variability of non-cash consideration could arise both from its form (e.g., shares) and for other reasons (e.g., performance factors that affect the amount of consideration to which the entity will be entitled). Consequently, it is not clear how the constraint on variable consideration would be applied in such circumstances.

At the January 2015 TRG meeting, the TRG members discussed these matters for purposes of IFRS 15 application.¹⁵⁷ We consider that such TRG discussions on these matters are relevant in applying the related Section 23 requirements.

¹⁵⁷ TRG Agenda paper no. 15, *Noncash consideration*, dated 26 January 2015, and TRG Agenda paper no. 25, *January 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 30 March 2015.

TRG members agreed that, while the revenue standard requires non-cash consideration (e.g., shares, advertising provided as consideration from a customer) to be measured at fair value, it is unclear when that fair value must be measured (i.e., the measurement date). The TRG members discussed three measurement date options:

- Contract inception
 - When the non-cash consideration is received (or receivable)
- Or
- At the earlier of (i) when the non-cash consideration is received (or is receivable) and (ii) when (or as) the related performance obligation is satisfied

Consider the example in Illustration 6-12 included in 6.6 above). Under the first view, the entity would measure fair value of all of the 5,200 shares on 1 January 20X6 (i.e., contract inception). Under the second view, it would measure the fair value of 100 shares at the end of each week, since this is when each week's shares are received (or receivable). Under the third view, the entity would measure the fair value of the weekly 100 shares over the course of each week. This is because the entity satisfies its performance obligation over time each week and this is earlier than when the non-cash consideration is received (or receivable), which is at the end of the week. As noted in the example in Illustration 6-12 above, the entity does not reflect any subsequent changes in fair value in revenue.

Each view received support from some TRG members. Since neither IFRS 15 nor Section 23 specifies the measurement date, an entity needs to use its judgement to determine the most appropriate measurement date when measuring the fair value of non-cash consideration. However, in accordance with paragraph 126 of IFRS 15 and in paragraphs 8.6 to 8.7, information about the methods, inputs and assumptions used to measure non-cash consideration might need to be disclosed. [IFRS 15.126, IFRS 15.BC254E, FRS 102.8.6, FRS 102.8.7].

Whichever method is selected, under IFRS 15, the objective is to choose a single measurement date. That is, the fact that IFRS 15 does not specify the measurement date does not change the requirement in the standard not to update the fair value measurement if the reason for the change is solely because of its form (i.e., because it is non-cash). [IFRS 15.68].

Also, as discussed in 6.6 above, IFRS 15 requires that the constraint on variable consideration be applied to non-cash consideration only if the variability is due to factors other than the form of consideration (i.e., variability arising for reasons other than changes in the price of the non-cash consideration). The constraint does not apply if the non-cash consideration varies because of its form (e.g., listed shares for which the share price changes).

However, IFRS 15 does not address how the constraint would be applied when the non-cash consideration is variable due to both its form and other reasons. While some of the TRG members said that IFRS 15 could be interpreted to require an entity to split the consideration based on the source of the variability, other TRG members highlighted that this approach would be overly complex and would not provide useful information.

6.6.2 Barter transactions

An entity might enter into barter transactions to provide goods or services in exchange for receiving similar or dissimilar goods or services from its customers. In some cases, barter transactions include cash consideration in addition to the non-cash consideration. Neither Section 23 nor IFRS 15 contains specific requirements for barter transactions. Therefore, significant judgement and consideration of the specific facts and circumstances will be needed when accounting for such transactions.

Refer to the EY publication, International GAAP®, for further discussions of, and additional guidance on, accounting for a barter transaction.

6.7 Consideration paid or payable to a customer

Many entities make payments to their customers. In some cases, the consideration paid or payable represents purchases by the entity of goods or services offered by the customer that satisfy a business need of the entity. In other cases, the consideration paid or payable represents incentives given by the entity to entice the customer to purchase, or continue purchasing, its goods or services.

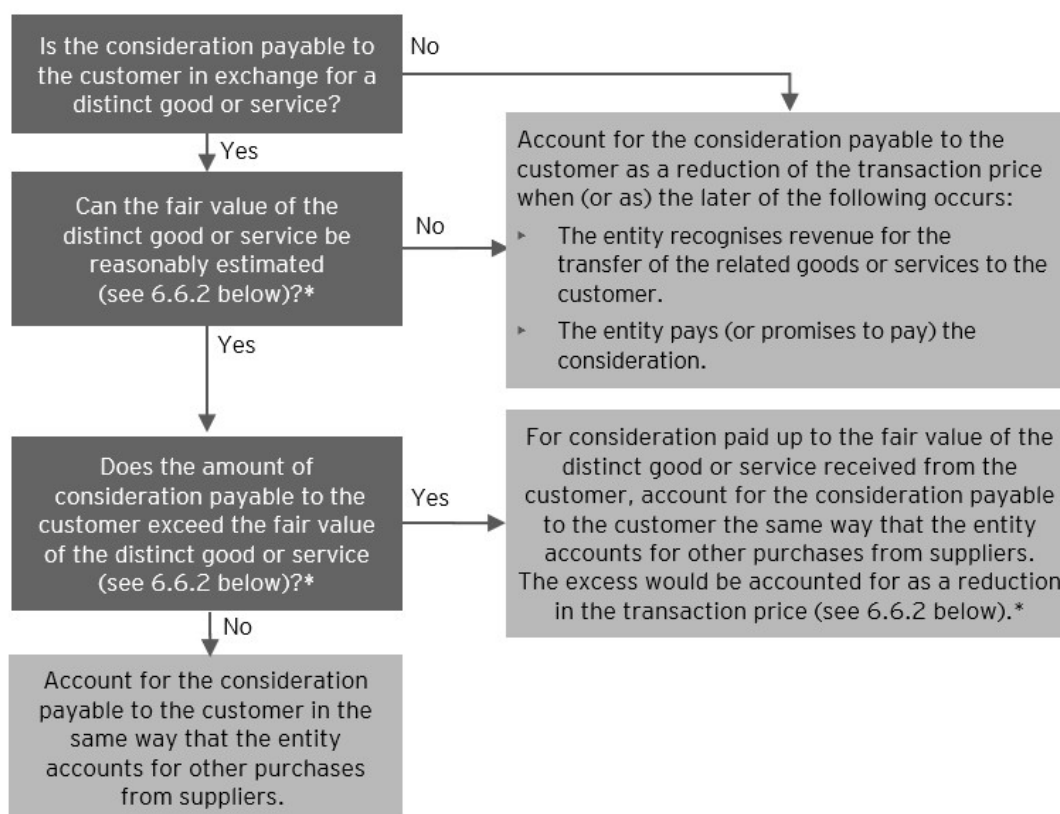
Section 23 provides the following requirements for consideration paid or payable to a customer: [FRS 102.23.62, FRS 102.23.63, FRS 102.23.64]

Extract from Section 23**Consideration payable to a customer**

- 23.62** Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (eg a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).
- 23.63** An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 23.21 to 23.25) that the customer transfers to the entity.
- 23.64** If consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognise the reduction of revenue when (or as) the later of either of the following events occurs:
- the entity recognises revenue for the transfer of the related goods or services to the customer; and
 - the entity pays or promises to pay the consideration (even if the payment is conditional on a future event).

Figure 6-3 below illustrates these requirements.

Figure 6-3: Consideration payable to a customer



* Section 23 does not have explicit guidance in circumstances when the consideration payable to the customer exceeds the fair value of the distinct good or service nor when the fair value of the distinct good or service cannot be reasonably estimated. This is further discussed in 6.6.2 below.

Section 23 indicates that an entity accounts for the consideration payable to a customer, regardless of whether the purchaser receiving the consideration is a direct or indirect customer of the entity. This includes consideration to any purchasers of the entity's products at any point along the distribution chain. This would include entities that make payments to the customers of resellers or distributors that purchase directly from the entity (e.g., manufacturers of breakfast cereals might offer coupons to end-consumers, even though their direct customers are the grocery stores that sell to end-consumers). The requirements in Section 23 apply to entities that derive revenue from sales of services, as well as entities that derive revenue from sales of goods.

The requirements for consideration payable to a customer could also be helpful for entities receiving such consideration from vendors to consider in the absence of other, specific guidance. For further discussion of this topic, entities reporting under FRS 102 also could refer to the publication *Applying IFRS: Accounting for Payments from Suppliers*.¹⁵⁸

Frequently asked questions

Question 6-23: Who is considered to be an entity's customer when applying the requirements for consideration payable to a customer?¹⁵⁹

The requirements for consideration payable to a customer generally apply to all payments made to entities/customers in the distribution chain for that contract. However, there could also be situations in which the requirements would apply to payments made to any customer of an entity's customer outside the distribution chain if both parties are considered the entity's customers. For example, in an arrangement with a principal, an agent and an end-consumer, an agent might conclude that its only customer is the principal or it might conclude that it has two customers - the principal and the end-consumer. Regardless of this assessment, an agent's payment to a principal's end-consumer that was contractually required based on an agreement between the entity (agent) and the principal would represent consideration payable to a customer. Absent similar contract provisions that clearly indicate when an amount is consideration payable, agents need to evaluate their facts and circumstances to determine whether payments made to an end-consumer would be considered a reduction of revenue or a marketing expense.

Question 6-24: How does an entity that acts as an agent account for incentive payments made to end-consumers that are not the entity's customers and are outside the distribution chain?

An entity might make incentive payments to an end-consumer that is not the entity's direct customer and is not identified as an indirect customer (e.g., the end-consumer does not purchase the entity's goods or services at any point along the distribution chain). Incentive payments of this nature might be common in arrangements in which an entity acts as an agent to facilitate the sale of its customer's (i.e., the principal's) goods or services to an end-consumer (e.g., incentive payments offered by platform entities). The entity will need to apply significant judgement to determine: (1) whether the end-consumer is a customer (see 3.1.3 above); and (2) the appropriate accounting treatment for incentive payments made to an end-consumer that is not identified as a customer (e.g., whether to account for the payment as a reduction of revenue or as a marketing expense).

The entity first has to consider whether the payment to the end-consumer is in exchange for a distinct good or service acquired from the end-consumer at fair value. If it is, the entity must account for the payment in the same way it accounts for other purchases from suppliers (see 6.7.2 below). If the incentive payment is not in exchange for a distinct good or service, the entity will need to apply significant judgement to determine whether the payment results in a reduction to revenue.

An entity's customer might have a valid expectation that the payment will be made to the end-consumer based on reasonably available information about the entity's incentive programme, including written or oral communications (e.g., advertisements, press releases, published policies, customer reporting) and any customary business practices of the entity. Entities will need to carefully consider their facts and circumstances to determine whether a valid expectation exists.

Similar to a contractually required obligation, an implied obligation to a customer to provide incentive payments to an end-consumer is accounted for as consideration payable to a customer and results in a reduction to the transaction price if the payment to the end-consumer is not in exchange for a distinct good or service.

In certain arrangements, an entity might make a payment to an end-consumer in exchange for a distinct good or service and the payment exceeds the fair value of that good or service. The entity will need to apply significant judgement in these arrangements to determine whether the excess payment represents an implied obligation to its customer. If the entity determines the excess payment is an implied obligation to the customer, then the excess payment must result in a reduction to the transaction price. See also discussion in 6.7.2 below.

Given the judgement involved with such arrangements, an entity needs to consider the disclosure requirements in FRS 102.8.6 (see 11 below and Chapter 6 at 7.3). [FRS 102.8.6].

¹⁵⁸ Available on www.ey.com/IFRS.

¹⁵⁹ Based on TRG Agenda paper no. 28, *Consideration Payable to a Customer*, dated 30 March 2015, TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015, and TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015.

6.7.1 Forms of consideration paid or payable to a customer

Consideration paid or payable to customers commonly takes the form of vouchers or coupons, among others. Furthermore, in determining the transaction price, the promise to pay the consideration might be implied by the entity's customary business practice. [FRS 102.23.41].

Since consideration paid or payable to a customer can take many different forms, entities have to carefully evaluate each transaction to determine the appropriate treatment of such amounts (i.e., as payment for a distinct good or service, a reduction of the transaction price or a combination of both, as illustrated in Figure 6-3 in 6.7 above). Some common examples of consideration paid to customers are given below:

- **Slotting fees** - Manufacturers of consumer products commonly pay retailers fees to have their goods displayed prominently on store shelves. Generally, such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price.
- **Co-operative advertising arrangements** - In some arrangements, an entity agrees to reimburse a reseller for a portion of costs incurred by the reseller to advertise the entity's products. The determination of whether the payment from the vendor is in exchange for a distinct good or service at fair value depends on a careful analysis of the facts and circumstances of the contract.
- **Price protection** - An entity might agree to reimburse a retailer up to a specified amount for shortfalls in the sales price received by the retailer for the entity's products over a specified period of time. Normally such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price (see Question 6-7 in 6.2.1 above).
- **Coupons, vouchers and rebates** - An indirect customer of an entity might receive a refund of a portion of the purchase price of the product or service acquired by returning a form to the retailer or the entity. Generally, such fees do not provide a distinct good or service to the manufacturer and are treated as a reduction of the transaction price.
- **'Pay-to-play' arrangements** - In some arrangements, an entity pays an upfront fee to the customer prior to, or in conjunction with, entering into a contract. In most cases, these payments are not associated with any distinct good or service to be received from the customer and are treated as a reduction of the transaction price.
- **Purchase of goods or services** - Entities often enter into supplier-vendor arrangements with their customers in which the customers provide them with a distinct good or service. For example, a software entity buys its office supplies from one of its software customers. In such situations, the entity has to carefully determine whether the payment made to the customer is solely for the goods or services received or whether part of the payment is actually a reduction of the transaction price for the goods or services the entity is transferring to the customer.

Frequently asked questions

Question 6-25: Which payments to a customer are within the scope of the requirements for consideration payable to a customer?¹⁶⁰

Generally, an entity does not need to separately analyse each payment to a customer if it is apparent that the payment is for a distinct good or service acquired in the normal course of business at a market price. However, if the business purpose of a payment to a customer is unclear or the goods or services are acquired in a manner that is inconsistent with market terms that other entities would receive when purchasing the customer's good or services, the payment needs to be evaluated under these requirements.

Also, in the Basis for Conclusions on IFRS 15, the IASB noted that the amount of consideration received from a customer for goods or services and the amount of any consideration paid to that customer for goods or services could be linked even if they are separate events. [IFRS 15.BC257].

Question 6-26: Do litigation settlements payable by an entity to its customer represent consideration payable to a customer?

An entity might be sued (for example, as a result of anti-competition investigations related to the price of the goods or services) by a current or previous customer in relation to goods or services that have already been transferred (or partially transferred) to a customer. If the entity is ordered to pay compensation to the customer, the entity needs to consider the accounting for the payment and the corresponding effects on the entity's statement of profit or loss. However, not all disputes with customers result in third-party arbitration or litigation proceeding. For example, an entity might agree to transfer consideration to a customer because of a resolution negotiated only between the entity and the customer.

Entities need to carefully consider all relevant facts and circumstances to determine the appropriate accounting, including whether compensation paid represents consideration payable to a customer. Factors to consider include whether the litigation is related to a revenue contract and whether the contract related to the litigation was previously completed, which might require judgement to determine.

If a litigation settlement is related to a revenue contract and that contract is not completed, Section 23 would apply unless it is covered by an assurance type warranty accounted for in accordance with Section 21 (see 10.1.3 below).

If a litigation settlement is related to a revenue contract and that contract is completed, an entity might conclude it is appropriate to apply Section 21 to account for any (contingent) liability because there is no longer a contract or a customer relationship. If the entity reaches that conclusion, the compensation to the customer charged by the court's decision would not be part of the price that the parties agreed for the completed contract, nor related to any future contracts with that customer. However, an entity that applies Section 21 might determine that it only applies to the recognition and measurement of any provision and not to the impact on profit or loss, and that, instead, it would apply Section 23 to determine the classification in profit or loss, in accordance with the requirements for consideration payable to a customer. This is because Section 21 requires an entity to recognise the amount paid or payable as an expense, unless another section of FRS 102 requires the cost to be recognised as part of the cost of an asset such as inventories or PP&E. [FRS 102.21.5, FRS 102.21.11].

However, an entity might conclude that only Section 23 applies because Section 21 excludes from its scope any provision, contingent liability or contingent asset addressed by other sections of FRS 102 (including Section 23) except for onerous contracts, [FRS 102.21.1], and that Section 23 provides specific requirements for consideration payable to a customer. Although there is no longer a contract or customer relationship, the litigation is directly attributable to a previously completed customer contract, and an entity might thus conclude it is reasonable to apply Section 23.

If an entity applies Section 23, it might need to apply the requirements for contract modifications. This is because, as a result of the court's decision, the entity has an enforceable obligation to pay the customer and an (implicit or explicit) agreement between the entity (see 4 above) and customer leads to a reduction of the total consideration in the original contract. [FRS 102.23.13]. If the court finds in favour of the customer, but the amount to pay is not finalised, the consideration payable to the customer would be variable, [FRS 102.23.14, FRS 102.23.43], and the entity would need to apply the variable consideration requirements (including the constraint).

¹⁶⁰ Based on TRG Agenda paper no. 28, *Consideration Payable to a Customer*, dated 30 March 2015, TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015, and TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015.

How we see it

If the revenue contract related to the litigation is not yet completed, an entity needs to apply Section 23 to account for the litigation settlement as consideration payable to a customer, unless it is covered by an assurance-type warranty that is accounted for under Section 21.

If the revenue contract related to the litigation was previously completed, we believe an entity needs to apply judgement, based on the specific facts and circumstances, to determine whether to either apply Section 21 or Section 23 to account for any (contingent) liability, and apply the judgement consistently to similar transactions. Even if Section 21 is applied to the liability for litigation settlements, an entity might conclude that, because it is a payment to a customer, the requirements for consideration payable to a customer apply when determining the classification in profit or loss, which might result in a reduction of revenue.

For settlements of litigation or disputes that result in consideration received or receivable from a customer, please see response to Question 6-9 in 6.2.1 above.

6.7.2 Classification and measurement of consideration paid or payable to a customer

To determine the appropriate accounting treatment (and as illustrated in Figure 6-3 in 6.7 above), an entity must first determine whether the consideration paid or payable to a customer is a payment for a distinct good or service. If it is not in exchange for a distinct good or service, an entity accounts for consideration payable to a customer as a reduction in the transaction price. This is because Section 23 requires an entity to account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment is for a distinct good or service (see 6.7 above). [FRS 102.23.63]. That is, for a payment by the entity to a customer to be treated as something other than a reduction of the transaction price, the good or service provided by the customer must be distinct (as discussed in 5.2.1 above).

Sometimes, consideration payable to a customer is a payment for a distinct good or service from the customer. In certain situations, such payment exceeds the fair value of the good or service purchased from the customer. IFRS 15 provides further guidance on this matter. Under IFRS 15, if consideration payable to a customer is in exchange for a distinct good or service at fair value, an entity accounts for such purchase of the good or service in the same way it accounts for other purchases from suppliers. However, if the payment to the customer is in excess of the fair value of the distinct good or service received, the entity must account for such excess as a reduction of the transaction price. In the event that the entity cannot reasonably estimate the fair value of the good or service received from the customer, it will need to account for all of the consideration payable to the customer as a reduction in the transaction price.

[IFRS 15.71].

Illustration 6-13: Consideration paid to a customer in exchange for a distinct good or service

Entity A enters into a contract to sell goods to Customer B in the ordinary course of business (see 3.1.3 above) in exchange for cash consideration. Separately, Entity A enters into an agreement to purchase market research from Customer B related to the launch of a new product in exchange for cash consideration. The two contracts were not negotiated in contemplation of one another.

Entity A elects to purchase the market research, rather than internally developing such knowledge because of Customer's B expertise in this area. Entity A could purchase similar services from a non-customer.

Based on an evaluation of the circumstances, the cash consideration paid to the customer is in return for Customer B providing distinct services to Entity A. To reach this conclusion, Entity A considers the requirements in paragraphs 23.21 to 23.25 (see 5.2 above) and concludes that the market research services are capable of being distinct, as well as separately identifiable (or distinct within the context of the contract), from Entity A's sale of its goods to Customer B.

Entity A determines that market research is capable of being distinct from the sale of its goods to Customer B because the market research could be purchased from a non-customer. Therefore, Entity A is able to demonstrate that the market research can provide benefits on its own or with other readily available resources.

Entity A determines that the market research is distinct within the context of the contract because of the following:

- Customer B is not providing a significant service of integrating the market research with the purchases of Entity A's goods because the promises to Entity A are not a combined output of integrated goods or services.

- The market research provided by Customer B does not modify or customise the purchases of Entity A's goods. The market research and the purchases of goods are not being assembled together to produce a combined output.
- The market research is not highly interrelated or interdependent with the sale of Entity A's goods because the market research is not needed for Customer B to purchase the goods. That is, there is no significant two-way dependency between the promises.

Entity A accounts for the cash consideration paid to Customer B in the same way that it accounts for other purchases from suppliers, provided that the cash consideration paid does not exceed the fair value of the distinct services received from Customer B. If the amount of cash consideration paid by Entity A exceeds the fair value of the distinct services, that excess amount would be characterised as a reduction of the transaction price of the goods sold to Customer B in Entity A's income statement.

In many cases, determining the amount of consideration payable to a customer (e.g., cash amounts an entity pays to a customer) will be straightforward. However, if the consideration paid or payable to a customer includes a variable amount, an entity would estimate the amount using the variable consideration requirements in paragraphs 23.43 to 23.57 (see 6.2 to 6.4 above).

6.7.3 Timing of recognition of consideration paid or payable to a customer

If the consideration paid or payable to a customer is accounted for as a reduction of the transaction price, this reduction of the transaction price (and, ultimately, revenue) is recognised at the later of when: (1) the entity recognises revenue for the transfer of the related promised goods or services to the customer; or (2) the entity pays or promises to pay the consideration (even if the payment is conditional on a future event) (see 6.7 above). [FRS 102.23.64]. For example, if goods subject to a discount through a coupon are already delivered to the retailers, the discount would be recognised when the coupons are issued. However, if a coupon is issued that can be used on a new line of products that have not yet been sold to retailers, the discount would be recognised upon sale of the products to a retailer. Section 23 also notes that in determining the transaction price, the promise to pay the consideration might be implied by an entity's customary business practices. [FRS 102.23.41].

Certain sales incentives, such as mail-in rebates and manufacturer coupons, entitle a customer to receive a reduction in the price of goods or services by submitting a form or claim for a refund of a specified amount of the price charged to the customer at the point of sale. An entity must recognise a liability for those sales incentives at the later of: (a) when it recognises revenue on the goods or services; or (b) the date at which the sales incentive was offered. The amount of liability will be based on the estimated amount of discounts or refunds that will be claimed by customers, similar to how the entity would estimate variable consideration (see 6.2.2 above).

Even if the sales incentives result in a loss on the sale of the product or service, an entity also recognises a liability for those sales incentives at the later of: (a) when it recognises revenue on the goods or services; or (b) the date at which the sales incentive was offered. That is, an entity does not recognise the loss before either date. However, an entity needs to consider whether the offer indicates that the value of inventories is lower than its cost, which will require write-down of inventories to estimated selling price less costs to complete and sell [FRS 102.13.4, FRS 102.13.19].

To determine the appropriate timing of recognition of consideration payable to a customer, entities also need to consider the requirements for variable consideration. That is, Section 23's description of variable consideration is broad and includes amounts such as coupons or other forms of credits that can be applied to the amounts owed to an entity by the customer (see 6.2.1 above). Section 23 requires that all potential variable consideration be considered and reflected in the transaction price at contract inception and reassessed as the entity performs. In other words, if an entity has a history of providing this type of consideration to its customers, the requirements on estimating variable consideration would require that such amounts be considered at contract inception, even if the entity has not yet provided or explicitly promised this consideration to the customer.

A potential inconsistency arises between the requirements on consideration payable to a customer and variable consideration because the requirements specific to consideration payable to a customer indicate that such amounts are not recognised as a reduction of revenue until the *later* of when:

- The related sales are recognised
- Or
- The entity promises to provide such consideration

A literal read of these requirements seems to suggest that an entity need not anticipate offering these types of programmes, even if it has a history of doing so, and would only recognise the effect of these programmes at the later of when the entity transfers the promised goods or services or makes a promise to pay the customer. Notwithstanding this, if an entity has historically provided or intends to provide this type of consideration to customers, the requirements on estimating variable consideration (i.e., FRS 102.23.43) would require the entity to consider such amounts at contract inception when the transaction price is estimated, even if the entity has not yet provided or promised to provide this consideration to the customer.¹⁶¹ If the consideration paid or payable to a customer includes variable consideration (e.g., in the form of a discount or refund for goods or services provided), an entity would use either the expected value method or most likely amount method to estimate the amount to which the entity expects to be entitled and apply the constraint to the estimate (see 6.2.3 above for further discussion) to determine the effect of the variable consideration payable to the customer.

How we see it

We believe entities generally need to consider the requirements for variable consideration to determine the appropriate timing of recognition of consideration payable to a customer. Therefore, significant judgement might be needed to determine the appropriate timing of recognition.

Illustration 6-14 below, which is based on Example 32 in IFRS 15, is an example of consideration paid to a customer: [IFRS 15.IE Example 32, IFRS 15.IE160-IE162]

Illustration 6-14: Consideration payable to a customer

An entity that manufactures consumer goods enters into a one-year contract to sell goods to a customer that is a large global chain of retail stores. The customer commits to buy at least £15 million of products during the year. The contract also requires the entity to make a non-refundable payment of £1.5 million to the customer at the inception of the contract. The £1.5 million payment will compensate the customer for the changes it needs to make to its shelving to accommodate the entity's products.

The entity considers the requirements in paragraphs 23.62 to 23.64 and concludes that the payment to the customer is not in exchange for a distinct good or service that transfers to the entity. This is because the entity does not obtain control of any rights to the customer's shelves. Consequently, the entity determines that, in accordance with paragraph 23.63, the £1.5 million payment is a reduction of the transaction price.

The entity applies the requirements in paragraph 23.64 and concludes that the consideration payable is accounted for as a reduction in the transaction price when the entity recognises revenue for the transfer of the goods. Consequently, as the entity transfers goods to the customer, the entity reduces the transaction price for each good by 10% (£1.5 million ÷ £15 million). Therefore, in the first month in which the entity transfers goods to the customer, the entity recognises revenue of £1.8 million (£2.0 million invoiced amount less £0.2 million of consideration payable to the customer).

Frequently asked questions

Question 6-27: How does an entity account for upfront payments to a customer or a potential customer?¹⁶²

While the requirements for consideration payable to a customer clearly apply to payments to customers under current contracts, it is unclear how to account for upfront payments to potential customers and payments that relate to both current and anticipated contracts.

There could be two approaches. Under Approach A, an entity would recognise an asset for the upfront payment and reduce revenue as the related goods or services (or as the expected related goods or services) are transferred to the customer. As a result, the payment might be recognised in profit or loss over a period that is longer than the contract term. Entities would determine the amortisation period based on facts and circumstances and would assess the asset for recoverability using the principles in asset impairment models in other sections of FRS 102. Under Approach B, entities would reduce revenue in the current contract by the amount of the payment. If there is no current contract, entities would immediately recognise the payment in profit or loss.

¹⁶¹ TRG Agenda paper no. 37, *Consideration Payable to a Customer*, dated 13 July 2015 and TRG Agenda paper no. 44, *July 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 9 November 2015.

¹⁶² Based on FASB TRG Agenda paper no. 59, *Payments to Customers*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

An entity needs to apply the view that best reflects the substance and economics of the payment to the customer; it would not be an accounting policy choice. Entities would evaluate the nature of the payment, the rights and obligations under the contract and whether the payment meets the definition of an asset. An entity's decision on which view is appropriate might be a significant judgement in the determination of the transaction price that would require disclosure under paragraph 8.6 (see 11 below and Chapter 6 at 7.3). [FRS 102.8.6].

How we see it

We believe an entity has to carefully evaluate all facts and circumstances of payments made to customers to determine the appropriate accounting treatment. However, if an entity expects to generate future revenue associated with the payment, we believe an entity generally applies Approach A (assuming any asset recorded is recoverable). If no revenue is expected as a result of the payment, Approach B might be appropriate.

If an entity recognises an asset for consideration paid to a customer (because the payment made to the customer will be recognised as a reduction from revenue in future periods when (or as) goods or services are transferred to the customer), a question arises about the nature of that asset. This is relevant because it would determine, among other things, which impairment requirements apply to the asset. This is discussed further in 6.7.4 below.

Question 6-28: How does an entity present 'negative revenue' resulting from consideration paid or payable to a customer that exceeds the amount to which the entity expects to be entitled?

In certain arrangements, consideration paid or payable to a customer could exceed the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services in a contract with a customer. In these situations, recognition of payments to the customer as a reduction of revenue could result in 'negative revenue'. Neither Section 23 nor IFRS 15 specifically address how entities would present negative revenue.

For application of IFRS 15, stakeholders had asked the TRG whether an entity would reclassify negative revenue resulting from consideration paid or payable to a customer to expense and, if so, in what circumstances. The TRG did not discuss this question in detail and no additional application guidance was provided.

As discussed above, paragraph 23.63 states that an entity must account for consideration payable to a customer as a reduction of the transaction price (and, therefore, of revenue), unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity.

How we see it

Therefore, we believe it is appropriate for an entity to present payments to a customer in excess of the transaction price that are not in exchange for a distinct good or service within revenue.

However, we believe it might also be acceptable, in limited circumstances, to reclassify negative revenue to expense in an entity's income statement. For example, if an entity demonstrates that characterisation of consideration payable to a customer as a reduction of revenue results in negative revenue for a specific customer on a cumulative basis (i.e., since the inception of the overall relationship between the entity and the customer), then the amount of the cumulative shortfall might be re-characterised as an expense.

In determining whether cumulative negative revenue exists for a specific customer, revenues from all transactions with that customer recognised by all entities within the consolidated group that includes the entity paying the consideration to the customer must be considered (i.e., revenues recognised from sales to the customer from all of the consolidated entities needs to be considered). Therefore, an entity that considers reclassifying negative revenue to expense must carefully evaluate all of its historical contractual arrangements with the customer before reclassifying any cumulative shortfall in revenue to expense. In addition, when making this evaluation, we believe an entity needs to incorporate revenue from any current or anticipated contracts with the customer to transfer goods or services in the future.

To provide users with sufficient information about its revenue transactions and significant judgements applied, entities need to consider the disclosure requirements in paragraph 8.6 (see 11 below and Chapter 6 at 7.3). [FRS 102.8.6].

6.7.4 Impairment of consideration paid to a customer recognised as an asset

If an entity has recognised an asset for consideration paid to a customer (because the payment made to the customer will be recognised as a reduction from revenue in future periods when (or as) goods or services are transferred to the customer, see 6.7.3 above), it will need to consider the nature of that asset to determine which impairment requirements apply. Specifically, whether the asset is subject to the impairment requirements in Section 11 (see 10.1.3 below) or the impairment requirements in Section 27 *Impairment of Assets* (see Chapter 29).

Consideration paid to a customer recognised as an asset arises from a contract that is within the scope of Section 23. However, it is not a 'contract asset' as defined in FRS 102 (see Appendix A and 11.1.1 below) because it does not represent a conditional right to consideration in exchange for goods or services that it has transferred to a customer. In substance, consideration paid to a customer recognised as an asset is similar to a prepayment.

If the payment to the customer is refundable, the impairment requirements in Section 11 would apply. Otherwise, the asset would be within the scope of Section 27 for impairment purposes (see Chapter 29). Judgement might be needed to assess impairment. For example, under Section 27, an entity might need to test the asset for impairment as part of a cash-generating unit. When assessing indicators and/or testing for impairment, identifying which goods or services are related to the deferred consideration payable to a customer and whether the customer is committed or only expected to purchase them might also be important.

6.8 Non-refundable upfront fees

In certain circumstances, entities receive payments from customers before they provide the contracted service or deliver a good. Upfront fees generally relate to the initiation, activation or set up of a good to be used or a service to be provided in the future. Upfront fees might also be paid to grant access to, or provide, a right to use a facility, product or service. In many cases, the upfront amounts paid by the customer are non-refundable. Examples include joining fees in health club membership contracts, set-up fees in some service contracts and initial fees in some supply contracts. [FRS 102.23.29].

Entities must evaluate whether a non-refundable upfront fee relates to the transfer of a promised good or service. If it does, the entity is required to determine whether to account for the promised good or service as a separate performance obligation (see 5 above). [FRS 102.23.30]. In addition, Question 5-7 in 5.2.1.G above discusses how entities would determine whether implementation services are distinct.

Section 23 notes that, even though a non-refundable upfront fee relates to an activity that the entity is required to undertake at or near contract inception in order to fulfil the contract, in many cases, that activity does not result in the transfer of a promised good or service to the customer. Instead, in many situations, an upfront fee represents an advance payment for future goods or services and, therefore, would be recognised as revenue when those future goods or services are provided. [FRS 102.23.30].

The existence of a non-refundable upfront fee might indicate that the contract includes a renewal option for future goods or services at a reduced price (if the customer renews the agreement without the payment of an additional upfront fee). In such circumstances, an entity would need to assess whether the option is a material right (i.e., another performance obligation in the contract) (see 5.6 above). [FRS 102.23.30]. If the entity concludes that the non-refundable upfront fee does not provide a material right, the fee would be part of the consideration allocable to the goods or services in the contract and would be recognised when (or as) the good or service to which the consideration was allocated is transferred to the customer. If an entity concludes that the non-refundable upfront fee provides a material right, the amount of the fee allocated to the material right would be recognised over the period of benefit of the fee, which might be the estimated customer life.

The following Illustration depicts the allocation of a non-refundable upfront fee determined to be a material right:

Illustration 6-15: Non-refundable upfront fees

A customer signs a one-year contract with a health club and is required to pay both a non-refundable initiation fee of £150 and an annual membership fee in monthly instalments of £40. At the end of each year, the customer can renew the contract for an additional year without paying an additional initiation fee. The customer is then required to pay an annual membership fee in monthly instalments of £40 for each renewal period. The club's activity of registering the customer does not transfer any service to the customer and, therefore, is not a performance obligation. By not requiring the customer to pay the upfront membership fee again upon renewal, the club is effectively providing a discounted renewal rate to the customer.

The club determines that the renewal option is a material right because it provides a renewal option at a lower price than the range of prices typically charged for new customers. Therefore, it is a separate performance obligation. Based on its experience, the club determines that its customers, on average, renew their annual memberships twice before terminating their relationship with the club. As a result, the club determines that the option provides the customer with the right to two annual renewals at a discounted price. In this scenario, the club would allocate the total transaction consideration of £630 (£150 upfront membership fee + £480 (£40 x 12 months)) to the identified performance obligations (monthly services for the one-year contract and renewal option) based on the relative stand-alone selling price method. In accordance with FRS 102.23.33, the amount allocated to the renewal option would be recognised when, or as, the future goods or services are transferred (e.g., years two and three of the services if the renewal option is fully exercised) or when the renewal option expires.

Alternatively, the club could value the option by 'looking through' to the optional goods or services using the practical alternative provided in paragraphs 23.34 to 23.35 (see 7.1.5 below). In that case, the club would determine that the total hypothetical transaction price (for purposes of allocating the transaction price to the option) is the sum of the upfront fee plus three years of service fees (i.e., £150 + £1,440) and would allocate that amount to all of the services expected to be delivered or 36 months of membership (or £44.17 per month). Therefore, the total consideration in the contract of £630 would be allocated to the 12 months of service (£530 (£44.17 x 12 months)) with the remaining amount being allocated to the renewal option (£100 (£630 - £530)). Assuming the renewal option is exercised for year 2 and year 3, the amount allocated to the renewal option (£100) would be recognised as revenue over each renewal period. One acceptable approach would be to reduce the initial £100 deferred revenue balance for the material right by £4.17 each month (£100 ÷ 24 months remaining), assuming that the estimated renewal period of two years remains unchanged. See 5.6 above and 7.1.5 below for a more detailed discussion of the treatment of options (including the practical alternative allowed under paragraphs 23.34 to 23.35) and 7.1 and 7.2 below for a discussion of estimating stand-alone selling prices and allocating consideration using the relative stand-alone selling price method.

In some cases, an entity might charge a non-refundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks). If those set-up activities do not satisfy a performance obligation, the entity is required to disregard such activities (and the related costs) when measuring progress (see 8.1.4 below). This is because the costs of set-up activities do not depict the transfer of services to the customer. In addition, the entity is required to assess whether costs incurred in setting up a contract are costs incurred to fulfil a contract that meet the requirements for capitalisation in Section 23 (see 10.3.2 below).

Frequently asked questions

Question 6-29: Over what period would an entity recognise a non-refundable upfront fee (e.g., fees paid for membership to a club, activation fees for phone, cable or internet services) that does not relate to the transfer of a good or service?¹⁶³

Generally, the period over which a non-refundable upfront fee is recognised depends on whether the fee provides the customer with a material right with respect to future contract renewals (see 5.6 above). For example, assume that an entity charges a one-time activation fee of £50 to provide £100 of services to a customer on a month-to-month basis. If the entity concludes that the activation fee provides a material right, the fee would be recognised over the service period during which the customer is expected to benefit from not having to pay an activation fee upon renewal of the service. That period might be the estimated customer life in some situations. If the entity concludes that the activation fee does not provide a material right, the fee would be recognised over the contract duration (i.e., one month).

Question 6-30: How does a utility entity determine whether a contract that includes a non-refundable upfront fee received for establishing a connection to a network (i.e., a connection fee) is within the scope of Section 23?

Utility entities are often responsible for constructing infrastructure (e.g., a pipe) that will physically connect a building to its network (i.e., connection) and for providing ongoing services (e.g., delivery of electricity, gas, water). In exchange, a utility entity generally charges the customer a non-refundable upfront connection fee and a separate fee for the ongoing services. Furthermore, the connection fee and/or the fee for ongoing services are often subject to rate regulation established through a formal regulatory framework that affects the rates that a utility entity is allowed to charge to its customers.

Utility entities first need to assess whether some or all of the contract is within the scope of another section of FRS 102 (e.g., Section 20, Section 17). If the contract is partially within the scope of Section 23, the entity would need to separate the non-revenue components, in accordance with paragraph 23.3, and account for the remainder within the scope of Section 23 (see 3.1.5 above for further discussion).

To be within the scope of Section 23, a vendor-customer relationship needs to exist.

How we see it

Provided such goods or services are an output of the ordinary activities of the entity (see 3.1.3 above), we believe a vendor-customer relationship would exist (and the contract would be wholly, or partially, within the scope of Section 23) if:

- The ongoing service is part of the contract or part of an associated contract for ongoing services that is combined with the contract to establish the connection if the combined contract criteria in paragraph 23.12 are met (see 4.3 above). In a rate-regulated environment, the contract to transfer ongoing services to a customer (e.g., delivery of energy) might be implied as the customer has no alternative other than purchasing the good or service from the entity that is responsible for creating the connection.
- Or
- The customer obtains control of the infrastructure asset (e.g., a pipe) or the connection.

Question 6-31: What factors might be relevant when a utility entity applies the guidance to non-refundable upfront fees for establishing a connection to a network?

As discussed in Question 6-30 above, utility entities are often responsible for constructing infrastructure (e.g., a pipe) that will physically connect a building to its network (i.e., connection) and might receive a non-refundable upfront connection fee in exchange. Applying the non-refundable upfront fee guidance in such contracts often requires significant judgement and depends on the facts and circumstances. For example, if more than one party is involved, the utility entity needs to consider the principal versus agent guidance (see 5.4 above) in addition to the non-refundable upfront fee guidance.

The non-refundable upfront fee guidance requires an entity to determine if the upfront fee is related to a distinct good or service. [FRS 102.23.30].

¹⁶³ Based on TRG Agenda paper no. 32, *Accounting for a Customer's Exercise of a Material Right*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

How we see it

Determining whether the connection to the network is a distinct good or service depends on the facts and circumstances and might require significant judgement.

As part of this assessment:

- A utility entity needs to determine whether the connection is a promised good or service in the contract. It considers explicit promises in the contract and implied promises that create a valid expectation of the customer that it will transfer control of the connection to the customer. [FRS 102.23.19, FRS 102.23.20]. This is likely to require significant judgement if the infrastructure asset remains an asset of the utility entity.
- If the connection is a promised good or service, a utility entity needs to determine whether the promise is distinct. In particular, the assessment of whether the connection is distinct in the context of the contract is highly judgemental and must consider the specific contract with the customer, including all relevant facts and circumstances. Entities must not assume that a particular type of good or service is distinct (or not distinct) in all instances. The manner in which the promised goods and services have been bundled within a contract, if any, will affect the entity's assessment. [FRS 102.23.21].

As part of assessing whether the promise is distinct within the context of the contract, a utility entity considers the three factors described in paragraph 23.24 (see 5.2.1.B above), as follows: [FRS 102.23.24]

- Factor (a): The utility entity needs to understand the promise(s) it has made to its customers and whether it integrates them to satisfy its promise(s). For example, if it promised its customer the ongoing supply of services, it might also bear the risk for distribution of these services (including ensuring continued connection). Therefore, it might be providing a significant service of integrating promised goods or services to provide a combined output.
- Factor (b): This factor is unlikely to be relevant in the assessment of whether connection is distinct within the context of the contract because the ongoing service and the connection are unlikely to modify or customise each other.
- Factor (c): The utility entity has to determine whether the connection is highly interdependent and highly interrelated with the ongoing service (e.g., supply of electricity). For example, whether there is more than just a functional relationship (i.e., one item, by its nature, depends on the other) because the utility entity cannot provide ongoing services (its main output, e.g., electricity, gas, water) without the connection and the customer cannot benefit from the connection without the ongoing services (i.e., is there two-way dependency?).

If the utility entity concludes that connection is not a distinct good or service, the non-refundable upfront fee is advanced payment for future goods or services and is recognised as revenue when (or as) the future goods or services are provided. As discussed above, in such situations, an entity must determine whether the non-refundable upfront fee represents an option to renew the contract at a lower price and must assess whether the option to renew represents a material right. [FRS 102.23.30, FRS 102.23.31, FRS 102.23.33].

How we see it

Significant judgement might be needed to determine whether the customer has a material right. However, the fact that the customer remains connected to the network and does not to pay the connection fee again while in the same property, for example, might indicate that a material right exists.

If the renewal option represents a material right, the period over which the upfront fee is recognised is longer than the initial contract duration. [FRS 102.23.30]. It is likely that significant judgement will be needed to determine the appropriate period over which to recognise the upfront fee in such circumstances (see Question 6-29 above).

Question 6-32: How is consideration that was received from a customer, but not yet recognised as revenue, accounted for when the contract is cancelled?

See response to Question 4-10 in 4.2 above.

6.9 Changes in the transaction price

Changes in the transaction price can occur for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which an entity expects to be entitled in exchange for the promised goods or services. See 7.4 below for additional requirements on accounting for a change in transaction price.

7 Step 4 – Allocate the transaction price to the performance obligations

As discussed in 3.2 above, the objective of the revenue recognition model in Section 23 is for an entity to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. [FRS 102.23.4]. Accordingly, the objective for the allocation of the transaction price to the performance obligations identified in a contract (the “allocation objective”) is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. Once the separate performance obligations are identified and the transaction price has been determined, Section 23 generally requires an entity to allocate the transaction price to the performance obligations in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis). [FRS 102.23.65]. In most cases, an allocation based on stand-alone selling prices will faithfully depict the different margins that might apply to promised goods or services. Note, however that, Section 23 specifies that an entity would not apply the allocation requirements if the contract has only one performance obligation (except for a single performance obligation that is made up of a series of distinct goods or services and includes variable consideration – see 7.3 below). It also states that an entity would not apply the allocation requirements if all performance obligations in a contract are satisfied at the same point in time (see 8.2 below). [FRS 102.23.66]. This is because any allocation under these cases would make no difference to the accounting outcome.

When allocating on a relative stand-alone selling price basis, variable consideration or any discount within the contract is generally allocated proportionately to all of the performance obligations in the contract. For this purpose, a discount refers to the excess, if any, of the sum of the stand-alone selling prices of the goods or services promised in the contract over the promised consideration.

However, as discussed further in 7.3 below, Section 23 offers flexibility in allocating discounts or variable consideration to the contract. That is, instead of allocating on a relative stand-alone selling price basis, an entity could allocate a discount or variable consideration to one or more, but not all, performance obligations in the contract using a method that reflects the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract.

[FRS 102.23.74].

This is similar to the IFRS 15’s allocation requirements. IFRS 15 provides two exceptions to the default method of allocation using relative stand-alone selling price method when allocating discount and variable consideration to the performance obligations. However, IFRS 15 requirements are more restrictive i.e., different specific set of criteria must be satisfied first before an entity applies the allocation exception to variable consideration or to discounts. Under IFRS 15, when the respective criteria are met, discounts and variable consideration must be entirely allocated to one or more, but not all, performance obligations in the contract. [IFRS 15.83, IFRS 15.85]. Under Section 23, the allocation requirements for discounts and variable consideration are combined into a single general requirement as described above.

Further, unlike Section 23, IFRS 15 establishes a hierarchy for allocation. Under IFRS 15, an entity identifies and allocates variable consideration first, if it meets the criteria for the exception, to one or some, but not all performance obligations. The general guidance related to allocation of transaction price to performance obligations on a relative stand-alone selling price basis and the specific requirements related to allocation of a discount are then applied to allocate the remaining amount of the transaction price that does not meet the criteria related to allocation of variable consideration. [IFRS 15.86]. In addition, when an entity meets the specified criteria and applies a discount to one or more performance obligations, IFRS 15 requires that the discount is allocated first before using the residual approach to estimate the stand-alone selling price of a good or service. [IFRS 15.83].

7.1 Determining stand-alone selling prices

To allocate the transaction price on a relative stand-alone selling price basis, an entity must first determine the stand-alone selling price at contract inception of the distinct good or service (which might represent a bundle of goods or services) underlying each performance obligation. [FRS 102.23.67]. Under Section 23, this is the price at which an entity would sell a distinct good or service on a stand-alone (or separate) basis at contract inception. [FRS 102.23.68]. If multiple non-distinct goods or services are bundled to form a single performance obligation, the stand-alone selling price is determined at the price the entity would sell the bundle separately to the customer. This amount is not always the sum of the prices at which the entity would sell the individual goods or services that make up the bundle.

Section 23 indicates the observable price of a good or service sold separately (in similar circumstances and to similar customers) provides the best evidence of stand-alone selling price. [FRS 102.23.68]. Accordingly, a contractually stated or list price for a good or service could be (but cannot be presumed to be) the stand-alone selling price of that good or service. However, in many situations, stand-alone selling prices are not readily observable. In those cases, the entity is required to estimate the stand-alone selling price by considering all relevant information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity and apply estimation methods consistently in similar circumstances. [FRS 102.23.69]. In doing so, entities could also consider the requirements in IFRS 15 i.e., when estimating a stand-alone selling price, an entity maximises the use of observable inputs. [IFRS 15.78].

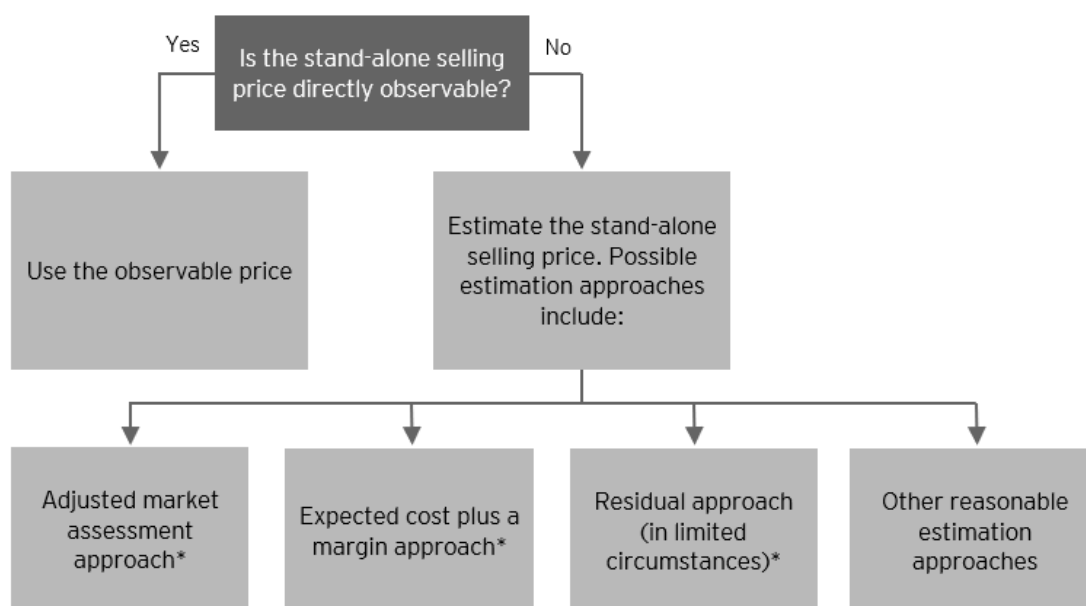
Section 23 includes the following requirements on estimating stand-alone selling prices: [FRS 102.23.69, FRS 102.23.70]

Extract from Section 23

- 23.69** If a stand-alone selling price is not directly observable, an entity shall estimate it. When estimating a stand-alone selling price, an entity shall take into account all information that is reasonably available to the entity, including market conditions, entity-specific factors and information about the customer or class of customer. An entity shall apply estimation methods consistently in similar circumstances.
- 23.70** Suitable estimation methods include, but are not limited to, the following:
- adjusted market assessment approach – an entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity’s competitors for similar goods or services and adjusting those prices as necessary to reflect the entity’s costs and margins.
 - expected cost plus a margin approach – an entity could forecast its expected costs of transferring the good or service promised to a customer and then add an appropriate margin for that good or service.
 - residual approach – only if the stand-alone selling price of a good or service is highly variable or uncertain, then an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable or estimated stand-alone selling prices of other goods or services promised in the contract.

The following flow chart illustrates how an entity determines the stand-alone selling price of a good or service, which might include estimation:

Figure 7-1: Determining the stand-alone selling price of a good or service



* See 7.1.2 below for further discussion of these estimation approaches, including when it might be appropriate to use a combination of approaches.

Stand-alone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. [FRS 102.23.76]. For example, assume an entity determines the stand-alone selling price for a promised good using the expected cost plus a margin approach and, before it can finish manufacturing and deliver that good, the underlying cost of the materials doubles. In such a situation, the entity would not revise its stand-alone selling price used for this contract. However, for future contracts involving the same good, the entity would need to determine whether the change in circumstances (i.e., the significant increase in the cost to produce the good) warrants a revision of the stand-alone selling price. If so, the entity would use that revised price for allocations in future contracts (see 7.1.3 below).

Similarly, when a modification is treated as part of the existing contract (see 4.4.2.B above), stand-alone selling prices are also not updated to reflect changes in a transaction price. However, new estimates of stand-alone selling prices are used if the modification creates a new or separate contract, as in the following situations:

- If the modification is treated as a termination of the existing contract and the creation of a new contract (see 4.4.2.A above), the entity would update its estimate of the stand-alone selling price at the time of the modification. This would include the portion of a paragraph 23.16(c) modification (see 4.4.2.C above) that is treated as the creation of a new contract.
- If the modification is treated as a separate contract (see 4.4.1 above), the accounting for the original contract would not be affected (and the stand-alone selling prices of the goods or services would not be updated), but the stand-alone selling prices of the distinct goods or services in the separate contract would have to be determined at the time of the modification.

See 4.4 above for further details about the accounting for contract modifications.

7.1.1 Factors to consider when estimating the stand-alone selling price

To estimate the stand-alone selling price (if not readily observable), an entity can consider the stated prices in the contract. However, as discussed in 7.1 above, an entity cannot presume that a contractually stated price, or a list price, for a good or service is the stand-alone selling price. In estimating a stand-alone selling price, an entity takes into account all information that is reasonably available to the entity, including market conditions, entity-specific factors and information about the customer or class of customer. [FRS 102.23.69]. As discussed in 7.1 above, an entity could also consider maximising the use of observable inputs in its estimate. This estimation is a very broad requirement for which an entity needs to consider a variety of data sources.

The following list, which is not comprehensive, provides examples of market conditions to consider:

- Potential limits on the selling price of the product
- Competitor pricing for a similar or identical product
- Market awareness and perception of the product
- Current market trends that are likely to affect the pricing (e.g., supply and demand for the good or service, competition)
- The entity's market share and position (e.g., the entity's ability to dictate pricing)
- Effects of the geographic area on pricing
- Effects of customisation on pricing
- Expected life of the product, including whether significant technological advances are expected in the market in the near future

Examples of entity-specific factors include:

- Profit objectives and internal cost structure
- Pricing practices and pricing objectives (including desired gross profit margin)
- Effects of customisation on pricing
- Pricing practices used to establish pricing of bundled products
- Effects of a proposed transaction on pricing (e.g., the size of the deal, the characteristics of the targeted customer)
- Expected life of the product, including whether significant entity-specific technological advances are expected in the near future

Examples of information about the customer, or class of customer, include:

- Type of customer
- Geographic region
- Distribution channel

An entity must also consider its customary business practices when determining the stand-alone selling price. To document its estimated stand-alone selling price, an entity ought to consider describing the information that it has considered (e.g., the factors listed above), especially if there is limited observable data or none at all.

7.1.2 Possible estimation approaches

Section 23 discusses three estimation approaches: (1) the adjusted market assessment approach; (2) the expected cost plus a margin approach; and (3) the residual approach. [FRS 102.23.70]. All of these are discussed further below. When applying Section 23, an entity might need to use a different estimation approach for each of the distinct goods or services underlying the performance obligations in a contract. In addition, an entity might need to use a combination of approaches to estimate the stand-alone selling prices of goods or services promised in a contract, if one or more of those goods or services have highly variable or uncertain stand-alone selling prices.

Section 23 does not limit estimation process to these three approaches. [FRS 102.23.70]. It allows any reasonable estimation approach, as long as it is consistent with the notion of a stand-alone selling price (i.e., consistent with the allocation objective – see 7 above) and is applied on a consistent basis for similar goods or services and customers (see discussion in 7 and 7.1 above). An entity could also consider the requirements in IFRS 15 which requires an entity to maximise the use of observable inputs when estimating a stand-alone selling price. [IFRS 15.78].

In some cases, an entity will have sufficient observable data to determine the stand-alone selling price. For example, an entity might have sufficient stand-alone sales of a particular good or service that provide persuasive evidence of the stand-alone selling price of that particular good or service. In such situations, no estimation would be necessary. [FRS 102.23.68].

In many instances, an entity will not have sufficient stand-alone sales data to determine the stand-alone selling price based solely on those sales. An entity needs to consider all factors contemplated in negotiating the contract with the customer and the entity's normal pricing practices factoring in the most objective and reliable information that is available. Accordingly, entities need to have robust practices and processes in place regarding the pricing of goods or services and developing estimates of stand-alone selling prices.

Section 23 includes the following estimation approaches: [FRS 102.23.70]

- **Adjusted market assessment approach** - this approach focuses on the amount that the entity believes a participant in the market in which it sells goods or services is willing to pay for a good or service. For example, an entity might refer to competitors' prices for similar goods or services and adjust those prices, as necessary, to reflect the entity's costs and margins. When using the adjusted market assessment approach, an entity considers market conditions, such as those listed in 7.1.1 above. Applying this approach is likely to be easiest when an entity has sold the good or service for a period of time (such that it has data about customer demand) or a competitor offers similar goods or services that the entity can use as a basis for its analysis. Applying this approach will be difficult when an entity is selling an entirely new good or service because it might be difficult to anticipate market demand. In these situations, entities might want to use the market assessment approach, with adjustments, as necessary, to reflect the entity's costs and margins, in combination with other approaches to maximise the use of observable inputs (e.g., using competitors' pricing, adjusted based on the market assessment approach in combination with an entity's planned internal pricing strategies if the performance obligation has never been sold separately).
- **Expected cost plus margin approach** - this approach focuses more on internal factors (e.g., the entity's cost basis), but has an external component as well. That is, the margin included in this approach must reflect the margin the market would be willing to pay, not just the entity's desired margin. The margin might have to be adjusted for differences in products, geographies, customers and other factors. The expected cost plus margin approach could be useful in many situations, especially when the performance obligation has a determinable direct fulfilment cost (e.g., the performance obligation is a tangible product or an hourly service). However, this approach will be less helpful when there are no clearly identifiable direct fulfilment costs or the amount of those costs is unknown (e.g., when the performance obligation is a new software licence or specified upgrade rights).

- **Residual approach** - this approach allows an entity to estimate the stand-alone selling price of a promised good or service as the difference between the total transaction price and the observable or estimated stand-alone selling prices of other promised goods or services in the contract, provided that one of the following two criteria are met i.e., the stand-alone selling price of a good or service is: *[FRS 102.23.70(c)]*

- Highly variable - for example, at or near the same time, the same good or service is sold by the entity to different customers at a wide range of prices (i.e., the representative stand-alone selling price cannot be determined from past transactions or other observable evidence as it is highly variable).
- Uncertain - for example, the good or service has not yet been sold on a stand-alone basis and a price for that good or service has not previously been established by the entity (i.e., the selling price is uncertain).

We expect the use of the residual approach will be limited because Section 23 indicates that it can only be used for contracts with multiple promised goods or services when the selling price of one or more of the promised goods or services in the contract is unknown because one of the two criteria above are met. However, allowing entities to use a residual technique provides relief to entities that rarely, or never, sell goods or services on a stand-alone basis, such as entities that sell intellectual property only with physical goods or services.

The use of the residual approach cannot result in a stand-alone selling price of zero if the good or service is distinct because a good or service must have value on a stand-alone basis to be distinct. Accordingly, if use of the residual approach results in very little, or no, consideration being allocated to a good or service or a bundle of goods or services, an entity has to re-evaluate whether the use of the residual approach is appropriate.

An example of an appropriate use of the residual approach would be an entity that frequently sells software, professional services and maintenance, bundled together, at prices that vary widely. However, the entity also sells the professional services and maintenance individually at relatively stable, observable prices. In such situation, it would be appropriate to estimate the stand-alone selling price for the software as the difference between the total transaction price and the observable selling prices of the professional services and maintenance. See Illustration 7-1 below for examples of when the residual approach is or is not appropriate.

Note that the use of the residual approach is simplified under Section 23. Under Section 23, an entity estimates the stand-alone selling price by reference to the total transaction price less either the sum of the observable or estimated stand-alone selling prices of other goods or services promised in the contract (see 7.1.2 below). *[FRS 102.23.70(c)]*. In contrast, IFRS 15 allows an entity to estimate the stand-alone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) stand-alone selling prices of other promised goods or services in the contract. *[IFRS 15.79(c)]*. Accordingly, in addition to meeting one of the two criteria (i.e., selling price is either highly variable or uncertain), the remaining promised goods or services in the contract must have at least one observable (i.e., not estimated) stand-alone selling prices in order to use the residual approach under IFRS 15. That is, the residual approach cannot be used if the selling price for all the goods or services in the contract are not observable.

Also, unlike IFRS 15, Section 23 does not provide explicit guidance on application of residual approach if there are two or more goods or services in the contract with highly variable or uncertain stand-alone selling prices. An entity could consider the guidance in IFRS 15 which allows a combination of methods to estimate the stand-alone selling prices of each of the promised goods or services with highly variable or uncertain stand-alone selling prices. For example, an entity could apply the residual approach to estimate the aggregate of the stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices, but then use another approach (e.g., adjusted market assessment, expected cost plus margin) to estimate the stand-alone selling prices of each of those promised goods or services with highly variable or uncertain stand-alone selling prices.

[IFRS 15.80].

Illustration 7-1: Estimating the stand-alone selling price using the residual approach

Entity X enters into a contract with a customer to sell equipment, professional services and maintenance as a bundled package for £20,000. The professional services and maintenance have observable prices from Entity X's historical sales. The equipment is a new product for Entity X for which it has limited historical sales and no established price. Entity X has not historically sold any similar equipment, and Entity X's cost of the equipment is £6,000.

Scenario A

Entity X frequently sells professional services and maintenance separately for observable prices of £7,000 and £5,000, respectively.

If Entity X determines that there is no other relevant observable data to determine the stand-alone selling price of the equipment, it could use the residual approach. This approach results in a stand-alone selling price for the equipment of £8,000 (£20,000 - £7,000 - £5,000).

Scenario B

Entity X frequently sells professional services and maintenance separately for observable prices of £14,000 and £5,500, respectively.

The residual approach would result in a stand-alone selling price for the equipment of £500 (£20,000 - £14,000 - £5,500). It might not be appropriate to use the approach in this situation because the result allocates very little consideration to the equipment.

Illustration 7-2 below, which is based on Example 33 in IFRS 15, is an example in which two estimation approaches are used to estimate stand-alone selling prices of two different goods in a contract: [IFRS 15.IE Example 33, IFRS 15.IE164-IE166]

Illustration 7-2: Allocation methodology

An entity enters into a contract with a customer to sell Products A, B and C in exchange for £100. The entity will satisfy the performance obligations for each of the products at different points in time. The entity regularly sells Product A separately and therefore the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, the entity must estimate them. To estimate the stand-alone selling prices, the entity uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, the entity maximises the use of observable inputs (see 7.1 above). The entity estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price	Method
	£	
Product A	50	Directly observable (FRS 102.23.68)
Product B	25	Adjusted market assessment approach (FRS 102.23.70(a))
Product C	75	Expected cost plus a margin approach (FRS 102.23.70(b))
Total	150	

The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (£150) exceeds the promised consideration (£100). The entity considers whether allocating the entire discount to one or more (but not all) performance obligations would meet the allocation objective in Section 23 (see 7.3 below) and concludes that it does not. Consequently, in accordance with paragraphs 23.67 and 23.72, the discount is allocated proportionately across Products A, B and C. The discount, and therefore the transaction price, is allocated as follows:

Product	Allocated transaction price
	£
Product A	33 (£50 ÷ £150 × £100)
Product B	17 (£25 ÷ £150 × £100)
Product C	50 (£75 ÷ £150 × £100)
Total	100

Given the flexibility provided by Section 23 to estimate stand-alone selling prices, it is both appropriate and necessary for entities to tailor the approach(es) used to their specific facts and circumstances. However, regardless of whether the entity uses a single approach or a combination of approaches, it must evaluate whether the resulting allocation of the transaction price is consistent with the overall allocation objective (see 7 above) and the requirements for estimating stand-alone selling prices discussed above.

In accordance with Section 23, an entity must make a reasonable estimate of the stand-alone selling price for the distinct good or service underlying each performance obligation if an observable selling price is not readily available.

How we see it

We believe entities generally have sufficient information to develop a reasonable estimate, even in instances in which limited information is available.

Entities need robust processes to estimate stand-alone selling prices. It is important for entities to be able to demonstrate the reasonableness of the calculations they make in estimating stand-alone selling prices.

7.1.3 Updating estimated stand-alone selling prices

As discussed in 7.1 above, stand-alone selling prices are determined at contract inception and are not updated to reflect changes between contract inception and when performance is complete. [FRS 102.23.76]. Similarly, when a modification is treated as part of the existing contract (see 4.4.2.B above), stand-alone selling prices are also not updated to reflect changes in a transaction price. However, new estimates of stand-alone selling prices are used if the modification creates a new or separate contract, as in the following situations:

- If the modification is treated as a termination of the existing contract and the creation of a new contract (see 4.4.2.A above), the entity would update its estimate of the stand-alone selling price at the time of the modification. This would include the portion of A paragraph 23.16(c) modification (see 4.4.2.C above) that is treated as the creation of a new contract.
- If the modification is treated as a separate contract (see 4.4.1 above), the accounting for the original contract would not be affected (and the stand-alone selling prices of the goods and services would not be updated), but the stand-alone selling prices of the distinct goods or services in the separate contract would have to be determined at the time of the modification.

See 4.4 above for further details about the accounting for contract modifications.

Furthermore, an entity needs to update its estimates of stand-alone selling prices for future transactions to reflect changes in circumstances. Section 23 does not specifically address how frequently estimated stand-alone selling prices for new contracts must be updated. Instead, it indicates that an entity must make this estimate for each distinct good or service underlying each performance obligation in each contract with a customer, which suggests that an entity needs to constantly update its estimates of stand-alone selling prices for each new contract.

In practice, we expect that entities will consider their own facts and circumstances in order to determine how frequently they will need to update their stand-alone selling price estimates for new contracts. If, for example, the information used to estimate the stand-alone selling price for similar transactions has not changed, an entity might determine at inception of the new contract that it is still reasonable to use the previously determined stand-alone selling price.

However, in order for changes in circumstances to be reflected in the estimate in a timely manner, we expect that an entity would formally update the estimate on a regular basis (e.g., monthly, quarterly, semi-annually). The frequency of updates needs to be based on the facts and circumstances of the distinct good or service underlying each performance obligation for which the estimate is made. An entity uses current information each time it develops or updates its estimate. While the estimates might be updated, the approach used to estimate stand-alone selling price does not change (i.e., an entity must use a consistent approach), unless facts and circumstances change. [FRS 102.23.69].

7.1.4 Additional considerations for determining the stand-alone selling price

While not explicitly stated in Section 23, a single good or service could have more than one stand-alone selling price. That is, the entity might be willing to sell goods or services at different prices to different customers. Furthermore, an entity might use different prices in different geographies or in markets where it uses different methods to distribute its products (e.g., it might use a distributor or reseller, rather than selling directly to the end-consumer) or for other reasons (e.g., different cost structures or strategies in different markets). Accordingly, an entity might need to stratify its analysis to determine its stand-alone selling price for each class of customer, geography and/or market, as applicable.

Frequently asked questions

Question 7-1: When estimating the stand-alone selling price, does an entity have to consider its historical pricing for the sale of the good or service involved?

Historical pricing is likely to be an important input as it often reflects both market conditions and entity-specific factors and can provide supporting evidence about the reasonableness of management's estimate. For example, if management determines, based on its pricing policies and competition in the market, that the stand-alone selling price of its good or service is X, historical transactions within a reasonable range of X would provide supporting evidence for management's estimate. However, if historical pricing was only 50% of X, this would indicate that historical pricing is no longer relevant due to changes in the market, for example, or that management's estimate is flawed.

Depending on the facts and circumstances, an entity might conclude that other factors such as internal pricing policies are more relevant to its determination of a stand-alone selling price. When historical pricing has been established using the entity's normal pricing policies and procedures, it is more likely that this information will be relevant in the estimation.

How we see it

We believe that an entity has to consider its historical pricing in all circumstances, but it is not necessarily determinative. If the entity has sold the product separately or has information on competitors' pricing for a similar product, it is likely that the entity would find historical data relevant to its estimate of stand-alone selling prices, among other factors. In addition, we believe it might be appropriate for entities to stratify stand-alone selling prices based on: the type or size of customer; the amount of product or services purchased; the distribution channel; the geographic location; or other factors.

Question 7-2: When using an expected cost plus margin approach to estimate a stand-alone selling price, how would an entity determine an appropriate margin?

When an entity elects to use the expected cost plus margin approach, it is important for the entity to use an appropriate margin.

How we see it

Determining an appropriate margin might require the use of significant judgement and involve the consideration of many market conditions and entity-specific factors, discussed in 7.1.1 above.

It would not be appropriate, for example, to determine that the entity's estimate of stand-alone selling price is equivalent to cost plus a 30% margin if a review of market conditions demonstrates that customers are only willing to pay the equivalent of cost plus a 12% margin for a comparable product. Similarly, it would be inappropriate to determine that cost plus a specified margin represents the stand-alone selling price if competitors are selling a comparable product at twice the determined estimate. Furthermore, the determined margin might have to be adjusted for differences in products, geographic locations, customers and other factors.

Question 7-3: When estimating the stand-alone selling price of a good or service, can an entity estimate a range of prices or does it have to identify a point estimate?

Entities might use a range of prices to help estimate the stand-alone selling price of a good or service.

How we see it

We believe it is reasonable for an entity to use such a range for the purpose of assessing whether a stand-alone selling price (i.e., a single price) that the entity intends to use is reasonably within that range. That is, we do not believe that an entity is required to determine a point estimate for each estimated stand-alone selling price if a range is a more practical means of estimating the stand-alone selling price for a good or service.

As discussed in 7 above, the objective of Section 23 is to allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. While Section 23 does not address ranges of estimates, using a range of prices would not be inconsistent with the objective of Section 23. The only requirements under Section 23 are that an entity must take into account all information that is reasonably available to the entity and that the entity is required to apply the estimation approaches consistently (see 7.1 above). Therefore, the use of a range would also be consistent with these principles.

Practices we have observed include an entity establishing that a large portion of the stand-alone selling prices falls within a narrow range (e.g., by reference to historical pricing).

How we see it

We believe the use of a narrow range is acceptable for determining estimates of stand-alone selling prices under Section 23. While the use of a range would be appropriate for estimating the stand-alone selling price, we believe that some approaches to identifying this range do not meet the requirements of Section 23.

It would not be appropriate, for example, for an entity to determine a range by estimating a single price point for the stand-alone selling price and then adding an arbitrary range on either side of that point estimate, nor would it be appropriate to take the historical prices and expand the range around the midpoint until a significant portion of the historical transactions fall within that band. The wider the range necessary to capture a high proportion of historical transactions, the less relevant it is in terms of providing a useful data point for estimating stand-alone selling prices.

Management's analysis of market conditions and entity-specific factors could support it in determining the best estimate of the stand-alone selling price. The historical pricing data from transactions, while not necessarily determinative, could be used as supporting evidence for management's conclusion. However, management would need to analyse the transactions that fall outside the range to determine whether they have similar characteristics and, therefore, need to be evaluated as a separate class of transactions with a different estimated selling price.

If the entity has established a reasonable range for the estimated stand-alone selling prices and the stated contractual price falls within that range, it would be appropriate to use the stated contractual price as the stand-alone selling price in the allocation calculation. However, if the stated contractual price for the good or service falls outside of the range, the stand-alone selling price needs to be adjusted to a point within the established range in order to allocate the transaction price on a relative stand-alone selling price basis. In these situations, the entity would need to determine which point in the range is most appropriate to use (e.g., the midpoint of the range or the outer limit nearest to the stated contractual price) when performing the allocation calculation.

Illustration 7-3: Allocating transaction price when there is a range of stand-alone selling prices

Entity X sells a product to Customer Y, along with a distinct service. Entity X sells the product on a stand-alone basis for prices that range from £7,500 to £8,500, and the service is sold on a stand-alone basis for £4,000.

Scenario A

Assume the stated contract prices for the product and the service are £8,000 and £2,000, respectively, for a total transaction price of £10,000.

The contract price for the product falls within the range that Entity X determined for the stand-alone selling price. Therefore, Entity X could use the stated contract price for the product as the stand-alone selling price when allocating the transaction price. The total stand-alone selling prices of the product and service would be £12,000 (£8,000 for the product and £4,000 for the service). This calculation is illustrated, as follows:

	Stand-alone selling price		Allocated transaction price
	£		£
Product	8,000	$(8,000 \div 12,000 \times 10,000)$	6,667
Service	4,000	$(4,000 \div 12,000 \times 10,000)$	3,333
Total	12,000		10,000

Scenario B

Assume the stated contract prices for the product and the service are £6,500 and £2,000, respectively, for a total transaction price of £8,500. Entity X has a policy that it will use the outer limit nearest to the stated contractual price when performing the allocation calculation.

In this scenario, the contract price for the product is not within the range of stand-alone selling prices. Therefore, Entity X would need to determine a price within the range to use as the stand-alone selling price of the product. Consistent with its policy, Entity X uses the outer limit closest to the contractual price, or £7,500. Therefore, in this scenario, the total of the stand-alone selling prices is £11,500 (£7,500 for the product and £4,000 for the service). The calculation is illustrated as follows:

	Stand-alone selling price		Allocated transaction price
	£		£
Product	7,500	$(7,500 \div 11,500 \times 8,500)$	5,543
Service	4,000	$(4,000 \div 11,500 \times 8,500)$	2,957
Total	11,500		8,500

Question 7-4: How does an entity evaluate a contract where the total transaction price exceeds the sum of the stand-alone selling prices?

If the total transaction price exceeds the sum of the stand-alone selling prices, it indicates that the customer is paying a premium for bundling the goods or services in the contract. This situation is likely to be rare because most customers expect to receive a discount for purchasing a bundle of goods or services. If a premium exists after determining the stand-alone selling prices of each good or service, the entity needs to evaluate whether it properly identified both the estimated stand-alone selling prices (i.e., are they too low?) and the number of performance obligations in the contract.

How we see it

If the entity determines that a premium does exist after this evaluation, we believe the entity would need to allocate the premium in a manner consistent with the Section 23's allocation objective, which would typically be on a relative stand-alone selling price basis (see 7 above).

Question 7-5: Can an entity use the stated contract price as the stand-alone selling price of a good or service?

As noted in 7.1 above, paragraph 23.68 states that the stand-alone selling price is the price at which an entity would sell a good or service promised in a contract separately to a customer and that the best evidence of this is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. [FRS 102.23.68]. Note that under IFRS 15, a contractually stated price or a list price for a good or service could be, but must not be presumed to be, the stand-alone selling price of that good or service. [IFRS 15.77]. In line with this, an entity cannot assume that the stated contract price is the stand-alone selling price. However, the stated contract or list price might be a data point in determining the stand-alone selling price.

7.1.5 Measurement of options that are separate performance obligations

As discussed in 7 above, an entity must allocate the transaction price to identified performance obligations on a relative stand-alone selling price basis. [FRS 102.23.65]. In line with this, an entity that determines that a customer option for additional goods or services is a separate performance obligation (because the option provides the customer with a material right, as discussed in 5.6 above) needs to determine the stand-alone selling price of the option.

If the option's stand-alone selling price is not directly observable, the entity needs to estimate it. [FRS 102.23.69]. In doing so, paragraph 23.71 requires an entity to take into consideration any discount the customer would receive in a stand-alone transaction and the likelihood that the customer would exercise the option. [FRS 102.23.71].

Generally, option pricing models consider both the intrinsic value of the option (i.e., the value of the option if it were exercised today) and its time value (e.g., the option might be more or less valuable based on the amount of time until its expiration date and/or the volatility of the price of the underlying good or service). However, an entity is only required to measure the intrinsic value of the option when estimating the stand-alone selling price of the option. Illustration 5-21 included in 5.6 above shows the measurement of an option determined to be a material right under paragraph 23.71 of FRS 102. The following Illustration also explains this concept:

Illustration 7-4: Estimating the stand-alone selling price of options that are separate performance obligations

Publisher A sells a physical textbook for £10 and offers the customer an option to purchase the digital version of the publication at 50% off the retail price of £8. The typical discount for digital versions is 15%. Therefore, Publisher A concludes that this discount exceeds the typical discount offered to customers and that it provides the customer with a material right.

To estimate the stand-alone selling price of the option, Publisher A estimates there is a 50% likelihood that a customer will redeem the discount option. Therefore, Publisher A's estimated stand-alone selling price of the discount option is £1.40 (£8 digital price x 35% incremental discount x 50% likelihood of exercising the option).

Publisher A allocates £1.23 (£10 x [$\frac{£1.40}{£1.40 + £10}$]) of the transaction price to the discount option and recognises revenue for the option when the customer exercises its right for the digital version or when the option expires. Publisher A allocates £8.77 (£10 - £1.23) to the physical book and recognises revenue for the physical book when it transfers control of the book to the customer.

Paragraph 23.34 provides a practical alternative to estimating the stand-alone selling price of an option. It applies when the customer is granted an option to renew a contract on similar terms and the additional goods or services are similar to the original goods or services in the contract (i.e., the entity continues to provide what it was already providing). [FRS 102.23.34].

Under the practical alternative, a portion of the transaction price is allocated to the option (i.e., the material right that is a separate performance obligation) by reference to the total goods or services expected to be provided to the customer (including expected renewals) and the corresponding expected consideration. That is, the total amount of consideration expected to be received from the customer (including consideration from expected renewals) is allocated to the total goods or services expected to be provided to the customer, including those from the expected contract renewals. [FRS 102.23.34]. The amount allocated to the goods or services that the entity is required to transfer to the customer under the contract (i.e., excluding the optional goods or services that will be transferred if the customer exercises the renewal option(s)) is then subtracted from the total amount of consideration received (or that will be received) for transferring those goods or services. The difference is the amount that is allocated to the option at contract inception. [FRS 102.23.35]. An entity using this alternative needs to apply the constraint on variable consideration (as discussed in 6.2.3 above) to the estimated consideration for the optional goods or services prior to performing the allocation. Scenario B in Illustration 7-5 below illustrates the use of the allocation alternative in paragraph 23.34.

Customer loyalty points and discount vouchers typically do not meet the criteria for use of this practical alternative. This is because customer loyalty points and discount vouchers are redeemable for goods or services that might differ in nature from those offered in the original contract and the terms of the original contract do not restrict the pricing of the additional goods or services. For example, if an airline offers flights to customers in exchange for points from its frequent flyer programme, the airline is not restricted because it can subsequently determine the number of points that are required to be redeemed for any particular flight.

It is important to note that the calculation of total expected consideration (i.e., the hypothetical transaction price), including consideration related to expected renewals, is only performed for the purpose of allocating a portion of the hypothetical transaction price to the option at contract inception. It does not change the enforceable rights or obligations in the contract, nor does it affect the actual transaction price for the goods or services that the entity is presently obliged to transfer to the customer (which would not include expected renewals). Accordingly, the entity would not include any remaining hypothetical transaction price in its disclosure of remaining performance obligations (see 11.4.1.D below). In this respect, the practical alternative is consistent with the conclusion in Question 5-21 in 5.6 above. That is, even if an entity thinks that it is almost certain that a customer will exercise an option to buy additional goods or services, an entity

does not include the additional goods or services underlying the option as promised goods or services (or performance obligations), unless there are substantive contractual penalties.

Subsequent to contract inception, if the actual number of contract renewals is different from an entity's initial expectations, the entity updates the hypothetical transaction price and allocation. However, as discussed in 7.1 above, the estimate of the stand-alone selling price at contract inception is not updated. See Scenario B in Illustration 7.5 below for an example of how an entity could update its practical alternative calculation based on a change in expectations.

The following Illustration shows the two possible approaches for measuring options included in a contract:

Illustration 7-5: Measuring an option

A machinery maintenance contract provider offers a promotion to new customers who pay full price for the first year of maintenance coverage that grants them an option to renew the services for up to two years at a discount. The entity regularly sells maintenance coverage for £750 per year. With the promotion, the customer can renew the one-year maintenance at the end of each year for £600. The entity concludes that the ability to renew is a material right because the customer would receive a discount that exceeds any discount available to other customers. The entity also determines that no directly observable stand-alone selling price exists for the option to renew at a discount.

Scenario A - Estimate the stand-alone selling price of the option directly (FRS 102.23.71)

Since the entity has no directly observable evidence of the stand-alone selling price for the renewal option, it estimates the stand-alone selling price of an option for a £150 discount on the renewal of service in years two and three. When developing its estimate, the entity considers factors such as the likelihood that the option will be exercised and the price of comparable discounted offers. For example, the entity might consider the selling price of an offer for a discounted price of similar services found on a 'deal of the day' website.

The option will then be included in the relative stand-alone selling price allocation. In this example, there are two performance obligations: one-year of maintenance services; and an option for discounted renewals. The consideration of £750 is allocated between these two performance obligations based on their relative stand-alone selling prices.

Illustration 5-21 included in 5.6 above illustrates the estimation of the stand-alone selling price of an option determined to be a material right under paragraph 23.71.

Scenario B - Practical alternative to estimating the stand-alone selling price of the option using the renewal option approach (FRS 102.23.34-23.35)

If the entity chooses to use the renewal option approach, it allocates the transaction price to the option for maintenance services by reference to the maintenance services expected to be provided (including expected renewals) and the corresponding expected consideration. Since there is a discount offered on renewal of the maintenance service, this calculation will result in less revenue being allocated to the first year of the maintenance service when compared to the amount of consideration received for the first year of service (i.e., an amount less than £750). The difference between the consideration received (or that will be received) for the first year of maintenance service (i.e., £750) and the revenue allocated to the first year of maintenance service (i.e., an amount less than £750) will represent the amount allocated to the option using the renewal option approach.

Assume the entity obtains 100 new customers under the promotion. Based on its experience, the entity anticipates approximately 50% attrition annually, after considering the anticipated effect that the £150 discount will have on attrition. The entity considers the constraint on variable consideration and concludes that it is highly probable that the entity will be entitled to the cumulative amount of revenue in the future. Therefore, the entity concludes that, for this portfolio of contracts, it will ultimately sell 175 contracts, each contract providing one-year of maintenance services (i.e., 100 customers in the first year, 50 customers in the second year and 25 customers in the third year).

Therefore, the total consideration the entity expects to receive is £120,000 $[(100 \times £750) + (50 \times £600) + (25 \times £600)]$ (i.e., the hypothetical transaction price). Assuming the stand-alone selling price for each maintenance contract period is the same, the entity allocates £685.71 $(£120,000 \div 175)$ to each maintenance contract sold.

During the first year, the entity will recognise revenue of £68,571 (100 one-year maintenance service contracts sold x the allocated price of £685.71 per maintenance service contract). Consequently, at contract inception, the entity would allocate £6,429 to the option to renew (£75,000 cash received - £68,571 revenue to be recognised in the first year).

If the actual renewals in years two and three differ from expectations, the entity would have to update the hypothetical transaction price and allocation accordingly. However, beyond stating, as discussed in 7.1 above, that the estimate of the stand-alone selling prices at contract inception would not be updated, the standard is not explicit about how the entity would update the hypothetical transaction price and allocation. Below is an

Illustration of how an entity could update its practical alternative calculation based on a change in expectations.

For example, assume that the entity experiences less attrition than expected (e.g., 40% attrition annually, instead of 50%). Therefore, the entity's revised estimate is that it will ultimately sell 196 one-year maintenance services (100 + 60 renewals after year one + 36 renewals after year two). Accordingly, the total consideration that the entity expects to receive is £132,600 [(100 x £750) + (60 x £600) + (36 x £600)] (i.e., the updated hypothetical transaction price). The entity would not update its estimates of the stand-alone selling prices (which were assumed to be the same for each maintenance period). As such, the entity allocates £676.53 (£132,600 ÷ 196) to each maintenance period. The entity would reduce the amount of revenue it recognises in year one by £918 (CU68,571 - (100 x £676.53)) because the amount allocated to the option would have been higher at contract inception.

See Illustration 6-15 in 6.8 above for another example of applying the practical alternative when the contract includes a non-refundable upfront fee that is deemed to be a material right.

Frequently asked questions

Question 7-6: Could the form of an option (e.g., a gift card versus a coupon) affect how an option's stand-alone selling price is estimated?

How we see it

We believe that the form of an option would not affect how the stand-alone selling price is estimated.

Consider, for example, a retailer that gives customers who spend more than £100 during a specified period a £15 discount on a future purchase in the form of a coupon or a gift card that expires two weeks from the sale date. If the retailer determines that this type of offer represents a material right (see 5.6 above), it will need to allocate a portion of the transaction price to the option on a relative stand-alone selling price basis.

As discussed in 7.1 above, Section 23 requires that an entity first look to any directly observable stand-alone selling price. This requires the retailer to consider the nature of the underlying transaction. In this example, while a customer can purchase a £15 gift card for its face value, that transaction is not the same in substance as a transaction in which the customer is given a £15 gift card or coupon in connection with purchasing another good or service. As such, the retailer could conclude that there is no directly observable stand-alone selling price for a 'free' gift card or coupon obtained in connection with the purchase of another good or service. It would then need to estimate the stand-alone selling price in accordance with paragraph 23.71.

The estimated stand-alone selling price of an option given in the form of a gift card or a coupon would be the same because both estimates would reflect the likelihood that the option will be exercised (i.e., breakage, as discussed in 8.9 below).

Question 7-7: Can an entity use the practical alternative when some, but not all, of the goods or services in the original contract are subject to a renewal option?

How we see it

In certain instances, we believe it might be appropriate to apply the practical alternative even if some of the goods or services in the original contract are not subject to a renewal option, provided that at least one of the goods or services in the original contract is subject to the renewal terms included in the original contract.

Consider a contract to sell hardware and a service-type warranty where the customer has the option to renew only the warranty. Furthermore, assume that the renewal option is determined to be a material right. If the terms of any future warranty renewals are consistent with the terms provided in the original contract, we believe it would be reasonable to use the practical alternative when allocating the transaction price of the contract.

7.2 Applying the relative stand-alone selling price method

Once an entity has determined the stand-alone selling price for the separate goods or services in a contract, the entity allocates the transaction price to those performance obligations. Section 23 requires an entity to use the relative stand-alone selling price method to allocate the transaction price, except in the two specific circumstances (variable consideration and discounts), which are described in 7.3 below.

Under the relative stand-alone selling price method, the transaction price is allocated to each performance obligation based on the proportion of the stand-alone selling price of each performance obligation (determined at contract inception) to the sum of the stand-alone selling prices of all of the performance obligations in the contract, as described in Illustration 7-6 below: [FRS 102.23.67]

Illustration 7-6: Relative stand-alone selling price allocation

Manufacturing Co. entered into a contract with a customer to sell a machine for £100,000. The total contract price included installation of the machine and a two-year extended warranty. Assume that Manufacturing Co. determined there were three performance obligations and the stand-alone selling prices of those performance obligations were as follows: machine - £75,000, installation services - £14,000 and extended warranty - £20,000. That is, if the customer had bought these items separately from Manufacturing Co. at contract inception, they would have cost £109,000 in total.

The aggregate of the stand-alone selling prices (£109,000) exceeds the total transaction price of £100,000, indicating there is a discount inherent in the contract. That discount must be allocated to each of the individual performance obligations based on the relative stand-alone selling price of each performance obligation. Therefore, the amount of the £100,000 transaction price is allocated to each performance obligation as follows:

Machine - £68,807 ($£100,000 \times (£75,000 \div £109,000)$)

Installation - £12,844 ($£100,000 \times (£14,000 \div £109,000)$)

Warranty - £18,349 ($£100,000 \times (£20,000 \div £109,000)$)

The entity would recognise as revenue the amount allocated to each performance obligation when (or as) each performance obligation is satisfied.

Frequently asked questions

Question 7-8: How does an entity allocate the transaction price in a contract with multiple performance obligations in which the entity acts as both a principal and an agent?¹⁶⁴

Section 23 does not illustrate the allocation of the transaction price for a contract with multiple performance obligations in which the entity acts as both a principal and an agent (see 5.4 above for a discussion of principal versus agent considerations). Below we illustrate two acceptable ways to perform the allocation for this type of contract that are consistent with the Section 23's objective for allocating the transaction price (see 7 above). Entities need to evaluate the facts and circumstances of their contracts to make sure that the allocation involving multiple performance obligations in which an entity acts as both a principal and an agent meets the allocation objective (see 7 above).

Illustration 7-7: Allocation when an entity is both a principal and an agent in a contract

Entity X sells two distinct products (i.e., Product A and Product B) to Customer Y, along with a distinct service for an aggregate contract price of £800. Entity X is the principal for the sale of Product A and Product B, but is an agent for the sale of the service.

The stand-alone selling price of each good and service in the contract is, as follows:

Contract	Stand-alone selling price
	£
Product A	500
Product B	300
Service	200
Total	1,000

¹⁶⁴ Based on TRG Agenda paper no. 1, *Gross versus Net Revenue*, dated 18 July 2014.

Entity X earns a 20% commission from the third-party service provider based on the stand-alone selling price of the service. That is, Entity X earns £40 of commission (i.e., £200 x 20%) and remits the remaining £160 to the third-party service provider.

Method A - Entity X determines that it has provided a single discount of £200 (i.e., sum of stand-alone selling prices of £1,000 less the contract price of £800) on the bundle of goods and services sold to Customer Y in the contract (i.e., Products A and B and the service provided by the third party). Assume in this example that Entity X concludes allocating the discount to all performance obligations in the contract meets the allocation objective in accordance with FRS 102.23.74 - see 7.3 below.

In order to allocate the discount to all of the goods and services in the contract, Entity X considers the performance obligation for the agency service as part of the contract with Customer Y for purposes of allocating the transaction price. Entity X determines the stand-alone selling prices of Products A and B and the agency service and allocates the transaction price of £640 (i.e., £800 contract price less £160 to be remitted to the third-party service provider) for Products A and B and the service on a relative stand-alone selling price basis. This method is illustrated, as follows:

Contract	Stand-alone selling price	Allocated transaction price
	£	£
Product A	500 (500 ÷ 840 × 640)	381
Product B	300 (300 ÷ 840 × 640)	229
Service	40 (40 ÷ 840 × 640)	30
Total	840	640

Method B - Entity X determines that it has provided a discount of £200 on Products A and B since it is the principal for the transfer of those goods to Customer Y. Entity X believes the third-party service provider is a separate customer for its agency services and the commission Entity X expects to be entitled to receive for the agency service is not part of the transaction price in the contract with Customer Y. Entity X allocates a transaction price of £600 (i.e., £800 contract price less £200 stand-alone selling price of service) to Product A and B on a relative stand-alone selling price basis. This method is illustrated, as follows:

Contract 1	Stand-alone selling price	Allocated transaction price
	£	£
Product A	500 (500 ÷ 800 × 600)	375
Product B	300 (300 ÷ 800 × 600)	225
Total	800	600

The entity would recognise £40 separately for its earned commission on the service contract when the performance obligation for the agency service has been satisfied.

In either method, the same amount of revenue is ultimately recognised (i.e., CU640). However, the timing of revenue recognition would be different if the products and agency service are transferred to the customer at different times.

Question 7-9: How does an entity allocate the transaction price in a contract with optional purchases using the relative stand-alone selling price method?¹⁶⁵

Generally, if there are no contractual penalties, the entity would not identify the additional goods and services underlying the option as performance obligations at contract inception. Therefore, the consideration that would be received for the optional goods or services is not included in the transaction price at contract inception (see Question 5-21 in 5.6 above for additional details). The option needs to be assessed to determine whether it represents a material right that would be accounted for as a performance obligation. If the entity concludes the option is a material right, a portion of the consideration is allocated to that option using the relative stand-alone selling price method. Consider the following Illustration:

¹⁶⁵ Based on TRG Agenda paper no. 48, *Customer options for additional goods and services*, dated 9 November 2015.

Illustration 7-8: Allocation using the relative stand-alone selling price method

An entity sells equipment and consumables, both of which are determined to be distinct goods that generate revenue that is recognised at a point in time. The stand-alone selling prices of the equipment and each consumable are £10,000 and £100, respectively.

The entity enters into a contract to sell the equipment for £10,000 and gives the customer the option to purchase each consumable for CU80 (the entity concludes the 20% discount on consumables is material). The equipment cost the entity £8,000, and each consumable costs the entity £60. The customer is not required to purchase any consumables, however, the option to purchase consumables represents a material right. The entity estimates that 200 consumables would be purchased, and the stand-alone selling price of the material right is £4,000.

The transaction price of £10,000 for the sale of the equipment (prior to the purchase of any consumables) is allocated to the performance obligations on a relative stand-alone selling price basis. This method is illustrated, as follows:

	Stand-alone selling price		Allocated transaction price
	£		£
Equipment	10,000	$(10,000 \div 14,000 \times 10,000)$	7,143
Material right	4,000	$(4,000 \div 14,000 \times 10,000)$	2,857
Total	14,000		10,000

The allocated transaction price would be recognised as each performance obligation is satisfied (see 8 below). The entity would recognise a loss on the sale of the equipment, and recognition of some of the transaction price would be deferred until the option to purchase the consumables has been exercised and control of the consumables is transferred.

Question 7-10: How does an entity allocate the effects of time value of money when there are multiple performance obligations in a contract?

See response to Question 6-21 in 6.5.3.

7.3 Allocating a discount or variable consideration

As discussed in 7.2 above, the relative stand-alone selling price method is the default method for allocating the transaction price. However, this method might not always result in a faithful depiction of the amount of consideration to which an entity expects to be entitled from the customer. Therefore, Section 23 provides two exceptions to the relative stand-alone selling price method of allocating the transaction price.

[FRS 102.23.65]. The exceptions relate to the allocation of a discount and to the allocation of variable consideration. [FRS 102.23.65].

Section 23 explains when these exceptions must be applied, as follows: [FRS 102.23.73, FRS 102.23.74]

Extract from Section 23

23.73 A discount or amount of variable consideration (see paragraphs 23.43 to 23.57) may be attributable to the entire contract or to a specific part of the contract.

23.74 An entity shall allocate a discount or variable consideration to all the performance obligations in the contract on a relative stand-alone selling price basis, unless this basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. In that case, the entity shall allocate that discount or variable consideration using a method that reflects such an amount (eg a variable payment may be allocated entirely to one performance obligation in the contract if the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation).

Section 23 states that a customer receives a discount if the sum of the stand-alone selling prices of the goods or services promised in the contract exceeds the promised consideration. [FRS 102.23.72]. This discount could be attributable to the entire contract or to a specific part of the contract, such as one or more (but not all) performance obligations in the contract if use of relative stand-alone selling price basis does not reflect Section 23's allocation objective (see 7 above). [FRS 102.23.73, FRS 102.23.74]. For example,

when an entity sells a bundle of goods or services, the selling price of the bundle is often less than the sum of the stand-alone selling prices of the individual elements. Under the relative stand-alone selling price allocation method, this discount would be allocated proportionately to all performance obligations. However, if an entity determines that a discount is not related to all of the promised goods or services in the contract, the entity allocates the contract's entire discount only to the goods or services to which it relates if doing so will meet the allocation objective of Section 23 (see 7 above).

The allocation exception for variable consideration requires allocating variable consideration entirely to a specific part of a contract, such as one or more (but not all) performance obligations in the contract (e.g., a bonus might be contingent on an entity transferring a promised good or service within a specified period of time). [FRS 102.23.73, FRS 102.23.74]. paragraph 23.66 also clarifies that paragraph 23.74 applies if an entity accounts for a series of distinct goods or services as a single performance obligation (see 5.2.2 above) and the consideration promised in the contract includes a variable amount. [FRS 102.23.66]. Accordingly, the allocation exception on variable consideration also requires an entity to allocate variable consideration to one or more (but not all) distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation (see 5.2.2 above). For example, the consideration promised for the second year of a two-year cleaning contract will increase according to movements in a specified inflation index. This exception will be applied to a single performance obligation, a combination of performance obligations or distinct goods or services that make up part of a performance obligation depending on the facts and circumstances of each contract.

It is important to note that if use of the relative stand-alone selling price basis does not reflect the allocation objective, allocating a discount or variable consideration to one or more, but not all, performance obligations or distinct goods or services in a series is a requirement, not a policy choice. In such a case, Section 23 does not specify a method to use as an alternative to the relative stand-alone selling price basis of allocation. Section 23 implies that an entity can use any method of allocating a discount or variable consideration provided it meets the allocation objective in Section 23 (see 7 above). This gives entities flexibility in allocating a discount or variable consideration in the contract. [FRS 102.BC.B23.9]. Accordingly, an entity would apply reasonable judgement to determine whether the allocation results in a reasonable outcome (and, therefore, meets the allocation objective in Section 23 (see 7 above)). [FRS 102.10.4]. Section 23 provides an example of a situation when the allocation objective could be met by allocating a variable payment entirely to one performance obligation in the contract. This is when the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation. [FRS 102.23.74].

In addition, when determining an alternative method of allocation that could meet the allocation objective in Section 23, an entity could consider further guidance in paragraphs 82 and 85 of IFRS 15 which sets out specific criteria in allocating a discount or a variable amount (and subsequent changes to that amount) entirely to one or more (but not all) performance obligations in the contract, or to one or more (but not all) distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation. [IFRS 15.82, IFRS 15.85].

An entity could consider the hierarchy of allocation in paragraph 86 of IFRS 15; that is, the variable consideration is identified and allocated first. The general guidance related to allocation of transaction price to performance obligations on a relative stand-alone selling price basis and the specific requirements related to allocation of a discount are then applied to allocate the remaining amount of the transaction price that does not meet the criteria related to allocation of variable consideration. [IFRS 15.86].

Furthermore, when an entity allocates a discount entirely to one or more (but not all) performance obligations, the entity could also consider the guidance in paragraph 83 of IFRS 15, which explains that an entity allocates a discount before using the residual approach to estimate the stand-alone selling price of a good or service (see discussion in 7.1.2 above). [IFRS 15.83].

Detailed discussions of the specified criteria in IFRS 15 for allocating a discount or variable consideration and the hierarchy of allocation in IFRS 15 are available in the EY publication, International GAAP®.

7.3.1 Variable fee arrangements based on usage

Consideration for some service contracts is based entirely on customer usage, and an entity has a stand-ready obligation to perform, regardless of how often the customer uses the service. Therefore, the usage-based fees are variable consideration.

It is important to note that, while these usage-based transactions might be economically similar to licensing arrangements that include sales-based or usage-based royalties, the accounting would be different. As described in 9.5 below, sales-based and usage-based royalties on licences of intellectual property are subject to the royalty recognition constraint and that requirement must be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property. Entities cannot analogue to the royalty recognition constraint for other situations.

If the usage-based fees relate specifically to the entity's effort to satisfy the performance obligation to provide services (or to a specific outcome from satisfying the performance obligation) and allocating the variable consideration to each distinct day is consistent with the allocation objective (see 7 above), the variable consideration allocation exception is met and the consideration is allocated to the period in which the usage occurred. If the usage-based fees do not relate to an entity's effort to satisfy the performance obligation (or to a specific outcome from satisfying the performance obligation) or if the allocation of the usage-based fees is not consistent with the allocation objective, the allocation exception is not met. For example, the allocation exception would not be met if the fees decline over the contract term as an incentive for the customer to achieve certain volume thresholds, if such pricing is not based on market terms or not linked to changes in the entity's cost to fulfil the obligation or value provided to the customer. In this situation, the variable consideration is estimated at contract inception and it is to be recognised over the contract duration based on a selected measure of progress. These estimates of variable consideration must be updated at the end of each reporting period and are subject to the constraint on variable consideration. See 6.2 above for further discussion on estimating variable consideration.

Consider the following Illustration of a contract with variable usage-based fees calculated daily that is likely to meet the on variable consideration allocation exception:

Illustration 7-9: Variable fee service arrangement based on usage

Provider C enters into a contract for cloud storage in which a customer agrees to pay daily fees based on the amount of storage space it uses (i.e., a fixed daily rate of £0.025 per gigabyte of storage is multiplied by the number of gigabytes used). Provider C invoices the customer at the end of each month. Assume that the entity has appropriately concluded that the nature of the entity's performance obligation is to stand ready to provide any amount of storage space the customer needs at any time during the contract term and the consideration in the contract is variable based on the number of gigabytes of storage used (and, therefore, each gigabyte used is not an optional purchase - see Question 5-20 in 5.6 above).

Provider C determines that the service provided to the customer in this contract meets the criteria to be accounted for as a series of distinct goods or services (see 5.2.2 above). This is because the performance obligation to stand ready to provide any amount of storage space represents a series of distinct services that are substantially the same and have the same pattern of transfer to the customer.

Provider C then considers whether the variable consideration allocation exception would apply to the daily usage-based fees. Provider C determines that it can allocate the daily variable fee to the distinct service performed that day because the uncertainty related to the consideration is resolved on a daily basis as the entity satisfies its obligation to provide cloud storage. This is because the variable payments specifically relate to transferring the distinct service (i.e., access to any amount of cloud storage that the customer chooses to use each day).

Provider C concludes that allocating the variable payments to each day is consistent with the allocation objective because the fixed-rate-per-gigabyte fees reflect the value to the customer based on the amount of storage the customer uses each day. Furthermore, the rates charged are consistent with Provider C's standard pricing practices.

Therefore, Provider C determines that it needs to apply the variable consideration allocation exception and recognises each day's fee for the day in which it occurs. That is, if the customer uses 250 gigabytes of storage the first day and 300 gigabytes the second, Provider C will recognise £6.25 and £7.50 of revenue for the respective days.

7.3.2 Fixed-fee arrangements with overages

Some service contracts have fixed fees (including any minimum amounts guaranteed) but also require customers to pay overage fees when they exceed certain thresholds based on usage. When an entity's performance obligation is to stand ready to perform, regardless of customer usage, the overage fee is considered variable consideration that the entity needs to estimate at contract inception, unless the variable consideration allocation exception is met (see 7.3 above).

How we see it

We believe that, for an entity to apply the variable consideration allocation exception by allocating overage fees to a particular period (e.g., day, month, year), the entity would have to conclude that the overage fees relate to its performance during that particular period.

Consider the following Illustration of a contract with fixed fees and annual overages:

Illustration 7-10: Fixed-fee service arrangement with overages

Entity X enters into a three-year contract with a customer to provide access to its SaaS application, which allows the customer to process transactions, among other functions. The customer agrees to pay an annual fee of £100,000, plus overage fees at a rate of £0.10 per transaction for transactions processed through the application during the year that exceed one million (i.e., overage fees are only paid if the customer processes more than one million transactions during the year).

Assume that Entity X has determined that the nature of its performance obligation is to provide continuous access to the SaaS application, regardless of the number of transactions processed. Entity X determines that the £100,000 annual fee is fixed consideration and all additional consideration received as overage fees is variable consideration.

Also assume that Entity X has determined that the fixed component of the consideration needs to be recognised rateably over the contract term because the service is provided to the customer on a consistent basis (i.e., the performance obligation is satisfied evenly over the period). Entity X will then need to determine whether the variable consideration allocation exception applies to the overage fees, which are calculated based on annual usage.

Evaluating the allocation exception for distinct daily periods

We believe that, for the entity to apply the variable consideration allocation exception by allocating overage fees to a particular day, the entity would have to conclude that the overage fees relate to its performance on that particular day. Therefore, Entity X concludes that it cannot apply the variable consideration allocation exception to the daily reporting periods for the overage fees because those payments do not relate to its efforts to satisfy the performance obligation to provide continuous access to the platform. That is, the nature of the performance obligation is a series of daily stand-ready obligations that are satisfied evenly over time, and the overage fees are additional consideration for satisfying that performance obligation over the course of each year.

Since the overage fees are only incurred after the annual minimum is reached, recognising revenue when the fees are incurred would result in more revenue recognised for the periods after the minimum is reached (i.e., backloading the revenue recognition), which is inconsistent with the allocation objective (see also 7.3 above). Therefore, the requirement for using the variable consideration allocation exception would not be met for each day of service, and Entity X would not recognise revenue for the overages on the days when the fees are incurred. However, we believe that if the overages in this example were calculated based on a short period of usage (e.g., daily or monthly (instead of annually)), Entity X might be able to demonstrate that it meets the requirement to apply the variable consideration allocation exception. This is because of the relatively short period of time between Entity X's performance and when it is entitled to the variable consideration such that Entity X could reasonably conclude that the allocation objective has been met.

Evaluating the allocation exception for annual periods

Since Entity X earns overage fees over a period of time that is less than the contract term (i.e., a three-year contract where overage fees are accrued and reset on an annual basis), Entity X would evaluate whether the overages need to be allocated to the period in which the overage fees are earned (e.g., to the annual period in which overages accrue).

To do so, Entity X evaluates whether it meets the requirement to apply the variable consideration allocation exception to the overage fees earned in each annual period in the three-year contract. Entity X might conclude that it needs to apply the variable consideration allocation exception to the overage fees earned in annual periods, which would require the entity to allocate the annual overage fees to each respective year (since the overages can be attributed to a single year). Therefore, Entity X will need to estimate overage fees only for each annual period (also considering the variable consideration constraint, as discussed in 6.2 above), rather than for the full three-year period at contract inception (which would be required if the variable consideration allocation exception was not met for any period). This would result in recognition of revenue from the overage fees only in the annual period to which the overages relate and not over the entire contract term.

For example, if the entity estimated that the overage fees for the first year would be £20,000, it would recognise this amount rateably over the year (i.e., £5,000 in each quarter), in addition to the fixed consideration that is also recognised rateably. The estimates of variable consideration must be updated at the end of each reporting period, as discussed in 6.2.4 above.

7.3.3 Example of allocating variable consideration

Illustration 7-11 below, which is based on Example 35 in IFRS 15, is an example to illustrate when an entity is or is not able to allocate variable consideration to a specific part of a contract. Note that the example focuses on licences of intellectual property, which are discussed in 9 below: [IFRS 15.IE Example 35, IFRS 15.IE178-IE187]

Illustration 7-11: Allocation of variable consideration

An entity enters into a contract with a customer for two intellectual property licences (Licences X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The stand-alone selling prices of Licences X and Y are £800 and £1,000, respectively.

Case A-Variable consideration allocated entirely to one performance obligation

The price stated in the contract for Licence X is a fixed amount of £800 and for Licence Y the consideration is 3% of the customer's future sales of products that use Licence Y. For purposes of allocation, the entity estimates its sales-based royalties (i.e., the variable consideration) to be £1,000, in accordance with paragraph 23.44 (see 6.2.2 above).

To allocate the transaction price, the entity considers the requirement in paragraph 23.74 (see 7.3 above) and concludes that the variable consideration (i.e., the sales-based royalties) must be allocated entirely to Licence Y. The entity concludes that allocating variable consideration on a relative stand-alone selling price basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract, for the following reasons:

- (a) the variable payment relates specifically to an outcome from the performance obligation to transfer Licence Y (i.e., the customer's subsequent sales of products that use Licence Y).
- (b) allocating the expected royalty amounts of £1,000 entirely to Licence Y is consistent with the allocation objective (see 7 above). This is because the entity's estimate of the amount of sales-based royalties (£1,000) approximates the stand-alone selling price of Licence Y and the fixed amount of £800 approximates the stand-alone selling price of Licence X. The entity allocates £800 to Licence X. This is because, based on an assessment of the facts and circumstances relating to both licences, allocating to Licence Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective (see 7 above).

The entity transfers Licence Y at inception of the contract and transfers Licence X one month later. Upon the transfer of Licence Y, the entity does not recognise revenue because the consideration allocated to Licence Y is in the form of a sales-based royalty. Therefore, in accordance with FRS 102.23.48 (see 9.5 below), the entity recognises revenue for the sales-based royalty when those subsequent sales occur.

When Licence X is transferred, the entity recognises as revenue the £800 allocated to Licence X.

Case B-Variable consideration allocated on the basis of stand-alone selling prices

The price stated in the contract for Licence X is a fixed amount of £300 and for Licence Y the consideration is 5% of the customer's future sales of products that use Licence Y. The entity's estimate of the sales-based royalties (i.e., the variable consideration) is £1,500 in accordance with FRS 102.23.44 (see 6.2.2 above).

To allocate the transaction price, the entity applies the requirement in paragraph 23.74 (see 7.3 above) to determine whether to allocate the variable consideration (i.e., the sales-based royalties) entirely to Licence Y. In applying the requirement, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer Licence Y (i.e., the customer's subsequent sales of products that use Licence Y), allocating the variable consideration entirely to Licence Y would be inconsistent with the principle for allocating the transaction price. Allocating £300 to Licence X and £1,500 to Licence Y does not reflect a reasonable allocation of the transaction price on the basis of the stand-alone selling prices of Licences X and Y of £800 and £1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 23.67 to 23.70 (see 7.1 and 7.2 above).

The entity allocates the transaction price of £300 to Licences X and Y on the basis of relative stand-alone selling prices of £800 and £1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative stand-alone selling price basis. However, in accordance with paragraph 23.48 (see 9.5 below), when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognise revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

Licence Y is transferred to the customer at the inception of the contract and Licence X is transferred three months later. When Licence Y is transferred, the entity recognises as revenue the £167 ($£1,000 \div £1,800 \times £300$) allocated to Licence Y. When Licence X is transferred, the entity recognises as revenue the £133 ($£800 \div £1,800 \times £300$) allocated to Licence X.

In the first month, the royalty due from the customer's first month of sales is £200. Consequently, in accordance with FRS 102.23.48 (see 9.5 below), the entity recognises as revenue the £111 ($£1,000 \div £1,800 \times £200$) allocated to Licence Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognises a contract liability for the £89 ($£800 \div £1,800 \times £200$) allocated to Licence X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

7.4 Changes in transaction price after contract inception

Section 23 requires entities to determine the transaction price at contract inception. However, there could be changes to the transaction price after contract inception. For example, as discussed in 6.2.4 above, when a contract includes variable consideration, entities need to update their estimate of the transaction price at the end of each reporting period to reflect any changes in circumstances. [FRS 102.23.75]. Changes in the transaction price can also occur due to contract modifications (see 4.4 above). [FRS 102.23.77].

As stated in paragraph 23.76, changes in the estimate of the total transaction price are generally allocated to the performance obligations on the same basis as the initial allocation, whether they are allocated based on the relative stand-alone selling price (i.e., using the same proportionate share of the total) or to individual performance obligations under the allocation exceptions discussed in 7.3 above. Consequently, an entity does not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception. Amounts allocated to a satisfied performance obligation must be recognised as revenue, or a reduction in revenue, in the period that the estimate of the transaction price changes. [FRS 102.23.76].

As discussed in 7.1 and 7.1.3 above, stand-alone selling prices are not updated after contract inception, unless the contract has been modified and the contract modification is accounted for as a new or separate contract. Furthermore, any amounts allocated to satisfied (or partially satisfied) performance obligations must be recognised in revenue in the period in which the transaction price changes (i.e., on a cumulative catch-up basis). This could result in either an increase or decrease to revenue in relation to a satisfied performance obligation or to cumulative revenue recognised for a partially satisfied over time performance obligation (see 8.1 below). [FRS 102.23.76].

The following Illustration explains this concept for a partially satisfied over time performance obligation:

Illustration 7-12: Change in transaction price after contract inception

Entity A, a construction company, enters into a contract with a customer on 1 January 20X6 to build three specific amenities at a community centre, a swimming pool, playground and a parking lot, for £3,000,000. Entity A will earn a bonus of £250,000 if it completes the swimming pool by 1 May 20X6.

At contract inception, Entity A concludes that the swimming pool, playground and parking lot are each distinct and, therefore, represent separate performance obligations. Entity A also concludes that the £250,000 bonus needs to be allocated entirely to the swimming pool because the requirement in paragraph 23.74 (see 7.3 above) for the variable consideration allocation are met. However, Entity A does not expect it will be entitled to the £250,000 bonus related to the completion of the swimming pool by 1 May 20X6 due to factors outside of Entity A's control, including inclement winter weather and the swimming pool supplier's backlog. Therefore, Entity A uses the most likely amount method to estimate variable consideration and does not include the bonus in the transaction price (see 6.2 above).

As at 1 January 20X6, Entity A allocates the transaction price to the performance obligations on a relative stand-alone selling price basis, as follows:

Performance obligations	Allocation of the transaction price
Swimming pool	£2,000,000
Playground	£750,000
Parking lot	£250,000
Total	£3,000,000

Entity A concludes that each of the performance obligations are satisfied over time because they meet the criteria in paragraph 23.81 (see 8.1 below for further discussion on evaluating whether performance obligations are satisfied over time). Due to the nature of Entity A's business, it determines that an input method based on costs incurred is an appropriate measure of progress over time.

As at 31 March 20X6, Entity A determines that it has incurred 60% of the total expected costs to complete each of its performance obligations. Therefore, Entity A recognises £1,800,000 (£3,000,000 × 60%) as revenue.

In addition, at 31 March 20X6, Entity A reassesses its estimate of variable consideration in the contract (including the constraint) and believes it will be able to complete the swimming pool by 1 May 20X6, because the significant uncertainties related to the weather and the supplier have been resolved. Entity A updates its transaction price to include the £250,000 bonus related to the swimming pool in accordance with paragraph 23.47 (see 6.2.4 above). Therefore, Entity A updates the transaction price as at 31 March 20X6, as follows:

Performance obligations	Allocation of the transaction price
Swimming pool	£2,250,000
Playground	£750,000
Parking lot	£250,000
Total	£3,250,000

Due to the change in the transaction price related to the swimming pool performance obligation, Entity A recognises £150,000 ($£250,000 \times 60\%$) as revenue on a cumulative catch-up basis as at 31 March 20X6.

A change in transaction price as a result of a contract modification arises from separate and subsequent negotiation between the parties to the contract that changes the enforceable rights and obligations of those parties. If the change in the transaction price is due to a contract modification, the contract modification requirements in paragraphs 23.13 to 23.16 must be followed (see 4.4 above for a discussion on contract modifications). [FRS 102.23.77]. See Question 4-15 in 4.4 for further discussion on how an entity would distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception. In addition, when contracts include variable consideration, it is possible that changes in the transaction price that arise after a modification are (or are not) related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification that is not treated as a separate contract, an entity must apply the following requirements, whichever is applicable: [FRS 102.23.77]

- If the change in transaction price is attributable to an amount of variable consideration promised before the modification and the modification was considered a termination of the existing contract and the creation of a new contract, the entity allocates the change in transaction price to the performance obligations that existed before the modification.
- In all other cases, the change in the transaction price is allocated to the performance obligations in the modified contract (i.e., the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

The first scenario is applicable to a change in transaction price that occurs after a contract modification that is accounted for in accordance with paragraph 23.16(a) (i.e., as a termination of the existing contract and the creation of a new contract) and the change in the transaction price is attributable to variable consideration promised before the modification. For example, an estimate of variable consideration in the initial contract might have changed or might no longer be constrained. [FRS 102.23.16(a), FRS 102.23.77(a)]. In this scenario, an entity has to allocate the corresponding change in the transaction price to the performance obligations identified in the contract before the modification (e.g., the original contract), including performance obligations that were satisfied prior to the modification. That is, it would not be appropriate for an entity to allocate the corresponding change in the transaction price to the performance obligations that are in the modified contract, if the promised variable consideration (and the resolution of the associated uncertainty) were not affected by the contract modification.

The second scenario (i.e., paragraph 23.77(b)) is applicable in all other cases when a modification is not treated as a separate contract (e.g., when the change in the transaction price is not attributable to variable consideration promised before the modification). [FRS 102.23.77(b)]. Under this scenario, the change in the transaction price is allocated to the performance obligation(s) in the modified contract (i.e., the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

Section 23 does not contain examples to illustrate application of the requirements described above, however, these are consistent with the requirements in IFRS 15. Accordingly, entities could consider Example 6 in IFRS 15, which illustrates the accounting for a change in the transaction price that occurs after a contract modification. [IFRS 15.IE Example 6, IFRS 15.IE25-IE32].

In some cases, an estimate of variable consideration made at the end of a reporting period could be affected by information that arises after the end of the reporting period, but before the release of the financial statements. In such a circumstance, an entity would follow the accounting requirements for subsequent events in Section 32 (see Chapter 34).

Frequently asked questions

Question 7-11: How does an entity distinguish between a contract modification and a change in the estimated transaction price due to variable consideration after contract inception?

See response to Question 4-15 in 4.4 above.

7.5 Allocation of transaction price to components outside the scope of Section 23

Revenue arrangements might include some components that are not within the scope of Section 23. As discussed in 3.1.5 above, Section 23 indicates that in such situations, an entity must first apply the other sections of FRS 102 if those sections address separation and/or measurement. [FRS 102.23.3].

For example, some sections of FRS 102 require certain components, such as financial liabilities, to be accounted for at fair value. As a result, when a revenue contract includes that type of component, the fair value of that component must be separated from the total transaction price. The remaining transaction price is then allocated to the remaining performance obligations.

The following Illustration explains this concept:

Illustration 7-13: Arrangements with components outside the scope of Section 23

Retailer sells products to customers and often bundles them with prepaid gift cards when the customer buys multiple units of its products. The prepaid gift cards are non-refundable, non-redeemable and non-exchangeable for cash and do not have an expiry date or back-end fees. That is, any remaining balance on the prepaid gift cards does not reduce, unless it is spent by the customer. Customers can redeem prepaid gift cards only at third-party merchants specified by Retailer (i.e., the prepaid gift card cannot be redeemed at the Retailer) in exchange for goods or services up to a specified monetary amount. When a customer uses the prepaid gift cards at a merchant(s) to purchase goods or services, Retailer delivers cash to the merchant(s).

Customer X enters into a contract to purchase 100 units of a product and a prepaid gift card for total consideration of £1,000. Because it bought 100 units, Retailer gives Customer X a discount on the bundle. The stand-alone selling price of the product and the fair value of the prepaid gift card are £950 and £200, respectively.

Retailer determines that it has a contractual obligation to deliver cash to specified merchants on behalf of the prepaid gift card owner (Customer X). Although this obligation is conditional upon Customer X redeeming or using the prepaid gift card to purchase goods or services, Retailer does not have an unconditional right to avoid delivering cash to settle this contractual obligation. Therefore, Retailer concludes that the liability for the prepaid gift card meets the definition of a financial liability and applies the requirements in Section 11 and Section 12 to account for it. In accordance with paragraph 23.3, because Section 11 provides measurement requirements for initial recognition (i.e., requires that financial liabilities within its scope be initially recognised at fair value, which is usually the initial transaction price), Retailer excludes from the Section 23 transaction price the fair value of the prepaid gift card. Retailer allocates the remaining transaction price to the products purchased. The allocation of the total transaction price is, as follows:

	Stand-alone selling price and fair value	% Allocated discount	Allocated discount	Arrangement consideration allocation
Products (100 units)	£950	100%	£150	£800
Prepaid gift card	£200	0%	-	£200
	£1,150		£150	£1,000

For components that must be recognised at fair value at inception, any subsequent remeasurement would be pursuant to other sections of FRS 102 (e.g., Section 11). That is, subsequent adjustments to the fair value of those components have no effect on the amount of Section 23 transaction price previously allocated to any performance obligations included within the contract or on revenue recognised.

8 Step 5 – Satisfaction of performance obligations

Under Section 23, an entity only recognises revenue when it satisfies an identified performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. [FRS 102.23.78].

Section 23 states that “Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining economic benefits that may flow from, the asset.” [FRS 102.23.80]. Control also means the ability to prevent others from directing the use of, and receiving the benefit from, a good or service. This definition of control in Section 23 is consistent with the definition of control in IFRS 15.

Under IFRS 15, the IASB notes that both goods and services are assets that a customer acquires (even if many services are not recognised as an asset because those services are simultaneously received and consumed by the customer). [IFRS 15.BC118]. The IASB explains the key terms in the definition of control in the Basis for Conclusions on IFRS 15, which are, as follows: [IFRS 15.BC120]

- *Ability* - a customer must have the present right to direct the use of, and obtain substantially all of the remaining benefits from, an asset for an entity to recognise revenue. For example, in a contract that requires a manufacturer to produce an asset for a customer, it might be clear that the customer will ultimately have the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, the entity does not recognise revenue until the customer has actually obtained that right (which, depending on the contract, might occur during production or afterwards).
- *Direct the use of* - a customer’s ability to direct the use of an asset refers to the customer’s right to deploy or to allow another entity to deploy that asset in its activities or to restrict another entity from deploying that asset.
- *Obtain the benefits from* - the customer must have the ability to obtain substantially all of the remaining benefits from an asset for the customer to obtain control of it. Conceptually, the benefits from a good or service are potential cash flows (either an increase in cash inflows or a decrease in cash outflows). Paragraph 33 of IFRS 15 indicates that a customer can obtain the benefits directly or indirectly in many ways, such as: using the asset to produce goods or services (including public services); using the asset to enhance the value of other assets; using the asset to settle a liability or reduce an expense; selling or exchanging the asset; pledging the asset to secure a loan; or holding the asset. [IFRS 15.33].

The transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer’s ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of the cash outflows, generated by the goods or services. Upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations.

Similar to IFRS 15, it is expected that control is assessed under Section 23 primarily from the customer’s perspective. While a seller often surrenders control at the same time the customer obtains control, assessment of control from the customer’s perspective minimises the risk of an entity recognising revenue from activities that do not coincide with the transfer of goods or services to the customer. [IFRS 15.BC121].

Section 23 indicates that an entity must determine, at contract inception, whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. [FRS 102.23.79]. These concepts are explored further in the following sections.

8.1 Performance obligations satisfied over time

Frequently, entities transfer the promised goods or services to the customer over time. While the determination of whether goods or services are transferred over time is straightforward in some contracts (e.g., many service contracts), it is more difficult in other contracts.

To help entities determine whether control transfers over time (rather than at a point in time), Section 23 states that an entity transfers control of a good or service over time (and, therefore, satisfies a performance obligation and recognises revenue over time) if one of the following criteria is met: [FRS 102.23.81]

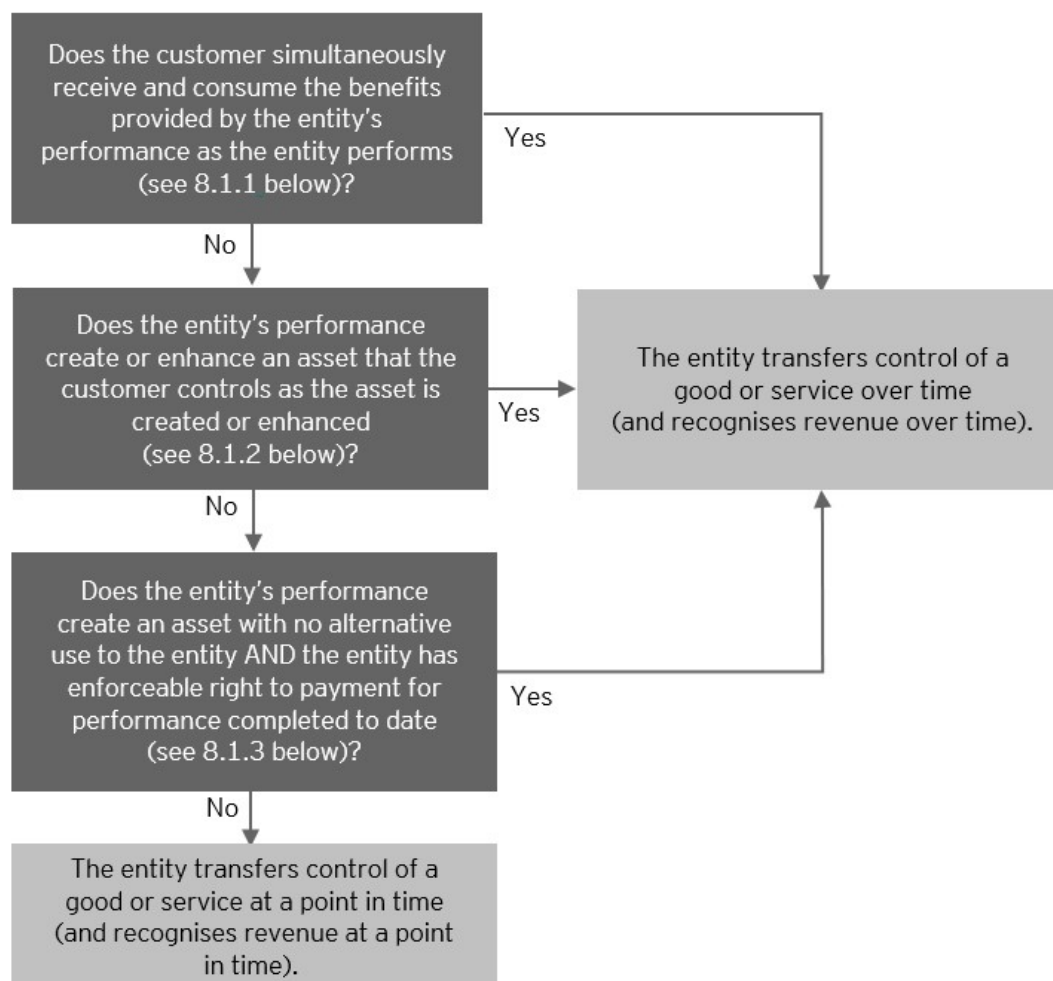
- As the entity performs, the customer simultaneously receives and consumes the benefits provided by the entity’s performance, e.g., routine or recurring services such as a cleaning service (see 8.1.1 below).

- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced e.g., in the case of a construction contract in which the customer controls the work in progress (see 8.1.2 below).
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (see 8.1.3 below).

Examples of each of the criteria above are included in the following sections. If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time (see 8.2 below). [FRS 102.23.79].

The following flow chart illustrates how to evaluate whether control transfers over time:

Figure 8-1: Evaluating whether control transfers over time



How we see it

Determining when performance obligations are satisfied requires judgement. paragraph 23.135(a) requires an entity to disclose when it typically satisfies its performance obligations (e.g., upon shipment, as services are delivered). Paragraph 23.136 also requires an entity to disclose the method used to recognise revenue (e.g., a description of the input or output method used and how that method is applied). See 11.4.1.D and 11.4.2 below for more information.

In line with the requirements in Section 8, an entity would also need to disclose any significant judgements applied in determining the timing of satisfaction of performance obligations and why the method selected provides a faithful depiction of the transfer of goods or services. See Chapter 6 at 7.3.

Frequently asked questions

Question 8-1: Can an entity elect to recognise revenue at a point in time under Section 23?

Entities cannot elect to recognise revenue at a point in time. Rather, entities must analyse their contracts to determine the appropriate timing and pattern of recognition while considering the specific criteria and requirements of Section 23. As discussed above, for each performance obligation identified in the contract, an entity is required to consider at contract inception whether it satisfies the performance obligation over time (i.e., whether it meets one of the three criteria for over time recognition in paragraph 23.81) or at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. That is, there is no exception in Section 23 that would allow entities to elect point-in-time recognition for contracts, including those with a short duration (e.g., a year or less).

Question 8-2: Do all contracts with a stand-ready element include a single performance obligation that is satisfied over time?

See response to Question 5-3 in 5.1 above.

8.1.1 Customer simultaneously receives and consumes benefits as the entity performs

Goods and services are assets, even if only momentarily, when they are received and used as in the case of many services. [FRS 102.23.80]. In many service contracts the entity's performance creates an asset, momentarily, because that asset is simultaneously received and consumed by the customer. In these cases, the customer obtains control of the entity's output as the entity performs. Therefore, the performance obligation is satisfied over time. Examples include a cleaning service that is routine or recurring in which the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. [FRS 102.23.81(a)].

While this criterion most often applies to service contracts, there might be instances in which commodity contracts (e.g., electricity, natural gas, heating oil) could be recognised over time. These situations could arise if the facts and circumstances of the contract indicate that the customer will simultaneously receive and consume the benefits (e.g., a continuous supply contract to meet immediate demands). See Question 8-3 below for further information.

There might be contracts in which it is unclear whether the customer simultaneously receives and consumes the benefit of the entity's performance over time. To assist entities, Section 23 states that if an entity cannot readily identify whether the customer simultaneously receives and consumes the benefit as the entity performs, "a performance obligation is satisfied over time if another entity would not need to substantially re-perform the work that the entity has completed to date if that other entity were to fulfil the remaining performance obligation (eg in a freight logistics contract)." [FRS 102.23.81(a)]. Following this guidance, assume that the entity has agreed to transport goods from London to Edinburgh. It could appear that the customer receives no benefit from the entity's performance until the goods are delivered to, in this case, Edinburgh. However, the customer benefits as the entity performs because if the goods were only delivered part of the way (e.g., to Manchester), another entity would not need to substantially re-perform the entity's performance to date. In these cases, the assessment of whether another entity would need to substantially re-perform the entity's performance to date is an objective way to assess whether the customer receives benefit from the entity's performance as it occurs.

In assessing whether a customer simultaneously receives and consumes the benefits provided by an entity's performance, all relevant facts and circumstances need to be considered. This includes considering the inherent characteristics of the good or service, the contract terms and information about how the good or service is transferred or delivered.

Section 23 and IFRS 15 are consistent in this area. Entities reporting under FRS 102 could consider further guidance provided in IFRS 15. Accordingly, in determining whether another entity would not need to substantially re-perform the work the entity has completed to date, an entity could consider the following assumptions provided in IFRS 15: [IFRS 15.B4]

- (a) Disregard potential contractual restrictions or practical limitations that otherwise would prevent the entity from transferring the remaining performance obligation to another entity.

And

- (b) Presume that another entity fulfilling the remainder of the performance obligation would not have the benefit of any asset that is presently controlled by the entity and that would remain controlled by the entity if the performance obligation were to transfer to another entity.

Illustration 8-1 below, which is based on Example 13 in IFRS 15, is an example that illustrates a customer simultaneously receiving and consuming the benefits as the entity performs in relation to a series of distinct payroll processing services: [IFRS 15.IE Example 13, IFRS 15.IE67-IE68]

Illustration 8-1: Customer simultaneously receives and consumes the benefits

An entity enters into a contract to provide monthly payroll processing services to a customer for one year. The promised payroll processing services are accounted for as a single performance obligation in accordance with paragraph 23.17(b) (see 5.2.2 above). The performance obligation is satisfied over time in accordance with paragraph 23.81(a) because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed. The fact that another entity would not need to re-perform payroll processing services for the service that the entity has provided to date also demonstrates that the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs. (The entity disregards any practical limitations on transferring the remaining performance obligation, including setup activities that would need to be undertaken by another entity.) The entity recognises revenue over time by measuring its progress towards complete satisfaction of that performance obligation in accordance with paragraphs 23.98 to 23.104 (see 8.1.4 below).

An entity does not evaluate this criterion (to determine whether a performance obligation is satisfied over time) if the entity's performance creates an asset that the customer does not consume immediately as the asset is received (see also discussions in Question 8-11 in 8.1.3.B below). Instead, an entity assesses that performance obligation using the criteria discussed in 8.1.2 and 8.1.3 below.

For some service contracts, the entity's performance will not satisfy its obligation over time because the customer does not consume the benefit of the entity's performance until the entity's performance is complete. Illustration 8-4 in 8.1.3.B below provides an example of an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. In this situation, an entity cannot conclude that the services are transferred over time based on this criterion. Instead, the entity must consider the remaining two criteria in paragraph 23.81 (see 8.1.2 and 8.1.3 and Illustration 8-4 in 8.1.3.B below).

Frequently asked questions

Question 8-3: What factors does an entity consider when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity (e.g., electricity, natural gas or heating oil) as the entity performs?¹⁶⁶

An entity would consider all known facts and circumstances when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity. These might include the inherent characteristics of the commodity (e.g., whether the commodity can be stored), contract terms (e.g., a continuous supply contract to meet immediate demands) and information about infrastructure or other delivery mechanisms.

As such, revenue related to the sale of a commodity might or might not be recognised over time, depending on whether the facts and circumstances of the contract indicate that the customer simultaneously receives and consumes the benefits. This evaluation could require the use of significant judgement.

Whether a commodity meets this criterion and is transferred over time is important in determining whether the sale of a commodity meets the criteria to apply the series requirement (see 5.2.2 above). This, in turn, affects how an entity allocates variable consideration and applies the requirements for contract modifications and changes in the transaction price.

8.1.2 Customer controls the asset as it is created or enhanced

The second criterion to determine whether control of a good or service is transferred over time requires entities to evaluate whether the customer controls the asset as it is being created or enhanced by the entity's performance. [IFRS 102.23.81(b)]. Therefore, in determining whether a customer controls an asset as it is created or enhanced, an entity applies the requirements for control in paragraphs 23.78 to 23.80 (see 8 above) and 23.85 (see 8.2 below). The asset being created or enhanced can be either tangible or intangible.

¹⁶⁶ Based on TRG Agenda paper no. 43, *Determining When Control of a Commodity Transfers*, dated 13 July 2015.

For the purpose of this determination, the definition of 'control' is the same as previously discussed in 8 above (i.e., the ability to direct the use of and obtain substantially all of the remaining benefits from the asset). This criterion addresses situations in which the customer clearly controls any work in progress arising from the entity's performance. In effect, the entity has agreed to sell its rights to the asset (i.e., work in progress) as the entity performs (i.e., a continuous sale). An example of which is an entity that has entered into a construction contract to build on the customer's land, stating that any work in progress arising from the entity's performance is generally controlled by the customer (see also discussions in Question 8-11 in 8.1.3.B below). In addition, some construction contracts might also contain clauses indicating that the customer owns any work in progress as the contracted item is being built.

Frequently asked questions

Question 8-4: How does an entity evaluate a customer's right to sell (or pledge) a right to obtain an asset when determining whether the customer controls the asset as it is created or enhanced under FRS 102.23.81(b)?

How we see it

We believe that an entity needs to assess control of the asset that the entity's performance creates or enhances, rather than any contractual rights to obtain the completed asset in the future.

As an example, (and as discussed by the IFRS IC - see Question 8-11 in 8.1.3.B below), in a contract for the sale of real estate that the entity constructs, the asset created is the real estate itself and not the customer's right to obtain the completed real estate in the future. That is, an entity would evaluate whether the customer controls the partially constructed real estate as it is being constructed to determine whether the criterion paragraph 23.81(b) is met. The customer's right to sell (or pledge) a right to obtain a completed asset in the future is not evidence that the customer controls the asset itself as it is being created or enhanced.

8.1.3 Asset with no alternative use and right to payment

In some cases, it might be unclear whether the asset that an entity creates or enhances is controlled by the customer when considering the first two criteria (discussed in 8.1.1 and 8.1.2 above) for evaluating whether control transfers over time. Therefore, a third criterion is provided, which requires revenue to be recognised over time if both of the following two requirements are met: [FRS 102.23.81(c)]

- The entity's performance does not create an asset with alternative use to the entity (see 8.1.3.A below).
- The entity has an enforceable right to payment for performance completed to date (see 8.1.3.B below).

Under IFRS 15, the IASB has clarified how the factors of 'no alternative use' and the 'right to payment' relate to the assessment of control. Since an entity is constructing an asset with no alternative use to the entity, the entity is effectively creating an asset at the direction of the customer. That asset would have little or no value to the entity if the customer were to terminate the contract. As a result, the entity will seek economic protection from the risk of customer termination by requiring the customer to pay for the entity's performance to date in the event of customer termination. The customer's obligation to pay for the entity's performance to date (or the inability to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance. [IFRS 15.BC142].

8.1.3.A No alternative use

The notion of 'alternative use' prevents over time revenue recognition when the entity's performance does not transfer control of the goods or services to the customer over time. This is because when the entity's performance creates an asset with an alternative use to the entity (e.g., standard inventory items), the entity can readily direct the asset to another customer. In those cases, the entity (not the customer) controls the asset as it is created because the customer does not have the ability to direct the use of the asset or restrict the entity from directing that asset to another customer (see 8 above).

Section 23 includes the following requirements for 'alternative use': [FRS 102.23.82, FRS 102.23.83]

Extract from Section 23

- 23.82** An asset created by an entity's performance does not have alternative use if the entity is either:
- (a) restricted contractually from readily directing the asset for another use during its creation or enhancement, because the customer could enforce its rights to that promised asset; or
 - (b) limited practically from readily directing the asset in its completed state for another use, because the entity would incur significant economic losses in doing so.
- 23.83** The assessment of whether an asset has an alternative use to the entity is made at contract inception and shall be reassessed only if there is a contract modification that substantially changes the performance obligation.

In assessing whether an asset has an alternative use to an entity, an entity considers the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use. Section 23 and IFRS 15 are consistent in this area. Entities reporting under FRS 102 could consider further guidance provided in IFRS 15 on 'alternative use'. The discussion of such guidance is available in the EY publication, International GAAP®.

Illustration 8-2 below, which is based on Example 15 in IFRS 15, is an example to illustrate an evaluation of practical limitations on directing an asset for another use: [IFRS 15.IE Example 15, IFRS 15.IE73-IE76]

Illustration 8-2: Asset has no alternative use to the entity

An entity enters into a contract with a customer, a government agency, to build a specialised satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, based on each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 23.81.

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 23.81(c) and 23.82) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 23.81(c) also requires the entity to have an enforceable right to payment for performance completed to date (see 8.1.3.B below). This condition is not illustrated in this example.

The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity does not update its assessment of whether an asset has an alternative use for any subsequent changes in facts and circumstances, unless the parties approve a contract modification that substantively changes the performance obligation. [FRS 102.23.83]. An entity's lack of an alternative use for an asset does not, by itself, mean that the customer effectively controls the asset. In addition, the entity would also need to determine that it has an enforceable right to payment for performance to date, as discussed in 8.1.3.B below.

Frequently asked questions

Question 8-5: Does an entity consider the completed asset or the work in progress when assessing whether its performance creates an asset with no alternative use under FRS 102.23.81(c)?¹⁶⁷

When an entity evaluates whether its performance creates an asset with no alternative use, it considers whether it could sell the completed asset to another customer without incurring a significant economic loss (i.e., whether it could sell the raw materials or work in progress to another customer is not relevant). This conclusion is supported by the IASB's comment in the Basis for Conclusions on IFRS 15 "that an entity should consider the characteristics of the asset that will ultimately be transferred to the customer". [IFRS 15.BC136].

However, as discussed above and in accordance with paragraph 23.82, if the entity is contractually restricted or has a practical limitation on its ability to direct the asset for another use, the asset would not have an alternative use, regardless of the characteristics of the completed asset. A contractual restriction is substantive if a customer could enforce its rights to the promised asset if the entity sought to direct the asset for another use. A practical limitation exists if an entity would incur a significant economic loss to direct the asset for another use.

Consider the following Illustration:

Illustration 8-3: No alternative use

An entity enters into a contract with a customer to build customised equipment. The customisation of the equipment occurs when the manufacturing process is approximately 75% complete. That is, for approximately the first 75% of the manufacturing process, the in-process asset could be redirected to fulfil another customer's equipment order (assuming no contractual restrictions). However, the equipment cannot be sold in its completed state to another customer without incurring a significant economic loss. The design specifications of the equipment are unique to the customer and the entity would only be able to sell the completed equipment at a significant economic loss.

The entity would evaluate, at contract inception, whether there is any contractual restriction or practical limitation on its ability to readily direct the asset (in its completed state) for another use. Because the entity cannot sell the completed equipment to another customer without incurring a significant economic loss, the entity has a practical limitation on its ability to direct the equipment in its completed state and, therefore, the asset does not have an alternative use. However, before concluding that revenue would be recognised over time, an entity must evaluate whether it has an enforceable right to payment (see 8.1.3.B below).

8.1.3.B Enforceable right to payment for performance completed to date

To evaluate whether it has an enforceable right to payment for performance completed to date, the entity considers the terms of the contract and any laws or regulations that relate to it. Section 23 does not specify whether the right to payment for performance completed to date need to be for a fixed amount. However, Section 23 clarifies that at any time during the contract term, an entity must be entitled to an amount that at least compensates the entity for performance completed to date, even if the contract is terminated by the customer (or another party) for reasons other than the entity's failure to perform as promised. [FRS 102.23.84]. Also, under IFRS 15, the IASB concluded that a customer's obligation to pay for the entity's performance is an indicator that the customer has obtained benefit from the entity's performance. [IFRS 15.BC142].

Section 23 states the following about an entity's right to payment for performance completed to date: [FRS 102.23.84]

¹⁶⁷ Based on FASB TRG Agenda paper no. 56, *Over Time Revenue Recognition*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, November 2016 Meeting - Summary of Issues Discussed and Next Steps, dated 31 January 2017.

Extract from Section 23

23.84 An enforceable right to payment for performance completed to date may arise from specific terms in the contract or laws that apply to that contract. At all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (eg recovery of the cost incurred by the entity in satisfying the performance obligation plus a reasonable profit margin).

The enforceable right to payment criterion has two components that an entity must assess:

- The amount that the customer would be required to pay.
- And
- What it means to have the enforceable right to payment.

Section 23 and IFRS 15 are consistent in this area. Entities reporting under FRS 102 could consider further guidance provided in IFRS 15 on 'enforceable right to payment'. The discussion of such guidance is available in the EY publication, International GAAP®. Illustration 8-4 below, which is based on Example 14 in IFRS 15, is an example which depicts an entity providing consulting services that will take the form of a professional opinion upon the completion of the services. [IFRS 15.IE Example 14, IFRS 15.IE69-IE72]. In this example, the entity's performance obligation meets the no alternative use and right to payment criterion:

Illustration 8-4: Assessing alternative use and right to payment

An entity enters into a contract with a customer to provide a consulting service that results in the entity providing a professional opinion to the customer. The professional opinion relates to facts and circumstances that are specific to the customer. If the customer were to terminate the consulting contract for reasons other than the entity's failure to perform as promised, the contract requires the customer to compensate the entity for its costs incurred plus a 15% margin. The 15% margin approximates the profit margin that the entity earns from similar contracts.

The entity considers the criterion in paragraph 23.81(a) to determine whether the customer simultaneously receives and consumes the benefits of the entity's performance (see 8.1.1 above). If the entity were to be unable to satisfy its obligation and the customer hired another consulting firm to provide the opinion, the other consulting firm would need to substantially re-perform the work that the entity had completed to date, because the other consulting firm would not have the benefit of any work in progress performed by the entity. The nature of the professional opinion is such that the customer will receive the benefits of the entity's performance only when the customer receives the professional opinion. Consequently, the entity concludes that the criterion in paragraph 23.81(a).

However, the entity's performance obligation meets the criterion in paragraph 23.81(c) and is a performance obligation satisfied over time because of both of the following factors:

- (a) in accordance with paragraph 23.82, the development of the professional opinion does not create an asset with alternative use to the entity because the professional opinion relates to facts and circumstances that are specific to the customer. Therefore, there is a practical limitation on the entity's ability to readily direct the asset to another customer.
- (b) in accordance with paragraph 23.84, the entity has an enforceable right to payment for its performance completed to date for its costs plus a reasonable margin, which approximates the profit margin in other contracts.

Consequently, the entity recognises revenue over time by measuring the progress towards complete satisfaction of the performance obligation in accordance with paragraphs 23.98 to 23.104 (see 8.1.4 below).

Illustration 8-5 below, which is based on Example 16 in IFRS 15, illustrates a contract in which the fixed payment schedule is not expected to correspond, at all times throughout the contract, to the amount that would be necessary to compensate the entity for performance completed to date. [IFRS 15.IE Example 16, IFRS 15.IE77-IE80]. Accordingly, the entity concludes that it does not have an enforceable right to payment for performance completed to date as follows:

Illustration 8-5: Enforceable right to payment for performance completed to date

An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10% of the contract price, regular payments throughout the construction period (amounting to 50% of the contract price) and a final payment of 40% of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are non-refundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.

At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 23.81.

As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 23.81(c) and 23.84 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are non-refundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.

Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 23.81(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraphs 23.81(a) or 23.81(b) and thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 23.85 (see 8.2 below).

Illustration 8-6 below contrasts similar situations and illustrates when revenue would be recognised over time (see 8.1 above) versus at a point in time (see 8.2 below). Specifically, Illustration 8-6, which is based on Example 17 in IFRS 15, illustrates the evaluation of the 'no alternative use' and 'right to payment for performance to date' concepts, as follows. [IFRS 15.IE Example 17, IFRS 15.IE81-IE90].

Illustration 8-6: Assessing whether a performance obligation is satisfied at a point in time or over time

An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).

Case A-Entity does not have an enforceable right to payment for performance completed to date

The customer pays a deposit upon entering into the contract and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

At contract inception, the entity applies paragraph 23.81(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because, until construction of the unit is complete, the entity only has a right to the deposit paid by the customer.

Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 23.81(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 23.85 (see 8.2 below).

Case B-Entity has an enforceable right to payment for performance completed to date

The customer pays a non-refundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, the entity applies paragraph 23.81(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

The entity also has a right to payment for performance completed to date in accordance with paragraph 23.84. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 23.81(c) are met and the entity has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, the entity measures its progress towards complete satisfaction of its performance obligation in accordance with paragraphs 23.98 to 23.104 (see 8.1.4 below).

In the construction of a multi-unit residential complex, the entity might have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (i.e., the foundation and the basic structure), as well as the construction of common areas, might need to be reflected when measuring its progress towards complete satisfaction of its performance obligations in each contract.

Case C-Entity has an enforceable right to payment for performance completed to date

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity could also choose to enforce its rights to full payment under the contract. The fact that the entity could choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment, provided that the entity's rights to require the customer to continue to perform as required under the contract (i.e., pay the promised consideration) are enforceable. As discussed above, this is consistent with the application guidance in paragraph B11 of IFRS 15.

Frequently asked questions

Question 8-6: How does an entity determine whether it has an enforceable right to payment under FRS 102.23.81(c)?¹⁶⁸

Generally, entities need to evaluate the contractual provisions to determine whether the right to payment compensates the entity for performance completed to date. For example, a contract might not explicitly provide an entity with an enforceable right to payment for anything other than finished goods. However, if the termination provisions in the contract allow for a notice period (e.g., 60 days) that would provide sufficient time for an entity to move all work in progress to the finished goods stage, it is likely that an entity would conclude that the contract provides for an enforceable right to payment for performance completed to date. In addition, an entity considers any legislation or legal precedent that could supplement or override any contractual terms.

¹⁶⁸ Based on FASB TRG Agenda paper no. 56, *Over Time Revenue Recognition*, dated 7 November 2016.

The linkage amongst right to payment, measure of progress and the timing of the customisation of a good would also need to be considered. For example, an entity might not always have an enforceable right to payment at contract inception, such as when an entity is producing standard goods (i.e., inventory) that might be customised for a customer towards the end of the production process. Generally, an entity would need to consider whether it has an enforceable right to payment related to its performance completed to date. If the entity's performance obligation is to customise its standard goods for a customer, generally, the entity would evaluate whether it has an enforceable right to payment at the point that the entity begins to satisfy the performance obligation to customise the goods for the customer. That is, because the right to payment is for performance completed to date, an entity's performance needs to coincide with how it defines the nature of its performance obligation and its measure of progress toward satisfaction of that performance obligation.

Question 8-7: To have an enforceable right to payment for performance completed to date, does an entity need to have a present unconditional right to payment?

The contractual payment terms in a contract might not always align with an entity's enforceable rights to payment for performance completed to date. As a result, an entity does not need to have a present unconditional right to payment. Instead, it must have an enforceable right to demand and/or retain payment for performance completed to date upon customer termination without cause. For example, consider a consulting contract that requires an entity to provide a report at the end of the project. In return, the entity earns a fixed amount, which is due and payable to the entity when it delivers the report. Assume that the entity is performing under the contract and that the contract (or the law) requires the customer to compensate the entity for its performance completed to date. In that situation, the entity would have an enforceable right to payment for performance completed to date, even though an unconditional right to the fixed amount only exists at the time the report is provided to the customer. This is because the entity has a right to demand and retain payment for performance completed to date.

The above discussion is consistent with the clarification made by the IASB in the Basis for Conclusions on IFRS 15. [IFRS 15.BC145].

Question 8-8: Does an entity have a right to payment for performance completed to date if the entity receives a non-refundable upfront payment that represents the full transaction price?

Such a payment would represent an entity's right to payment for performance completed to date provided that the entity's right to retain and not refund the payment is enforceable upon termination by the customer. This is because a full upfront payment would at least compensate an entity for the work completed to date throughout the contract. This is consistent with the observations of IASB in the Basis for Conclusions on IFRS 15. [IFRS 15.BC146]. Conversely, if the non-refundable upfront payment does not represent the full transaction price, an entity will have to apply judgement to determine whether the upfront payment provides the entity with a right to payment for performance completed to date in the event of a contract termination.

Question 8-9: Can an entity conclude it has an enforceable right to payment for performance completed to date when a contract is priced at a loss?

The specific facts and circumstances of the contract must be considered to determine whether an entity has an enforceable right to payment for performance completed to date when a contract is priced at a loss. As discussed above, Section 23 states that, if a contract is terminated for reasons other than the entity's failure to perform as promised, the entity must be entitled to an amount that at least compensates it for its performance to date. Furthermore, Section 23 states that "An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin)." [FRS 102.23.84]. Accordingly, it is unclear whether an entity could have an enforceable right to payment for performance completed to date if the contract was priced at a loss.

How we see it

We believe that the example in paragraph 23.84 of cost recovery plus a reasonable profit margin does not preclude an entity from having an enforceable right to payment even if the contract is priced at a loss. Rather, we believe an entity needs to evaluate whether it has an enforceable right to receive an amount that approximates the selling price of the goods or services for performance completed to date in the event the customer terminates the contract.

Consider the following Illustration below (which is based on an example from the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Revenue Recognition):¹⁶⁹

Illustration 8-7: Determination of enforceable right to payment for a contract priced at a loss

Customer X requests bids for the design of a highly customised system. The customer expects to award subsequent contracts for systems over the next 10 years to the entity that wins the design contract. Contractor A is aware of the competition and knows that in order to win the design contract it must bid the contract at a loss. That is, Contractor A is willing to bid the design contract at a loss due to the significant value in future expected orders.

Contractor A wins the contract with a value of £100 and estimated costs to complete of £130. Contractor A has determined that the contract contains a single performance obligation and that its performance does not create an asset with an alternative use. The contract is non-cancellable, however, the contract terms stipulate that if the customer terminates the contract, Contractor A would be entitled to payment for work completed to date. The payment amount would be equal to a proportional amount of the price of the contract based upon the performance of work done to date. For example, if at the termination date Contractor A was 50% complete (i.e., incurred £65 of costs), it would be entitled to a £50 payment from Customer X (i.e., 50% of £100 contract value).

In this example, we believe Contractor A has an enforceable right to payment for performance completed to date. This is in accordance with paragraph 23.81(c) because Contractor A is entitled to an amount that approximates the selling price of the good or service for performance completed to date in the event the customer terminates the contract.

See 10.2 below regarding accounting for anticipated losses on contracts.

Question 8-10: Can an entity have an enforceable right to payment for performance completed to date if it is not entitled to a reasonable profit margin on standard inventory materials that were purchased but not yet used in completing the performance obligation?

It is possible for an entity to have an enforceable right to payment for performance completed to date if it is not entitled to a reasonable profit margin on standard inventory materials that were purchased, but not yet used in completing the performance obligation. Consider an example in which an entity agrees to construct a specialised asset for a customer that has no alternative use to the entity. The construction of this asset requires the use of standard inventory materials that could be used interchangeably on other projects of the entity until they are integrated into the production of the customer's asset. The contract with the customer entitles the entity to reimbursement of costs incurred plus a reasonable profit margin if the contract is terminated. However, the contract specifically excludes reimbursement of standard inventory purchases before they are integrated into the customer's asset. As previously discussed, Section 23 states that, at any time during the contract, an entity must be entitled to an amount that compensates the entity for performance completed to date (as defined in paragraph 23.84) if the contract is terminated for reasons other than the entity's failure to perform. However, in this example, the standard inventory materials have not yet been used in fulfilling the performance obligation, so the entity does not need to have an enforceable right to payment in relation to these materials. The entity could also repurpose the materials for use in other contracts with customers.

The entity will still need to evaluate whether it has an enforceable right to payment for performance completed to date once the standard inventory materials are used in fulfilling the performance obligation. [FRS 102.23.84].

Question 8-11: What does an entity consider when assessing the over time criteria for the sale of a real estate unit?

Whilst decisions of the IFRS IC do not apply directly to entities reporting under FRS 102, due to the similarities of accounting requirements between Section 23 and IFRS 15 in this area, the analysis set out below is relevant to entities considering a similar fact pattern under FRS 102 (see 1 above).

The IFRS IC received three requests regarding the assessment of the over time criteria in relation to contracts for the sale of a real estate unit. At its March 2018 meeting, the IFRS IC concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether to recognise revenue over time, or at a point in time, including whether it has an enforceable right to payment for performance completed to date for a contract for the sale of a real estate unit. Consequently, the IFRS IC decided not to add these matters to its agenda.¹⁷⁰

¹⁶⁹ See AICPA guide, *Revenue Recognition*, Chapter 3, *Aerospace and Defense Entities*, paragraphs 3.5.18 - 3.5.23.

¹⁷⁰ [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

The agenda decisions included the following reminders:

- An entity accounts for contracts within the scope of IFRS 15 only when all the criteria in IFRS 15.9 are met, which includes the collectability criterion (Section 23 provides similar criteria to be met in paragraph 23.7 – see 4.1 above).
- Before considering the over time criteria, an entity is required to apply paragraphs 22-30 of IFRS 15 to identify whether each promise to transfer a good or service to the customer is a performance obligation (Section 23 provides similar requirements in paragraphs 23.17-23.25 – (see 5.2 above for further discussion).
- An entity assesses the over time criteria in paragraph 35 of IFRS 15 at contract inception. Paragraph 35 of IFRS 15 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if any of the three criteria is met. If an entity does not satisfy a performance obligation over time, it satisfies the performance obligation at a point in time (Section 23 provides similar criteria to be met in paragraph 23.81 – see 8.1 above).

The agenda decisions also set out the following in relation to the over time criteria.

Criterion (a)

According to IFRS 15.35(a) (or FRS 102.23.81(a)), an entity recognises revenue over time if the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. This criterion is not applicable in a contract for the sale of a real estate unit that the entity constructs because the real estate unit created by the entity's performance is not consumed immediately.

Criterion (b)

IFRS 15.35(b) (or FRS 102.23.81(b)) specifies that an entity recognises revenue over time if the customer controls the asset that an entity's performance creates or enhances as the asset is created or enhanced. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The IASB included this criterion to "address situations in which an entity's performance creates or enhances an asset that a customer *clearly* controls as the asset is created or enhanced". [IFRS 15.BC129]. Therefore, all relevant facts and circumstances need to be considered by an entity when assessing whether there is evidence that the customer clearly controls the asset that is being created or enhanced (e.g., the part-constructed real estate unit) as it is created or enhanced. None of the facts and circumstances is determinative.

The IFRS IC observed that "in a contract for the sale of real estate that the entity constructs, the asset created is the real estate itself. It is not, for example, the right to obtain the real estate in the future. The right to sell or pledge a right to obtain real estate in the future is not evidence of control of the real estate itself".¹⁷¹ That is, it is important to apply the requirements for control to the asset that the entity's performance creates or enhances (see Question 8-4 in 8.1.2 above).

Criterion (c)

The IASB developed this third criterion because, in some cases, it might not be clear whether the asset that is created or enhanced is controlled by the customer. IFRS 15.35(c) (or FRS 102.23.81(c)) requires an entity to determine whether: (a) the asset created by an entity's performance does not have an alternative use to the entity; and (b) the entity has an enforceable right to payment for performance completed to date. However, the underlying objective of this criterion is still to determine whether the entity is transferring control of goods or services to the customer as it is creating the asset for that customer. The agenda decisions reiterate that:

- The asset being created does not have an alternative use to the entity if the entity is restricted contractually from readily directing the asset for another use during the asset's creation or if it is limited practically from readily directing the asset in the completed state for another use. [IFRS 15.36, FRS 102.23.82].¹⁷²

¹⁷¹ [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

¹⁷² [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

- The entity has an enforceable right to payment if it is entitled to an amount that at least compensates it for performance completed to date were the contract to be terminated by the customer for reasons other than the entity's failure to perform as promised. [IFRS 15.37, FRS 102.23.84].¹⁷³ The entity must be entitled to this amount at all times throughout the duration of the contract and this amount must at least approximate the selling price of the goods or services transferred to date. That is, it is not meant to refer to compensation for only the entity's potential loss of profit were the contract to be terminated. The IFRS IC observed that "it is the payment the entity is entitled to receive under the contract with the customer relating to performance under that contract that is relevant in determining whether the entity has an enforceable right to payment for performance completed to date". As discussed in Question 8-12 below, the IFRS IC also observed that an entity does not consider consideration it might receive upon resale of the asset if the original customer were to terminate the contract.¹⁷⁴

In determining whether it has an enforceable right to payment, an entity considers the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. While an entity does not need to undertake an exhaustive search for evidence, it is not appropriate for an entity to ignore evidence of relevant legal precedent that is available to it or to anticipate evidence that might become available in the future. The IFRS IC also observed that "the assessment ... is focused on the existence of the right and its enforceability. The likelihood that the entity would exercise the right is not relevant to this assessment. Similarly, if a customer has the right to terminate the contract, the likelihood that the customer would terminate the contract is not relevant to this assessment".¹⁷⁵

Question 8-12: Does an entity contemplate consideration it might receive from the potential resale of the asset to determine whether an enforceable right to payment for performance completed to date exists?

How we see it

We believe that only the payment the entity is entitled to receive relating to performance under the current customer contract is relevant in determining whether the entity has an enforceable right to payment for performance completed to date.

As an example, and as discussed by the IFRS IC (see Question 8-11 above), an entity would not look to potential consideration it might receive upon resale of the asset if the original customer were to terminate the contract. This is because the resale of an asset typically represents a separate contract with a different customer and, therefore, is not relevant to determining the existence and enforceability of a right to payment with the existing customer.

Consider the following Illustration (which is based on an example discussed by the IFRS IC):¹⁷⁶

Illustration 8-8: Determining whether an enforceable right to payment exists when cancellation by a customer obliges an entity to resell the asset

Entity X, a construction company, enters into a contract with a customer to sell a real estate unit in a residential multi-unit complex before the entity constructs the unit. The entity determines that it has a single performance obligation to construct and deliver the real estate unit as specified in the contract. The customer pays 10% of the purchase price at contract inception and the remainder after construction is complete. The entity retains legal title to the real estate unit (and any land attributed to it) until the customer has paid the purchase price after construction is complete.

Under the contract, the customer has the right to cancel the contract at any time before construction is complete. However, if it does, the entity is legally required to make reasonable efforts to resell the real estate unit to a third party. If the entity finds a new buyer, a new contract is executed and the original contract is not novated to the third party. If the resale price in the contract with the third party is less than the original purchase price (plus selling costs), the customer is legally obliged to pay the difference to the entity.

The entity concludes that the over time criteria in paragraphs 23.81(a) and 23.81(b) are not met. In considering the over time criterion in paragraph 23.81(c), the entity determines that its performance does not create an asset with an alternative use to the entity during the period of construction. It, therefore, considers whether it has an enforceable right to payment.

When determining whether an entity has an enforceable right to payment, an entity considers the payment to which it is entitled under the existing contract with the customer, which relates to its performance under that contract. It does not consider the consideration it would receive from a third party in a potential resale contract. Such consideration relates to that resale contract and is not payment for performance under the existing contract with the customer.

Since Entity X cannot consider the resale contract, the only future payment to which it has rights under the existing contract with the customer is for the difference between the resale price of the unit, if any, and its original purchase price (plus selling costs). That payment, together with the deposit received, does not (at all times throughout the duration of the contract) entitle the entity to an amount that at least approximates the selling price of the part-constructed real estate unit (i.e., it does not compensate for performance completed to date). Therefore, Entity X does not have an enforceable right to payment for performance completed to date. Accordingly, none of the over time criteria are met and the entity would therefore recognise revenue at a point in time in accordance with paragraph 23.85 (see 8.2 below).

8.1.4 Measuring progress

When an entity has determined that a performance obligation is satisfied over time, Section 23 requires the entity to recognise revenue over time by measuring its progress towards complete satisfaction of that performance obligation. [FRS 102.23.98]. In doing so, an entity is required to select a single revenue recognition method for the relevant performance obligation that faithfully depicts the entity's performance in transferring control of the goods or services to a customer. An entity applies the method selected consistently to similar performance obligations and in similar circumstances. In addition, at the end of each reporting period, an entity is required to remeasure its progress toward completion of the performance obligation.

Section 23 provides the following requirements: [FRS 102.23.99, FRS 102.23.100, FRS 102.23.101]

Extract from Section 23

- 23.99** An entity shall select a method of measuring progress that depicts the entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of the performance obligation). An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and shall apply that method consistently to similar performance obligations and in similar circumstances.
- 23.100** At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time and update its measure of progress. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with paragraphs 10.14D to 10.18.
- 23.101** In determining a method of measuring progress, an entity shall consider the nature of the good or service that the entity will transfer to the customer. Appropriate methods of measuring progress include methods that recognise revenue based on:
- (a) measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services to be transferred under the contract (referred to as output methods); and
 - (b) the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to satisfy the performance obligation (referred to as input methods).

173 [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

174 [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

175 [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

176 [IFRIC Update](#), March 2018, available on the IFRS Foundation's website.

While Section 23 requires an entity to remeasure its progress towards satisfaction of an over time performance obligation at the end of each reporting period related to the measure of progress selected, it does not permit a change in method. A performance obligation is accounted for using the method the entity selects (i.e., either the specific input or output method it has chosen) from inception until the performance obligation has been fully satisfied. It would not be appropriate for an entity to start recognising revenue based on an input measure and later switch to an output measure (or to switch from one input method to a different input method). Furthermore, Section 23 requires that the selected method be applied to similar contracts in similar circumstances. It also requires that a single method of measuring progress be used for each performance obligation. [FRS 102.23.99]. Applying more than one method to measure performance would effectively override the guidance on identifying performance obligations.

When measuring progress of an over time performance obligation, the objective is to faithfully depict the entity's performance in transferring control of the goods or services to a customer (i.e., the satisfaction of an entity's performance obligation). [FRS 102.23.99]. To achieve this objective, an entity would need to exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity must include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

Changes in circumstances over time might require an entity to update its measure of progress to reflect any changes in the outcome of the performance obligation. For example, an entity might determine that total expected costs are greater than its original expectation. If the entity was using an input method based on costs incurred, it would need to update its measure-of-progress calculation with this new information.

Changes to an entity's measure of progress are accounted for in accordance with the requirements in Section 10 for changes in accounting estimates (i.e., paragraphs 10.14D to 10.18). [FRS 102.23.100]. Section 10 requires a change in accounting estimate to be accounted for prospectively, i.e., by adjusting the carrying amount of an asset, liability or item of equity in the statement of financial position; and recognising the change by including it "in profit or loss in: (1) the period of the change, if the change affects that period only; or (2) the period of the change and future periods, if the change affects both".

[FRS 102.10.16, FRS 102.23.17]. A change in accounting estimate, by its nature, does not relate to prior periods and is not the correction of an error. The disclosure requirements in Section 10 related to changes in accounting estimates are also applicable (see Chapter 9 at 3.4.1).

If an entity does not have a reasonable basis to measure its progress, revenue cannot be recognised until progress can be reasonably measured. However, if an entity cannot reasonably measure its progress towards complete satisfaction of a performance obligation (e.g., in the early stages of a contract), but the entity expects to recover the costs incurred in satisfying that performance obligation, Section 23 requires the entity to recognise revenue only to the extent of the costs incurred. [FRS 102.23.104]. Subsequently, an entity would stop using this method once it is able to reasonably measure its progress towards satisfaction of the performance obligation. A cumulative catch-up adjustment would be recognised in the period in which the entity is able to reasonably measure its progress.

Furthermore, an entity's inability to measure progress would not mean that costs incurred would also be deferred. That is, costs cannot be deferred in these situations, unless they meet the criteria for capitalisation under paragraph 23.117 (see 10.3.2 below).

Section 23 provides two methods for recognising revenue on contracts involving the transfer of goods or services over time: input methods and output methods. In determining the best method for measuring progress that faithfully depicts an entity's performance, an entity needs to consider both the nature of the promised goods or services and the nature of the entity's performance. [FRS 102.23.101]. In other words, an entity's selection of a method to measure its performance needs to be consistent with the nature of its promise to the customer and what the entity has agreed to transfer to the customer. To illustrate this concept, consider a contract for health club services. Regardless of when, or how frequently, the customer uses the health club, the entity's obligation to stand ready for the contractual period does not change. Furthermore, the customer is required to pay the fee regardless of whether the customer uses the health club. As a result, the entity would need to select a measure of progress based on its service of standing ready to make the health club available. Illustration 8-10 in 8.1.4.E below illustrates how a health club might select this measure of progress.

An entity is required to recognise as revenue the amount of the transaction price it allocates to each performance obligation in a contract when or as it transfers the promised goods or services to customers, regardless of whether the consideration is paid upfront or the entity has a conditional or unconditional right to receive the consideration in the future. An entity that has not yet received the consideration to which it is entitled for transferring promised goods or services recognises a corresponding receivable if its right to payment is unconditional or a contract asset if its right to payment is conditional (see 11.1 below for further discussion). This requirement, which applies to both revenue recognised over time and at a point in time, does not limit the arrangement consideration otherwise allocable to a satisfied performance obligation to the amount that is not contingent on future performance. See 7 above for further discussion of allocating the transaction price to the performance obligations.

8.1.4.A Output methods

Appropriate methods of measuring progress include methods that recognise revenue based on measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services to be transferred under the contract (referred to as output methods).

[FRS 102.23.101(a)]. Under Section 23, common output methods, and circumstances when they might be appropriate, include: [FRS 102.23.102]

- An output method based on surveys of work completed, when the surveys provide an objective measure of an entity's performance to date.
- An output method based on units delivered, when each item transfers an equal amount of value to the customer on delivery and partly-completed items are not significant (see further discussion below).
And
- An output method based on time elapsed, when control of the goods or services is transferred evenly over time.

In addition to above, IFRS 15 mentions other examples of output methods such as appraisals of results achieved, milestones reached and units produced.

When an entity evaluates whether to apply an output method to measure its progress, the entity considers whether the output selected would faithfully depict the entity's performance towards complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer.

Under IFRS 15, the IASB discussed two output methods (i.e., units of delivery and units of production) that are not considered to be appropriate in many instances if the entity's performance obligation is satisfied over time. [IFRS 15.BC165]. Refer to the EY publication, International GAAP®, for the detailed discussion.

It is important to note that 'value to the customer' in paragraph 23.101(a) refers to an objective method of measuring the entity's performance in the contract. Aligned with IFRS 15, this is not intended to be assessed by reference to the market prices, stand-alone selling prices or the value a customer perceives to be embodied in the goods or services. [IFRS 15.BC163]. This concept of value is different from the concept of value an entity uses to determine whether it can use the 'right to invoice' practical expedient, as discussed in 8.1.4.B below. When an entity determines whether items individually transfer an equal amount of value to the customer (i.e., when applying paragraph 23.101(a)), the evaluation related to how much, or what proportion, of the goods or services (i.e., quantities) have been delivered (but not the price). For example, for the purposes of applying paragraph 23.101(a), an entity might consider the amount of goods or services transferred to date in proportion to the total expected goods or services to be transferred when measuring progress. However, if this measure of progress results in material work in progress at the end of the reporting period, it would not be appropriate, as discussed above.

See the discussion in 8.1.4.B below regarding the evaluation of 'value to the customer' in the context of evaluating the 'right to invoice' practical expedient in paragraph 23.103.

8.1.4.B Output methods: practical expedient for measuring progress towards satisfaction of a performance obligation

Section 23 provides a practical expedient for an entity that is using an output method to measure progress towards completion of a performance obligation that is satisfied over time. The practical expedient only applies if an entity has a right to consideration from a customer in amount that corresponds directly with the value to the customer of the entity's performance work to date. In that situation, the practical expedient allows an entity to recognise revenue in the amount for which it has the right to invoice (i.e., the 'right to invoice' practical expedient). For example, an entity could use this practical expedient in a service contract in which the entity bills a fixed amount for each hour of service provided. [FRS 102.23.103].

IFRS 15 also provides similar 'right to invoice' practical expedient. Further discussions on other considerations when applying such practical expedient are available in the EY publication International GAAP®.

8.1.4.C Input methods

Input methods recognise revenue based on an entity's efforts or inputs towards satisfying a performance obligation relative to the total expected efforts or inputs to satisfy the performance obligation.

[FRS 102.23.101(b)]. Under Section 23, common input methods, and circumstances when they might be appropriate, include: [FRS 102.23.102]

- An input method based on time elapsed, when an entity's efforts or inputs are expended evenly throughout the performance period.
- An input method based on costs incurred, when the method includes costs that reflect an entity's performance to date and contribute to the entity's progress in transferring control of goods or services promised to a customer (see below and further discussion in 8.1.4.D below).
- And
- An input method based on labour hours expended, when there is a relationship between labour hours expended and the transfer of control of goods or services to a customer.

In addition to above, IFRS 15 mentions other examples of input methods such as resources consumed and machine hours used.

As discussed in 8.1.4 above, an entity is required to select a single measure of progress for each performance obligation that depicts the entity's performance in transferring control of the goods or services promised to a customer. If an entity's efforts or inputs are used evenly throughout the entity's performance period, a time-based measure that results in a straight-line recognition of revenue might be appropriate. However, there might be a disconnect between an entity's inputs (e.g., cost of non-distinct goods included in a single performance obligation satisfied over time) and the depiction of an entity's performance to date. In these situations, adjustments to the measure of progress might be necessary. See 8.1.4.D below for additional discussion.

Regardless of which method an entity selects, it excludes from its measure of progress any goods or services for which control has not transferred to the customer. Likewise, if an entity uses an input method based on costs incurred, it excludes from its measure of progress those costs that do not reflect its performance in transferring a good or service to the customer (e.g., borrowing costs incurred, which it incurs to fund its activities, rather than to fulfil a performance obligation).

8.1.4.D Input methods: adjustments to the measure of progress based on an input method

As discussed in 8.1.4.C above, an entity could apply an input method based on costs incurred when the method includes costs that reflect an entity's performance to date and contribute to the entity's progress in transferring control of goods or services promised to a customer. [FRS 102.23.102(e)]. Consequently, an entity would exclude the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer. Therefore, when using a cost-based input method, an adjustment to the measure of progress might be required in the following circumstances:

- When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation.
- Or
- When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation.

The principles in paragraph 23.101(e) are consistent with those in IFRS 15. Hence, entities reporting under FRS 102 could consider application guidance in IFRS 15.B19 on adjustments to the measure of progress that might be necessary when using a cost-based input method. A detailed discussion of such application guidance is available in the EY publication, International GAAP®.

8.1.4.E Examples of measures of progress

The following Illustration shows some possible considerations when determining an appropriate measure of progress:

Illustration 8-9: Choosing the measure of progress

A ship-building entity enters into a contract to build 15 vessels for a customer over a three-year period. The contract includes both design and production services. The entity has not built a vessel of this type in the past. In addition, the entity expects that the first vessels might take longer to produce than the last vessels because, as the entity gains experience building the vessels, it expects to be able to construct the vessels more efficiently.

Assume that the entity has determined that the design and production services represent a single performance obligation. In this situation, it is likely that the entity would not choose a 'units-of-delivery' method as a measure of progress because that method would not accurately capture the level of performance. That is, such a method would not reflect the entity's efforts during the design phase of the contract because no revenue would be recognised until a vessel was shipped. In such situations, an entity would likely determine that an input method is more appropriate, such as a percentage of completion method based on costs incurred.

Illustration 8-10, which is based on Example 18 in IFRS 15, is an example on selecting an appropriate measure of progress towards satisfaction of a performance obligation: *[IFRS 15.IE Example 18, IFRS 15.IE92-IE94]*

Illustration 8-10: Measuring progress when making goods or services available

An entity, an owner and manager of health clubs, enters into a contract with a customer for one year of access to any of its health clubs. The customer has unlimited use of the health clubs and promises to pay £100 per month.

The entity determines that its promise to the customer is to provide a service of making the health clubs available for the customer to use as and when the customer wishes. This is because the extent to which the customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. The entity concludes that the customer simultaneously receives and consumes the benefits of the entity's performance as it performs by making the health clubs available. Consequently, the entity's performance obligation is satisfied over time in accordance with paragraph 23.81(a) (see 8.1.1 above).

The entity also determines that the customer benefits from the entity's service of making the health clubs available evenly throughout the year. That is, the customer benefits from having the health clubs available, regardless of whether the customer uses it or not. Consequently, the entity concludes that the best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure and it recognises revenue on a straight-line basis throughout the year at £100 per month.

Frequently asked questions

Question 8-13: How are the effects of learning curve costs addressed in Section 23?

See response to Question 10-16 in 10.3.2 below.

Question 8-14: How would an entity measure progress towards satisfaction of a stand-ready obligation that is satisfied over time?¹⁷⁷

An entity generally cannot default to a straight-line revenue attribution model. However, if an entity expects the customer to receive and consume the benefits of its promise throughout the contract period, a time-based measure of progress (e.g., straight-line) would be appropriate. This is generally the case for unspecified upgrade rights, help-desk support contracts and cable or satellite television contracts. In contrast, rateable recognition might not be appropriate if the benefits are not spread evenly over the contract period (e.g., an annual snow removal contract that provides most benefits in winter).

Also, as discussed in Question 5-13 in 5.2.2 above, we generally believe that a stand-ready obligation that is satisfied over time will meet the criteria to be accounted for as a series of distinct goods and services. Similar to the discussion above, while it is not appropriate to default to a straight-line revenue attribution model for a series, straight-line revenue recognition might be reasonable in many cases. Management needs to select the measure of progress that faithfully depicts the entity's performance in transferring the goods or services promised in a series.

Question 8-15: Can multiple measures of progress be used to depict an entity's performance in transferring a performance obligation comprised of two or more goods and/or services that is satisfied over time (i.e., a combined performance obligation)?¹⁷⁸

When an entity has determined that a combined performance obligation is satisfied over time, the entity has to select a single measure of progress that faithfully depicts the entity's performance in transferring the goods or services. For example, using different measures of progress for different non-distinct goods or services in the combined performance obligation would be inappropriate because doing so ignores the unit of account that has been identified under Section 23 (i.e., the single combined performance obligation). Furthermore, the Basis for Conclusions on IFRS 15 noted that it would be inappropriate because the entity would recognise revenue in a way that overrides the separation and allocation requirements in the revenue standard. [IFRS 15.BC161].

A single method of measuring progress cannot be broadly interpreted to mean an entity might apply multiple measures of progress as long as all measures used are either output or input measures.

Question 8-16: How would an entity determine the appropriate single measure of progress for a combined performance obligation that is satisfied over time?¹⁷⁹

It might be difficult to appropriately determine a single measure of progress when the entity transfers goods or services that make up the combined performance obligation over different points of time and/or the entity would otherwise use a different measure of progress (e.g., a time-based method versus a labour-based input method) if each promise was a separate performance obligation.

Such a determination requires significant judgement, but the measure of progress selected is not meant to be a 'free choice'. Entities need to consider the nature of the overall promise for the combined performance obligation in determining the measure of progress to use. For example, entities must not default to a 'final deliverable' methodology, such that all revenue would be recognised over the performance period of the last promised good or service. Rather, an entity is required to select the single measure of progress that most faithfully depicts the entity's performance in satisfying its combined performance obligation.

¹⁷⁷ Based on TRG Agenda paper no. 16, *Stand-Ready Performance Obligations*, dated 26 January 2015.

¹⁷⁸ Based on TRG Agenda paper no. 41, *Measuring progress when multiple goods or services are included in a single performance obligation*, dated 13 July 2015. Note that under Step 2 of the model (see 5 above), a single performance obligation might contain multiple non-distinct goods or services and/or distinct goods or services that were required to be combined with non-distinct goods or services in order to identify a distinct bundle. This bundled performance obligation is referred to as a 'combined performance obligation' for the purpose of this discussion.

¹⁷⁹ Based on TRG Agenda paper no. 41, *Measuring progress when multiple goods or services are included in a single performance obligation*, dated 13 July 2015.

An entity would need to consider the reasons why goods or services were bundled into a combined performance obligation in order to determine the appropriate pattern of revenue recognition. For example, if a good or service was combined with other goods or services because it was not capable of being distinct, that might indicate that it does not provide value or use to the customer on its own. As such, the entity would not contemplate the transfer of that good or service when determining the pattern of revenue recognition for the combined performance obligation.

Also, if an appropriately selected single measure of progress does not faithfully depict the economics of the arrangement, the entity generally needs to challenge whether the performance obligation was correctly combined (i.e., there might be more than one performance obligation).

Consider the following Illustration:

Illustration 8-11: Combined licence and installation service performance obligation

An entity promises to provide a software licence and installation services that will substantially customise the software to add significant new functionality that enables the software to interface with other customised applications used by the customer.

The entity concludes that the software and services are not separately identifiable from the customised installation service, and the criterion in paragraph 23.21(b) is not met (see 5.2.1 above). Therefore, the software licence and installation service are combined into a single performance obligation and the entity concludes that the combined performance obligation is satisfied over time. If the licence were distinct, it would be considered a right-to-use licence and revenue would be recognised at a point in time.

The entity further determines that the nature of its overall promise is to develop the customised software over time. Accordingly, the entity determines that it needs to use a measure of progress that depicts the performance of completing the customised software solution. Therefore, all of the revenue for this contract would be recognised over the period that the customisation services are performed.

Question 8-17: Can control of a good or service underlying a performance obligation satisfied over time be transferred at discrete points in time?¹⁸⁰

Generally, if a performance obligation meets the criteria for revenue to be recognised over time (rather than at a point in time), control of the underlying good or service is not transferred at discrete points in time. Because control transfers as an entity performs, an entity's performance (as reflected using an appropriate measure of progress) must not result in the creation of a material asset in the entity's accounts (e.g., work in progress).

The question whether control of a good or service underlying a performance obligation that is satisfied over time can be transferred at discrete points in time arose because the IFRS 15 highlights several output methods, including 'milestones reached', as potentially acceptable methods for measuring progress towards satisfaction of an over time performance obligation. Generally, an entity could use an output method only if that measure of progress correlates to the entity's performance to date.

Question 8-18: Can an entity use the 'right to invoice' practical expedient for a contract that includes rates that change over the contractual term?¹⁸¹

Determining whether an entity can apply the 'right to invoice' practical expedient generally requires judgement. It is also generally possible for entities to meet the requirements for the practical expedient in contracts with changing rates, provided that the changes in rates correspond directly to changes in value to the customer. That is, a contract does not need to have a fixed price per unit for the duration of a contract to qualify for the practical expedient. Examples of contracts that might qualify include an IT outsourcing arrangement with rates that decrease over the contract term as the level of effort to the customer decreases or a multi-year electricity contract that contemplates the forward market price of electricity. However, entities need to have strong evidence that variable prices reflect the value to the customer to recognise variable amounts of revenue for similar goods or services.

Question 8-19: If an entity does not meet the criteria to use the 'right to invoice' practical expedient, can it still use the disclosure practical expedient regarding the amount of transaction price allocated to remaining performance obligations?

See response to Question 11-11 in 11.4.1.D below.

Question 8-20: If an entity begins activities on a specifically anticipated contract either: (1) before it agrees to the contract with the customer; or (2) before the arrangement meets the criteria to be considered a contract under Section 23, how would revenue for those activities be recognised at the date a contract exists?¹⁸²

If the goods or services that ultimately will be transferred meet the criteria to be recognised over time, revenue would generally be recognised on a cumulative catch-up basis at the 'contract establishment

date', reflecting the performance obligation(s) that are partially or fully satisfied at that time. The cumulative catch-up method is consistent with the overall principle of Section 23 that revenue is recognised when (or as) an entity transfers control of goods or services to a customer.

When recording revenue on a cumulative catch-up basis in these circumstances, an entity needs to consider the requirements in Step 5 of the model to determine the goods or services that the customer controls. This determines what portion of costs incurred before the contract establishment date would be included in any measure of progress used to calculate the cumulative catch-up adjustment. If, for example, costs incurred prior to the contract establishment date relate to uninstalled materials or any goods or services that the customer does not control, the inclusion of those costs in determining how much revenue to recognise might not be appropriate (see 8.1.4.D above for further discussion on uninstalled materials).

Question 8-21: How do entities consider costs subject to volatility caused by factors such as foreign exchange rates and commodity prices in a measure of progress if an entity applies an input method based on costs incurred?

Entities might enter into contracts for which they will incur costs that are subject to volatility caused by market factors such as foreign exchange rates, inflation and commodity prices, either directly or indirectly (e.g., when suppliers pass on such costs to the entity). That volatility in prices might be passed along to the customer in some cases but not in others.

The underlying premise of an input method based on costs incurred (e.g., cost-to-cost) for measuring progress is that the costs incurred are proportionate to an entity's progress as the entity performs. That is, an entity must include costs that contribute to its performance and exclude those costs that do not. See further discussions in 8.1.4.C and 8.1.4.D above.

Under Section 23, an entity needs to ensure that the measure of progress appropriately reflects the entity's performance in transferring control of the promised good or service to the customer, which could require judgement. Exchange rates and commodity prices are subject to changes in market activity and often drive a degree of mismatch between expected costs and market prices. In some cases, the entity might conclude that the use of an input method based on costs incurred is not appropriate if the costs it will incur will be subject to significant market volatility.

If the entity concludes the cost contributes to performance, but the volatility of the market price or exchange rate does not, it will need to appropriately reflect that in an input method based on costs incurred to measure progress, which will require judgement.

Entities might need to consider whether the determination of an exchange rate or commodity price applied on an input method based on costs incurred requires significant judgement or is a source of estimation uncertainty. If so, disclosure would be required in accordance with Section 8 (see Chapter 6 at 7.4). [FRS 102.8.6, FRS 102.8.7].

Question 8-22: How does an entity account for fulfilment costs incurred prior to the contract establishment date that are outside the scope of another section of FRS 102 (e.g., Section 13 *Inventories*)?

See response to Question 10-15 in 10.3.2 below.

8.2 Control transferred at a point in time

For performance obligations in which control is not transferred over time, control is transferred as at a point in time. [FRS 102.23.85]. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in other circumstances, this determination is more complex.

To help entities determine the point in time when a customer obtains control of a particular good or service, Section 23 provides the following requirements: [FRS 102.23.85, FRS 102.23.86]

180 Based on FASB TRG Agenda paper no. 53, *Evaluating How Control Transfers Over Time*, dated 18 April 2016.

181 Based on TRG Agenda paper no. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, dated 13 July 2015.

182 Based on TRG Agenda paper no. 33, *Partial Satisfaction of Performance Obligations Prior to Identifying the Contract*, dated 30 March 2015.

Extract from Section 23

- 23.85** If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset, an entity shall consider indicators of the transfer of control, which include but are not limited to the following:
- (a) the entity has a present right to payment for the asset;
 - (b) the customer has legal title to the asset;
 - (c) the customer has physical possession of the asset;
 - (d) the customer has the significant risks and rewards of ownership of the asset; and
 - (e) the customer has accepted the asset (see paragraphs 23.88 to 23.89).
- 23.86** The existence or absence of an indicator in paragraph 23.85 does not determine whether control of a promised asset has transferred.
- (a) For example, in some situations a customer may obtain control of an asset, and an entity shall recognise revenue, even though the entity retains legal title of the asset as protection against the customer's failure to pay, or retains physical possession of the asset under a bill and hold arrangement.
 - (b) Conversely, in a consignment arrangement, the other party (eg a dealer or distributor) has physical possession of a product that an entity controls. An entity shall not recognise revenue upon delivery of a product to another party if the delivered product is held on consignment.

None of the indicators above are meant to individually determine whether the customer has gained control of the good or service. For example, while shipping terms might provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. See Question 8-23 in 8.2.5 below for further discussion on shipping terms. An entity must consider all relevant facts and circumstances to determine whether control has transferred. Similar to IFRS 15, the indicators are not meant to be a checklist. Furthermore, not all of them must be present for an entity to determine that the customer has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset and the list is meant to help entities apply the principle of control. [FRS 102.23.86, IFRS 15.BC155].

Paragraph 23.85 also states that indicators of control transfer are not limited to those listed above. For example, channel stuffing is a practice that entities sometimes use to increase sales by inducing distributors or resellers to buy substantially more goods than can be promptly resold. To induce the distributors to make such purchases, an entity might offer deep discounts that it would have to evaluate as variable consideration in estimating the transaction price (see 6.2 above). Channel stuffing also might be accompanied by side agreements with the distributors that provide a right of return for unsold goods that is in excess of the normal sales return privileges offered by the entity. Significant increases in, or excess levels of, inventory in a distribution channel due to channel stuffing might affect or preclude the ability to conclude that control of such goods has transferred.

How we see it

Entities need to carefully consider the expanded rights of returns offered to customers in connection with channel stuffing in order to determine whether they prevent the entity from recognising revenue at the time of the sales transaction.

If an entity uses channel stuffing practices, it needs to consider whether disclosure in its financial statements is required when it expects these practices to materially affect future operating results.

If, for example, an entity sold excess levels into a certain distribution channel at, or near, the end of a reporting period, it is likely that those sales volumes would not be sustainable in future periods. That is, sales into that channel might, in fact, slow down in future periods as the excess inventory takes longer to entirely sell through the channel. In such a case, the entity needs to consider whether disclosure of the effect of the channel stuffing practice on its current and future earnings is required, if material.

In determining when control transfers, it is important that the entity consider the good or service it is transferring, not the right to obtain that good or service in the future. For example, the right to sell (or pledge) a right to obtain an asset (e.g., real estate) in the future is not evidence of control of the asset itself (see Question 8-4 in 8.1.2 above and Question 8-11 in 8.1.3.B above for further discussion).

We discuss the indicators in paragraph 23.85 that an entity considers when determining when it transfers control of the promised good or service to the customer in more detail in 8.2.1 – 8.2.4 below.

8.2.1 Present right to payment for the asset

A right to payment is one of the indicators under Section 23 but it is not an overarching criterion for determining when revenue would be recognised. So, while the date at which the entity has a right to payment for the asset might be an indicator of the date the customer obtained control of the asset, it does not always indicate that the customer has obtained control of the asset. For example, in some contracts, a customer is required to make a non-refundable upfront payment but receives no goods or services in return at that time.

8.2.2 Legal title and physical possession

The term ‘title’ is often associated with a legal definition denoting the ownership of an asset or legally recognised rights that preclude others’ claim to the asset. Accordingly, the transfer of title often indicates that control of an asset has been transferred. Determination of which party has title to an asset does not always depend on which party has physical possession of the asset, but without contractual terms to the contrary, title generally passes to the customer at the time of the physical transfer. For example, in a retail store transaction, there is often no clear documentation of the transfer of title. However, it is generally understood that the title to a product is transferred at the time it is purchased by the customer.

While the retail store transaction is relatively straightforward, determining when title has transferred might be more complicated in other arrangements. Transactions that involve the shipment of products might have varying shipping terms and could involve third-party shipping agents. In such cases, a clear understanding of the seller’s practices and the contractual terms is required to assess when title transfers. Legal title and/or physical possession might be an indicator of which party to a contract has the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset or to restrict the access of other entities to those benefits. However, in some situations a customer might obtain control of an asset, and an entity recognises revenue, even though the entity retains legal title of the asset as protection against the customer’s failure to pay or retains physical possession of the asset under a bill and hold arrangement (see 8.5 below). [FRS 102.23.86(a)]. These rights of the entity or nature of the arrangement would not preclude the customer from obtaining control of the asset. By contrast, in a consignment arrangement (see 8.4 below), the other party (the consignee, e.g., a dealer or distributor) has physical possession of a product that the entity controls. In such a case, the entity does not recognise revenue upon delivery of a product to the consignee if the delivered product is held on consignment. [FRS 102.23.86(b)]. This is also the case in some repurchase agreements where a customer might have physical possession of an asset that the entity controls (see 8.3 below).

See also Question 8-23 in 8.2.5 below for further discussion on how shipping terms affect when an entity has transferred control of a good to a customer.

8.2.3 Risks and rewards of ownership

Although paragraph 23.85 of FRS 102 includes risks and rewards of ownership as one factor to consider when evaluating whether control of an asset has transferred, this factor does not change the principle of determining the transfer of goods or services based on control. The concept of the risks and rewards of ownership is based on how the seller and the customer share both the potential gain (the reward) and the potential loss (risk) associated with owning an asset. Rewards of ownership include the following:

- Rights to all appreciation in value of the asset
- Unrestricted usage of the asset
- Ability to modify the asset
- Ability to transfer or sell the asset
- Ability to grant a security interest in the asset

Conversely, the risks of ownership include the following:

- Absorbing all the declines in market value
- Incurring losses due to theft or damage of the asset
- Incurring losses due to changes in the business environment (e.g., obsolescence, excess inventory, effect of retail pricing environment)

However, an entity does not consider risks that give rise to a separate performance obligation when evaluating whether the entity has the risks of ownership of an asset. For example, an entity does not consider warranty services that represent a separate performance obligation when evaluating whether it retains the risks of ownership of the asset sold to the customer.

8.2.4 Customer acceptance

When determining whether the customer has obtained control of the goods or services, an entity must consider any customer acceptance clauses that require the customer to approve the goods or services before it is obliged to pay for them. If a customer does not accept the goods or services, the entity might not be entitled to consideration, might be required to take remedial action or be required to take back the delivered good. [FRS 102.23.85(e), FRS 102.23.88].

Section 23 provides the following guidance regarding how to evaluate customer acceptance provisions: [FRS 102.23.89]

Extract from Section 23

23.89 If an entity can objectively determine (ie determine based on information available to the entity) that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance.

Some acceptance provisions might be straightforward, giving a customer the ability to accept or reject the transferred products based on objective criteria specified in the contract (e.g., the goods function at a specified speed or specified size and weight characteristics of the goods). Other acceptance clauses might be subjective or appear in parts of the contract that do not typically address acceptance matters, such as warranty provisions or indemnification clauses. Professional judgement might be required to determine the effect on revenue recognition of the latter types of acceptance clauses.

Acceptance criteria that an entity cannot objectively evaluate against the agreed-upon specifications in the contract preclude an entity from concluding that a customer has obtained control of a good or service until formal customer sign-off is obtained or the acceptance provisions lapse. That is because in this circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all the remaining benefits from, the good or service. However, the entity would consider all information available to it, including its experience with other contracts for similar goods or services because that experience might provide evidence about whether the entity is able to objectively determine that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract.

How we see it

We believe one or more of the following would represent circumstances in which the entity might not be able to objectively evaluate the acceptance criteria:

- The acceptance provisions are unusual or 'non-standard'. Indicators of 'non-standard' acceptance terms are:
 - The duration of the acceptance period is longer than in contracts for similar goods or services.
 - The majority of the entity's contracts lack similar acceptance terms.
 - The contract contains explicit customer-specified requirements that must be met prior to acceptance.
- The contract contains a requirement for explicit notification of acceptance (not just deemed acceptance). Explicit notification requirements might indicate that the criteria with which the customer is assessing compliance are not objective. In addition, such explicit notification clauses might limit the time period within which the customer can reject transferred products and might require the customer to provide, in writing, the reasons for the rejection of the products by the end of a specified period. When such clauses exist, acceptance can be deemed to have occurred at the end of the specified time period if notification of rejection has not been received from the customer, as long as the customer has not indicated it will reject the products.

In determining whether compliance with the criteria for acceptance can be objectively assessed (and acceptance is only a formality), the following is considered:

- Whether the acceptance terms are standard in arrangements entered into by the entity.
- Whether the acceptance is based on the transferred product performing to standard, published, specifications, and the entity can demonstrate that it has an established history of objectively determining that the product functions in accordance with those specifications.

As discussed above, customer acceptance would not be deemed a formality if the acceptance terms are unusual or non-standard. If a contract contains acceptance provisions that are based on customer-specified criteria, it might be difficult for the entity to objectively assess compliance with them and the entity might not be able to recognise revenue prior to obtaining evidence of customer acceptance. However, determining that the acceptance criteria have been met (and, therefore, acceptance is merely a formality) might be appropriate if the entity can demonstrate that its product meets all of the customer's acceptance specifications by replicating, before shipment, the conditions under which the customer intends to use the product.

If it is reasonable to expect that the product's performance (once it has been installed and is operating at the customer's facility) will be different from the performance when it was tested prior to shipment, the acceptance provision will not have been met. The entity, therefore, would not be able to conclude that the customer has obtained control until customer acceptance occurs. Factors indicating that specifications cannot be tested effectively prior to shipment include:

- The customer has unique equipment, software or environmental conditions that can reasonably be expected to make performance in that customer's environment different from testing performed by the entity. If the contract includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, revenue recognition is deferred until it can be demonstrated that the criteria are met.
- The products that are transferred are highly complex.
- The entity has a limited history of testing products prior to control transferring to the customer or a limited history of having customers accept products that it has previously tested.

Determining when a customer obtains control of an asset in a contract with customer-specified acceptance criteria requires the use of professional judgement and depends on the weight of the evidence in the particular circumstances. The conclusion could change based on an analysis of an individual factor, such as the complexity of the equipment, the nature of the interface with the customer's environment, the extent of the entity's experience with this type of transaction or a particular clause in the agreement. An entity might need to discuss the situation with knowledgeable project managers or engineers in making such an assessment.

In addition, each contract containing customer-specified acceptance criteria might require a separate compliance assessment of whether the acceptance provisions have been met prior to confirmation of the customer's acceptance. That is, since different customers might specify different acceptance criteria, an entity might not be able to make one compliance assessment that applies to all contracts because of the variations in contractual terms and customer environments.

Even if a contract includes a standard acceptance clause, if the clause relates to a new product or one that has only been sold on a limited basis previously, an entity might be required to initially defer revenue recognition for the product until it establishes a history of successfully obtaining acceptance.

If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses. See further discussion of 'free' trial periods in Question 4-2 in 4.1 above, including when such arrangements might meet the criteria to be considered a contract within the scope of the model in Section 23.

8.2.5 Example of control transferring at a point in time

The following Illustration shows the application of the indicators of the transfer of control in paragraph 23.85 (see 8.2 above) to a performance obligation that is satisfied at a point in time:

Illustration 8-12: Applying the indicators of the transfer of control to a performance obligation satisfied at a point in time

BCB Liquors (BCB) uses a distribution network to sell its product to end-consumers. Upon receipt of the product, a distributor receives legal title to the goods and is required to pay BCB for the product. In this example, BCB has determined its relationship with the distributor is not a consignment agreement (see 8.4 below). Rather, the distributor is BCB's customer.

BCB determines that its performance obligation for the sale of product to the distributor is satisfied at a point in time. BCB considers the indicators of the transfer of control and concludes that control transfers to the distributor when the product is delivered to the distributor. At this point in time, BCB has a present right to payment and the distributor has legal title and physical possession of the product, as well as the risks and rewards of ownership. BCB concludes customer acceptance is a formality as BCB can objectively determine that the goods meet the agreed-upon specifications before shipment to the distributor.

Alternatively, if BCB sold the product to the distributor on consignment or determined that the end-consumer was its customer, the distributor was not obligated to pay for the product until it was sold to the end-consumer and BCB had the ability to require the return of any unsold product or the distributor had an unlimited amount of time to return any unsold products, then BCB might have concluded that control of the product would not transfer until it is sold to the end-consumer. Therefore, BCB would not recognise revenue until the product was sold to the end-consumer.

An entity is required to recognise as revenue the amount of the transaction price it allocates to each performance obligation in a contract when or as it transfers the promised goods or services to customers, regardless of whether the consideration is paid upfront or the entity has a conditional or unconditional right to receive the consideration in the future. An entity that has not yet received the consideration to which it is entitled for transferring promised goods or services recognises a corresponding receivable if its right to payment is unconditional or a contract asset if its right to payment is conditional (see 11.1 below for further discussion). This requirement, which applies to both revenue recognised over time and at a point in time, does not limit the consideration allocable to satisfied performance obligations to the amount that is not contingent on future performance. See 7 above for further discussion of allocating the transaction price to the performance obligations.

Frequently asked questions

Question 8-23: How do shipping terms affect when an entity has transferred control of a good to a customer?

Under Section 23, an entity recognises revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer. While shipping terms might provide information about when legal title to a good transfers to the customer, they are not determinative when evaluating the point in time at which the customer obtains control of the promised asset. Entities must consider all relevant facts and circumstances to determine whether control has transferred.

[FRS 102.23.85, FRS 102.23.86].

As an example, when the shipping terms are free on board (FOB), entities need to carefully consider whether the customer or the entity has the ability to control the goods during the shipment period. Furthermore, if the entity has the legal or constructive obligation to replace goods that are lost or damaged in transit, it needs to evaluate whether that obligation influences the customer's ability to direct the use, and obtain substantially all of the remaining benefits from, the goods. A selling entity's historical practices also need to be considered when evaluating whether control of a good has transferred to a customer because the entity's practices might override the contractual terms of the arrangement.

Contractually specified shipping terms might vary depending on factors such as the mode of transport (e.g., by sea, inland waterway, road, air) and whether the goods are shipped locally or internationally. A selling entity might utilise International Commerce Terms (Incoterms®) to clarify when delivery occurs. Incoterms® are a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) relating to international commercial law. For example, 'EXW' or 'Ex Works' in Incoterms® 2020 means that the selling entity 'delivers' when it places the goods at the disposal of the customer, either at the seller's premises or at another named location (e.g., a factory, warehouse). The selling entity is not required to load the goods on any collecting vehicle, nor does it need to clear the goods for

export (if applicable, see further discussion on Ex Works in 8.5 below). The Incoterm FOB means “the seller delivers the goods on board the vessel nominated by the buyer at the named port of shipment or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel, and the buyer bears all costs from that moment onwards”.¹⁸³

8.3 Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option to repurchase the asset. The repurchased asset could be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component. Some agreements include such repurchase provisions either as part of a sales contract or as a separate contract that relates to the goods in the original agreement or similar goods.

[FRS 102.23.90]. These provisions affect how an entity applies the requirements on control to affected transactions. That is, when evaluating whether a customer obtains control of an asset, an entity needs to consider any agreement to repurchase the asset. [FRS 102.23.90].

Repurchase agreements generally come in three forms:

- (a) An entity’s obligation to repurchase the asset (a forward) – see 8.3.1 below
- (b) An entity’s right to repurchase the asset (a call option) – see 8.3.1 below

And

- (c) An entity’s obligation to repurchase the asset at the customer’s request (a put option) – see 8.3.2 below

For an obligation or right to purchase an asset to be accounted for as a repurchase agreement under Section 23, it needs to exist at contract inception, either as a part of the same contract or in another contract. [FRS 102.23.79]. An entity’s subsequent decision to repurchase an asset (after transferring control of that asset to a customer) without reference to any pre-existing contractual right would not be accounted for as a repurchase agreement under Section 23. That is, the customer is not obliged to resell that good to the entity as a result of the initial contract. Therefore, any subsequent decision to repurchase the asset does not affect the customer’s ability to control the asset upon initial transfer. However, in cases in which an entity decides to repurchase a good after transferring control of the good to a customer, the entity needs to carefully consider whether the customer obtained control in the initial transaction. Furthermore, it might need to consider the guidance on principal versus agent considerations (see 5.4 above).

8.3.1 Forward or call option held by the entity

When an entity has the obligation or right to repurchase an asset (i.e., a forward or a call option), Section 23 indicates that the customer has not obtained control of the asset. This is because the customer is limited in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset even though the customer might have physical possession of the asset. Section 23 provides the following guidance: [FRS 102.23.92]

Extract from Section 23

- 23.92** If an entity has an obligation or a right to repurchase an asset (a forward or a call option), a customer does not obtain control of the asset and the entity shall not recognise revenue from a sale of a good or service. Consequently, the entity shall account for the contract as either:
- (a) a lease in accordance with Section 20 if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset. As an exception, the entity shall account for the contract in accordance with paragraph 20.122 if the contract forms part of a sale and leaseback transaction; or
 - (b) a financing arrangement in accordance with paragraph 23.93 if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

The guidance in the extract above requires an entity to account for a transaction including a forward or a call option based on the relationship between the repurchase price and the original selling price, regardless of whether the option will be exercised. It indicates that if the entity has the right or obligation to repurchase the asset at a price less than the original selling price (taking into consideration the effects of

¹⁸³ See the [ICC website](#) for further information.

the time value of money), the entity would account for the transaction as a lease in accordance with Section 20, unless the contract is part of a sale and leaseback transaction. For additional information on lease accounting under Section 20, see Chapter 23. If the entity has the right or obligation to repurchase the asset at a price equal to or greater than the original selling price (considering the effects of the time value of money) or if the contract is part of a sale and leaseback transaction (as discussed further below), the entity would account for the contract as a financing arrangement in accordance with Section 23.

[FRS 102.23.92].

When comparing the repurchase price with the selling price, an entity considers the time value of money.

[FRS 102.23.91(a)].

How we see it

It is important to remember that the effect of the time value of money must be considered when comparing the repurchase price to the original selling price of the asset. This evaluation can influence the determination of whether the repurchase agreement represents a lease or financing arrangement.

The following figure depicts this guidance for transactions that are not sale and leaseback transactions:

Figure 8-2: Forward or call options

Forward or call option				
Repurchase price	<	Original selling price	=	Lease*
Repurchase price	≥	Original selling price	=	Financing

* If the transaction is not part of a sale and leaseback transaction.

Note: When comparing the repurchase price with the original selling price, an entity considers the time value of money.

Under Section 23, a transaction in which a seller has an option to repurchase the product is treated as a lease or a financing arrangement (i.e., not a sale). This is because the customer does not have control of the product and is constrained in its ability to direct the use of and obtain substantially all of the remaining benefits from the good. Similar to IFRS 15, entities would not need to consider the likelihood that a call option will be exercised in determining the accounting for the repurchase provision. However, non-substantive call options are ignored and would not affect when a customer obtains control of an asset.

[IFRS 15.BC427]. See Question 8-24 below for how an entity might consider conditional call options and an example of a conditional call option that might qualify to be treated as a sale.

In the Basis for Conclusions on IFRS 15, the IASB observes that, “Theoretically, a customer is not constrained in its ability to direct the use of and obtain substantially all of the benefits from, the asset if an entity agrees to repurchase, at the prevailing market price, an asset from the customer that is substantially the same and is readily available in the marketplace.” [IFRS 15.BC425]. For example, an entity might transfer control of a commodity to a customer together with a forward or call option to repurchase that commodity (or one that is substantially the same). If (1) the repurchase price in the forward or call option is at the prevailing market price at the repurchase date, (2) the commodity to be repurchased is substantially the same, and (3) the commodity to be repurchased under the forward or call option is readily available (e.g., by being traded in an active commodity market), then the customer might not be constrained in its ability to direct the use of, and obtain substantially all the remaining benefits from, the asset as discussed in paragraph 23.92.

How we see it

To conclude that the customer obtains control in such an arrangement would require the use of significant judgement, and such a conclusion might not be appropriate in situations that do not meet the narrow fact pattern discussed above.

If a transaction is considered a financing arrangement under Section 23, the selling entity continues to recognise the asset. In addition, it records a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration to be paid to the customer subsequently (upon repurchasing the asset) represents the interest (and if applicable as processing or holding costs, e.g., insurance) that are recognised over the term of the financing arrangement using the effective interest method in accordance with paragraphs 11.15 to 11.20.

[FRS 102.23.93].

If the option lapses unexercised, the entity derecognises the liability and recognises revenue at that time. [FRS 102.23.91(b)].

Also note that paragraph 23.92(a) specifies that an entity must account for the contract in accordance with paragraph 20.122 if the contract forms part of a sale and leaseback transaction. This is discussed in Chapter 23 at 9.1 and 9.3.

How we see it

Since lease guidance is embedded in Section 23, it is important for entities to understand the interaction between the lease and revenue standards.

Illustration 8-13, which is based on Case A within Example 62 in IFRS 15, is an example of a call option: [IFRS 15.IE Example 62 Case A, IFRS 15.IE315-IE318]

Illustration 8-13: Repurchase agreements – Call option: financing

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X6 for £1 million. The contract includes a call option that gives the entity the right to repurchase the asset for £1.1 million on or before 31 December 20X6.

Control of the asset does not transfer to the customer on 1 January 20X6 because the entity has a right to repurchase the asset and therefore the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, in accordance with paragraph 23.92(b), the entity accounts for the transaction as a financing arrangement, because the exercise price is more than the original selling price. In accordance with paragraph 23.93, the entity does not derecognise the asset and instead recognises the cash received as a financial liability. The entity also recognises interest expense for the difference between the exercise price (£1.1 million) and the cash received (£1 million), which increases the liability.

On 31 December 20X6, the option lapses unexercised; therefore, the entity derecognises the liability and recognises revenue of £1.1 million.

Frequently asked questions

Question 8-24: How can an entity evaluate a conditional call option to repurchase an asset?

Neither Section 23 nor IFRS 15 specifically address conditional call options.

How we see it

We believe entities need to consider the following when evaluating conditional call options to repurchase an asset.

- If the entity controls the outcome of the condition that causes the call option to become active, then the presence of the call option indicates that control has not transferred because the customer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset. That is, the entity would be required to treat the contract as a lease or a financing arrangement as required by paragraph 23.92.
- If the entity does not control the condition that causes the call option to become active, then it would be acceptable for the entity to apply judgement to determine whether the call option limits the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. For example, if neither the entity nor the customer controls the outcome of the contingency, the entity could evaluate the nature of the contingency, together with the likelihood of the contingency becoming active, to determine whether it limits the customer's ability to obtain control of the asset. This could be the case for certain types of product recalls. See also Question 10-3 in 10.1.1 below for how an entity would account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item).
- If the customer controls the outcome of the contingency, then the conditional call option might not prevent the customer from obtaining control of the asset if the customer can direct the use of, and obtain substantially all the remaining benefits from, the asset. The guidance in paragraphs 23.94-23.97 (see 8.3.2 below) might be helpful for an entity to consider when determining whether the customer obtains control of the asset when it controls the outcome of the contingency.

- In the case of perishable products, an entity's conditional right to remove and replace expired goods does not necessarily constrain the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the products. That is, the entity is not able to remove and replace the products until they expire. Furthermore, the customer has control of the products over their entire useful life. Consequently, it might be reasonable for an entity to conclude that control of the initial product does transfer to the customer in this situation and that an entity could consider this right to be a form of a right of return (see 6.4 above).

8.3.2 Put option held by the customer

Section 23 indicates that if the customer has an unconditional right to require an entity to repurchase an asset (i.e., a put option), the customer obtains control of the asset unless the customer has a significant economic incentive to exercise that right. The entity considers, at contract inception, whether the customer has a significant economic incentive to exercise that right. [FRS 102.23.94]. That is, this determination influences whether the customer truly has control over the asset received.

The determination of whether an entity has a significant economic incentive to exercise its right determines whether the arrangement is treated as a lease, a financing arrangement or a sale with the right of return (discussed in 6.4 above). An entity must consider all relevant facts and circumstances to determine whether a customer has a significant economic incentive to exercise its right, including the relationship between the repurchase price to the expected market value (taking into consideration the effects of the time value of money) of the asset at the date of repurchase and the amount of time until the right expires. [FRS 102.23.95]. For example, if the repurchase price is expected to significantly exceed the market value of the asset, the customer might have a significant economic incentive to exercise the put option.

Since Section 23 provides limited guidance on determining whether a significant economic incentive exists, judgement might be required to make this determination:

- If a customer has a significant economic incentive to exercise its right (e.g., the repurchase price is more than the expected market value of the asset), the customer is expected to ultimately return the asset. An entity accounts for the contract as either a lease or a financing arrangement depending on the relationship between the amount that the entity might be required to pay to repurchase the asset and its original selling price. This is similar to the accounting discussed in 8.3.1 above. [FRS 102.23.97].
- In cases where the repurchase price is lower than original selling price, the entity accounts for the agreement as a lease because the customer is effectively paying the entity for the right to use the asset for a period of time. However, an exception to this is if the contract is part of a sale and leaseback, in which case, the contract would be accounted for as a financing arrangement (financing arrangements are discussed in 8.3.1 above). If the contract is part of a sale and leaseback transaction, the entity continues to recognise the asset. Furthermore, the entity recognises a financial liability for any consideration received from the customer to which the entity applies the accounting policy choice it made for its financial instruments under Section 11 and Section 12 (see Chapter 23 at 9.3 and Chapter 11 at 4). [FRS 102.23.92(a), FRS 102.20.126(a)].
- If the customer has the ability to require an entity to repurchase the asset at a price equal to, or more than, the original selling price, the contract is in effect a financing arrangement. Accordingly, the selling entity applies the accounting for a financing arrangement discussed in 8.3.1 above. [FRS 102.23.92(b), FRS 102.23.93].
- If a customer does not have a significant economic incentive to exercise its right, the entity accounts for the agreement in a manner similar to a sale of a product with a right of return. [FRS 102.23.96]. For example, if the repurchase price of an asset is equal to or greater than the original selling price, but less than or equal to the expected market value of the asset, it must be accounted for as a sale of a product with a right of return if the customer does not have a significant economic incentive to exercise its right based on other factors. See 6.4 above for a discussion of sales with a right of return.

Note that when comparing the repurchase price with the selling price, an entity considers the time value of money. If the option lapses unexercised, an entity derecognises the liability and recognises revenue at that time. [FRS 102.23.91].

Illustration 8-14, which is based on Case B within Example 62 in IFRS 15, is an example of a put option: [IFRS 15.IE Example 62 Case B, IFRS 15.IE315, IFRS 15.IE319-IE321]

Illustration 8-14: Repurchase agreements - Put option: lease

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 20X6 for £1 million. The contract includes a put option that obliges the entity to repurchase the asset at the customer's request for £900,000 on or before 31 December 20X6. The market value is expected to be £750,000 on 31 December 20X6.

At the inception of the contract, the entity assesses whether the customer has a significant economic incentive to exercise the put option, to determine the accounting for the transfer of the asset (see paragraphs 23.94-23.97). The entity concludes that the customer has a significant economic incentive to exercise the put option because the repurchase price significantly exceeds the expected market value of the asset at the date of repurchase. The entity determines there are no other relevant factors to consider when assessing whether the customer has a significant economic incentive to exercise the put option. Consequently, the entity concludes that control of the asset does not transfer to the customer, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

In accordance with paragraphs 23.97 and 23.92(a), the entity accounts for the transaction as a lease in accordance with Section 20.

8.3.3 Sales with residual value guarantees

An entity that sells equipment might use a sales incentive programme under which it guarantees that the customer will receive a minimum resale amount when it disposes of the equipment (i.e., a residual value guarantee). While the economics of a repurchase agreement and a residual value guarantee might be similar, the accounting could be quite different. A detailed discussion of factors an entity must consider in sales with residual value guarantees is available in the EY publication, International GAAP®.

8.4 Consignment arrangements

Entities frequently deliver inventory on a consignment basis to other parties (e.g., distributor, dealer). A consignment sale is one in which physical delivery of a product to a counterparty has occurred, but the counterparty is not required to pay until the product is either resold to an end-consumer or used by the counterparty. Under such arrangements, the seller (or consignor) retains the legal title to the merchandise and the counterparty (or consignee) acts as a selling agent. The consignee earns a commission on the products that have been sold and periodically remits the cash from those sales, net of the commission it has earned, to the consignor. In addition, consigned products that are not sold or used generally can be returned to the consignor. By shipping on a consignment basis, consignors are able to better market products by moving them closer to the end-consumer. However, they do so without selling the goods to the intermediary (consignee). [FRS 102.23.86(b)].

Section 23 provides the following guidance for determining whether an arrangement is a consignment arrangement: [FRS 102.23.87]

Extract from Section 23

- 23.87** Indicators that an arrangement is a consignment arrangement include, but are not limited to, the following:
- (a) the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the distributor or until a specified period expires;
 - (b) the entity is able to require the return of the product or transfer the product to a third party (such as another distributor); and
 - (c) the distributor does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

Entities entering into a consignment arrangement need to determine the nature of the performance obligation (i.e., whether the obligation is to transfer the product to the consignee or to transfer the product to the end-consumer). This determination would be based on whether control of the product passes to the consignee. Typically, a consignor does not relinquish control of the consigned product until the product is sold to the end-consumer or, in some cases, when a specified period expires. Consignees commonly do not have any obligation to pay for the product, other than to pay the consignor the agreed-upon portion of the sale price once the consignee sells the product to a third party. As a result, for consignment arrangements, revenue generally would not be recognised when the products are delivered to the consignee because control has not transferred (i.e., the performance obligation to deliver goods to the end-consumer has not yet been satisfied). [FRS 102.23.86(b)].

While some transactions are clearly identified as consignment arrangements, there are other less transparent transactions, in which the seller has retained control of the goods, despite no longer having physical possession. Such arrangements might include the shipment of products to distributors that are not required (either explicitly or implicitly), or do not have the wherewithal, to pay for the product until it is sold to the end-consumer.

Judgement is necessary in assessing whether the substance of a transaction is a consignment arrangement. The identification of such arrangements often requires a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties and the seller's customary business practices in such arrangements. [FRS 102.23.87]. While not required by Section 23 or Section 13, we would encourage entities to disclose separately the amount of their consigned inventory, if material.

8.5 Bill-and-hold arrangements

In some sales transactions, the selling entity fulfils its obligations and bills the customer for the work performed, but does not ship the goods until a later date. These transactions, often called bill-and-hold transactions, are usually designed this way at the request of the purchaser for a number of reasons, including a lack of storage capacity or an inability to use the goods until a later date. Whereas in a consignment sale (discussed in 8.4 above), physical delivery has occurred, but control of the goods has not transferred to the customer, the opposite might be true in a bill-and-hold transaction.

The general principle in recognising revenue under Section 23 must be applied in a bill-and-hold arrangement. That is, an entity determines when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product (see 8.2 above). For some contracts, control is transferred either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer might obtain control of a product even though that product remains in an entity's physical possession. [FRS 102.23.86(a)]. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. Consequently, the entity does not control the product. Instead, the entity provides custodial services to the customer over the customer's asset.

Unlike Section 23, IFRS 15 includes specific guidance which includes the four criteria that must be met before concluding that a customer has obtained control of a product in a bill-and-hold arrangement. An entity could consider such guidance in IFRS 15 when accounting for bill-and-hold arrangements. A detailed discussion of the guidance is available in the EY publication, International GAAP®.

If an entity concludes that it can recognise revenue for a bill-and-hold transaction, the entity needs to further consider whether it is also providing custodial services for the customer that would be identified as a separate performance obligation in the contract. Entities need to carefully evaluate their bill-and-hold arrangements and apply judgement to determine the performance obligations in the arrangements (e.g., products, custodial services) and assess when control transfers to the customer.

As discussed in Question 8-23 in 8.2.5 above, certain entities might use Ex Works from Incoterms® 2020 in contracts with customers. Under an Ex Works arrangement, the entity's responsibility is to make ordered goods available to the customer at the entity's premises or another named location. The customer is responsible for arranging, and paying for, shipment of the goods to the desired location and bears all of the risks related to them once they are made available.

How we see it

We believe that all Ex Works arrangements need to be evaluated using the requirements discussed above to determine whether revenue recognition is appropriate prior to shipment.

8.6 Recognising revenue for licences of intellectual property

Section 23 provides guidance for recognising revenue from licences of intellectual property that differs in some respects from the general requirements for other promised goods or services. We discuss licensing in detail in 9 below.

8.7 Recognising revenue when a right of return exists

As discussed in 5.7 above, a right of return does not represent a separate performance obligation. Instead, the existence of a right of return affects the transaction price and the entity must determine whether the customer will return the transferred product.

Under Section 23, as discussed in 6 above, an entity estimates the transaction price and applies the constraint to the estimated transaction price. In doing so, it considers the products expected to be returned in order to determine the amount to which the entity expects to be entitled (excluding consideration for the products expected to be returned). The entity recognises revenue based on the amounts to which the entity expects to be entitled through to the end of the return period (considering expected product returns). An entity does not recognise the portion of the revenue that is subject to the constraint until the amount is no longer constrained, which could be at the end of the return period or earlier if the entity's expectations about the products expected to be returned change prior to the end of the return period. The entity recognises the amount received or receivable that is expected to be returned as a refund liability, representing its obligation to return the customer's consideration. An entity also updates its estimates at the end of each reporting period. See 5.7 and 6.4 above for further discussion on this topic.

8.8 Recognising revenue for customer options for additional goods or services

As discussed in 5.6 above, when an entity grants a customer the option to acquire additional goods or services, that option is a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the contract (e.g., a discount that exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer has, in effect, paid the entity in advance for future goods or services. Section 23 requires the entity to allocate a portion of the transaction price to the material right at contract inception (see 7.1.5 above). The revenue allocated to the material right is recognised when (or as) the option is exercised (and the underlying future goods or services are transferred) or when the option expires.

In contrast, if a customer option is not deemed to be a material right and is instead a marketing offer, the entity does not account for the option and waits to account for the underlying goods or services until those subsequent purchases occur.

Frequently asked questions

Question 8-25: How would an entity account for the exercise of a material right? That is, would an entity account for it as: a contract modification, a continuation of the existing contract or variable consideration?

See response to Question 5-27 in 5.6 above.

8.9 Breakage and prepayments for future goods or services

In certain industries, an entity collects non-refundable payments from its customers for goods or services that the customer has a right to receive in the future. However, a customer might ultimately leave that right unexercised (often referred to as 'breakage'). [FRS 102.23.129]. Retailers, for example, frequently sell gift cards that might not be partially redeemed or completely redeemed and airlines sometimes sell non-refundable tickets to passengers who allow the tickets to expire unused.

When an entity receives consideration that is attributable to a customer's unexercised rights, the entity recognises a contract liability equal to the full amount prepaid by the customer for the performance obligation to transfer, or to stand ready to transfer, goods or services in the future. [FRS 102.23.125, FRS 102.23.129]. As discussed further below, an entity derecognises that contract liability (and recognises revenue) when it transfers those goods or services and, therefore, satisfies its performance obligation. [FRS 102.23.125]. Effectively, this guidance requires the same pattern of revenue recognition as the requirements for customer options (see 7.1.5 above).

However, since entities might not be required by customers to fully satisfy their performance obligations, Section 23 requires that when an entity expects to be entitled to a breakage amount, the expected breakage would be recognised as revenue in proportion to the pattern of rights exercised by the customer. If an entity does not expect to be entitled to a breakage amount, it would not recognise any breakage amounts as revenue until the likelihood of the customer exercising its right becomes remote.

[FRS 102.23.130].

When estimating any breakage amount, an entity has to consider the constraint on variable consideration, as discussed in 6.2.3 above. [FRS 102.23.130]. That is, if it is highly probable that the entity will not be entitled for any estimated breakage amounts, an entity would not recognise those amounts until the breakage amounts are no longer constrained.

Entities cannot recognise estimated breakage as revenue immediately upon receipt of prepayment from the customer. This is because the entity has not performed under the contract. That is, recognising revenue would not be a faithful depiction of the entity's performance and would understate its obligation to stand ready to provide future goods or services. This is the case even if an entity has historical evidence to support the view that no further performance will be required for some portion of the customer contract(s).

As discussed in 6 above and following the guidance on principal versus agent considerations (see 5.4 above), the amount to which the entity expects to be entitled excludes amounts collected on behalf of another party. Accordingly, regardless of whether an entity can demonstrate the ability to reliably estimate breakage, entities would not estimate or recognise any amounts attributable to a customer's unexercised rights in income (e.g., an unused gift card balance) if the amounts are required to be remitted to another party (e.g., the government). Such an amount is recognised as a liability (not as revenue). The liability would not be derecognised until the derecognition requirements in Section 11 are met, generally when cash is remitted to the other party.

Consider the following Illustration which shows how an entity would apply the above guidance to the sale of a gift card in the scope of Section 23 (see Question 3-3 in 3.1.5 above for further discussion):

Illustration 8-15: Accounting for the sale of a gift card

Entity A sells a £500 non-refundable gift card that can be redeemed at any of its retail locations. Any unused balance is not subject to laws that require from the entity to remit the payment to another party. When the gift card is sold, Entity A recognises a contract liability of £500 (i.e., the full amount that was prepaid by the customer). No breakage is recognised as revenue upon sale of the gift card.

Scenario A - Entity expects to be entitled to a breakage amount

Based on historical redemption rates, Entity A expects 90% of the gift card (or £450) to be redeemed. That is, Entity A expects breakage of 10% (or £50). Upon its first use, the customer redeems £225 of the gift card. That is, 50% of the expected redemption has occurred (i.e., £225 redemption ÷ £450 total expected redemption). Upon this redemption, Entity A recognises revenue and reduces the contract liability by £250. This is equal to £225 for the transfer of goods or services purchased by the customer, as well as breakage of £25 (50% redemption × £50 breakage estimate) that is recognised in proportion to the exercise of the customer's rights. Similar accounting would occur for future redemptions.

Scenario B - Entity does not expect to be entitled to a breakage amount

Based on historical redemption experiences that customers fully redeem similar gift cards (or possibly the lack of historical experience due to a new gift card programme that means Entity A is unable to estimate the redemption rates), Entity A does not expect to be entitled to a breakage amount. Upon its first use of the gift card, the customer redeems £225. Entity A recognises revenue and reduces the contract liability by the same amount as the redemption (or £225). That is, no additional amounts are recognised for breakage. Similar accounting would occur for future redemptions.

If no further redemptions occur, Entity A recognises the remaining gift card balance (or £275) as revenue (and reduces the contract liability by the same amount) when the likelihood of the customer exercising its remaining rights becomes remote.

As discussed above, the guidance on breakage requires that an entity recognise a contract liability for the full amount of the prepayment. It would then recognise breakage on that contract liability proportionate to the pattern of rights exercised by the customer. If the prepayment element (e.g., the sale of a gift card, loyalty points) is part of a multiple-element arrangement, an entity needs to allocate the transaction price between the identified performance obligations. As a result, the deferred revenue associated with this element would be less than the 'prepaid' amount received for the unsatisfied performance obligations.

Illustration 8-16, which is based on Example 52 in IFRS 15, depicts the sale of goods with loyalty points. [IFRS 15.IE Example 52, IFRS 15.IE267-IE270]. In this example, the amount allocated to the points (i.e., the 'prepaid' element) is less than the stand-alone selling price of those points because of the allocation of the transaction price among the two performance obligations.

Illustration 8-16: Customer loyalty programme

An entity has a customer loyalty programme that rewards a customer with one customer loyalty point for every £10 of purchases. Each point is redeemable for a £1 discount on any future purchases of the entity's products. During a reporting period, customers purchase products for £100,000 and earn 10,000 points that are redeemable for future purchases. The consideration is fixed and the stand-alone selling price of the purchased products is £100,000. The entity expects 9,500 points to be redeemed. The entity estimates a stand-alone selling price of £0.95 per point (totalling £9,500) on the basis of the likelihood of redemption in accordance with paragraph 23.71 (see 7.1.5 above).

The points provide a material right to customers that they would not receive without entering into a contract. Consequently, the entity concludes that the promise to provide points to the customer is a performance obligation. The entity allocates the transaction price (£100,000) to the product and the points on a relative stand-alone selling price basis as follows:

	£	
Product	91,324	$[\text{£}100,000 \times (\text{£}100,000 \text{ stand-alone selling price} \div \text{£}109,500)]$
Points	8,676	$[\text{£}100,000 \times (\text{£}9,500 \text{ stand-alone selling price} \div \text{£}109,500)]$

At the end of the first reporting period, 4,500 points have been redeemed and the entity continues to expect 9,500 points to be redeemed in total. The entity recognises revenue for the loyalty points of £4,110 $[(4,500 \text{ points} \div 9,500 \text{ points}) \times \text{£}8,676]$ and recognises a contract liability of £4,566 ($\text{£}8,676 - \text{£}4,110$) for the unredeemed points at the end of the first reporting period.

At the end of the second reporting period, 8,500 points have been redeemed cumulatively. The entity updates its estimate of the points that will be redeemed and now expects that 9,700 points will be redeemed. The entity recognises revenue for the loyalty points of £3,493 $[(8,500 \text{ total points redeemed} \div 9,700 \text{ total points expected to be redeemed}) \times \text{£}8,676 \text{ initial allocation}] - \text{£}4,110$ recognised in the first reporting period. The contract liability balance is £1,073 ($\text{£}8,676 \text{ initial allocation} - \text{£}7,603 \text{ of cumulative revenue recognised}$).

As depicted in Illustration 8-16 above, entities need to routinely refine and evaluate estimates of breakage. An entity can elect to apply the portfolio approach practical expedient (see 4.3.1 above) to estimate breakage. Similar to the discussion in Question 6-15 in 6.4 above, an entity can consider evidence from similar contracts to develop an estimate without applying the portfolio approach practical expedient. That is, considering historical experience does not necessarily mean the entity is applying the portfolio approach practical expedient.

Frequently asked questions

Question 8-26: Are customers' unexercised rights (i.e., breakage) a form of variable consideration?

How we see it

Although the breakage guidance in paragraph 23.130 specifically refers to the constraint on variable consideration, we do not believe breakage is a form of variable consideration (see 6.2 above).

This is because it does not affect the transaction price. Breakage is a recognition concept (Step 5) that could affect the timing of revenue recognition. It is not a measurement concept (Step 3). For example, the transaction price for a sale of a £20 gift card is fixed at £20 regardless of the expected breakage amount. The expected breakage, however, could affect the timing of revenue recognition because an entity is required under paragraph 23.130 to "recognise the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer" if it expects to be entitled to a breakage amount. [IFRS 102.23.130].

Question 8-27: How would revenue be recognised for customer options for additional goods or services that represent a material right, but do not have an expiration date (i.e., can an entity recognise breakage for these options)?

See response to Question 5-29 in 5.6 above.

9 Licences of intellectual property

Section 23 provides guidance for recognising revenue from licences of intellectual property that differs in some respects from the requirements for other promised goods or services. Given that licences include a wide array of features and economic characteristics, an entity needs to evaluate the nature of its promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognised) over time or at a point in time. A licence provides either: *[FRS 102.23.107]*

- A right to access the entity's intellectual property throughout the licence period, which results in revenue that is recognised over time.

Or

- A right to use the entity's intellectual property as it exists at the point in time in which the licence is granted, which results in revenue that is recognised at a point in time.

Section 23 states that licences of intellectual property establish a customer's rights to the intellectual property of an entity and could include, but are not limited to, licences for any of the following: software and technology, media and entertainment (e.g., motion pictures and music), franchises, patents, trademarks and copyrights. *[FRS 102.23.105]*.

The guidance provided on licences of intellectual property is only applicable to licences that are distinct. When the licence is the only promised item (either explicitly or implicitly) in the contract, the guidance is clearly applicable to that licence. The assessment as to whether the contract includes a distinct licence of intellectual property will be straightforward for many contracts. However, if there are multiple promises in a contract, entities might have to more carefully evaluate the nature of the rights conveyed.

Licences of intellectual property are frequently included in multiple-element arrangements with promises for additional goods or services that could be explicit or implicit. In these situations, an entity first applies the requirements of Step 2 of the model to determine whether the licence of intellectual property is distinct, as discussed in 5 above and 9.1 below.

For most licences that are not distinct, an entity would follow the general requirements in Step 5 of the model to account for the recognition of revenue for the performance obligation that includes the licence (i.e., the requirements in paragraphs 23.78-23.89 to determine whether the performance obligation transfers over time or at a point in time, as discussed in 8.1 and 8.2 above).

FRS 102 aims to be simpler than adopted IFRS. Accordingly, the FRC included a more straightforward description of the requirements for licensing. *[FRS 102.BC.B23.7]*. The overall accounting requirements for licences of intellectual property are consistent between Section 23 and IFRS 15. However, IFRS 15 provides more detailed guidance and illustrations, which an entity reporting under FRS 102 could consider in applying the requirements of Section 23. For example, the IASB noted in the Basis for Conclusions on IFRS 15 that there might be some situations in which, even though the licence is not distinct from the good or service transferred with the licence, the licence is the primary or dominant component (i.e., the predominant item) of the combined performance obligation. *[IFRS 15.BC407]*. In such situations, the IASB indicated that the application guidance for licences still applies. The IASB provided no application guidance or bright lines for determining when a licence is the primary or dominant component. However, an example in the Basis for Conclusions on IFRS 15 illustrates this concept further. *[IFRS 15.BC414X]*. See 9.2.1 below for further discussion. The determination of whether a licence is the predominant component will be obvious in some cases, but not in others. Therefore, entities might need to exercise significant judgement and consider both qualitative and quantitative factors.

9.1 Identifying performance obligations in a licensing arrangement

Contracts for licences of intellectual property frequently include explicit or implicit promises for additional goods or services (e.g., equipment, when-and-if available upgrades, maintenance and installation). *[FRS 102.23.19]*. Consistent with Step 2 of the general model (see 5 above), entities need to apply the requirements on identifying performance obligations in paragraphs 23.17 to 23.25 when a contract with a customer includes a licence of intellectual property and other promised goods or services in order to appropriately determine whether the licence of intellectual property and the other promises are distinct (i.e., are separate performance obligations).

In respect of identifying performance obligations in a licensing arrangement, Section 23 states that "If a contract with a customer includes a promise to grant a licence (or licences) in addition to other promised goods or services, an entity shall apply paragraphs 23.17 to 23.25 to identify each of the performance obligations in the contract." *[FRS 102.23.106]*.

As discussed in 5.2 above, Section 23 outlines a two-step process for determining whether a promised good or service (including a licence of intellectual property) is distinct and, therefore, is a performance obligation, as follows:

- (a) Consideration of the individual good or service (i.e., whether the good or service is capable of being distinct).

And

- (b) Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., whether the promise to transfer the good or service is distinct in the context of the contract).

To conclude that a good or service is distinct, an entity needs to determine that the good or service is both capable of being distinct and distinct in the context of the contract. These requirements need to be applied to determine whether a promise to grant a licence of intellectual property is distinct from other promised goods or services in the contract. Therefore, entities are required to assess whether the customer can benefit from a licence of intellectual property on its own or together with readily available resources (i.e., whether it is capable of being distinct) and whether the entity's promise to transfer a licence of intellectual property is separately identifiable from other promises in the contract (i.e., whether it is distinct in the context of the contract). The assessment of whether a licence of intellectual property is distinct needs to be based on the facts and circumstances of each contract.

9.1.1 Licences of intellectual property that are distinct

Licences are frequently capable of being distinct (i.e., the first criteria of a distinct good or service) as a customer can often obtain at least some benefit from the licence of intellectual property on its own or with other readily available resources. An entity could consider Case A within Example 11 in IFRS 15 which includes a contract for a software licence that is transferred along with installation services, technical support and unspecified software updates. In this example, the installation service is routinely performed by other entities and does not significantly modify the software. The software licence is delivered before the other goods or services and remains functional without the updates and technical support. The entity concludes that the customer can benefit from each of the goods or services either on their own or together with other goods or services that are readily available. [IFRS 15.IE Example 11 Case A, IFRS 15.IE49-IE58]. That is, each good or service, including the software licence, is capable of being distinct under paragraph 23.21.

If an entity determines that a licence of intellectual property and other promised goods or services are capable of being distinct, the second step in the evaluation is to determine whether they are distinct in the context of the contract. As part of this evaluation, an entity considers the indicators for whether the goods or services are not separately identifiable, including whether:

- (a) The entity provides a significant service of integrating the licence and other goods or services into a combined output or outputs.
- (b) The licence and other goods or services significantly modify or customise each other.

Or

- (c) The licence and other goods or services are highly interdependent or highly interrelated, such that the entity would not be able to fulfil its promise to transfer the licence independently of fulfilling its promise to transfer the other goods or services to the customer.

Continuing with Case A within Example 11 in IFRS 15, which is discussed above, the entity considers the separately identifiable principle and factors in paragraph 23.24 and determines that the promise to transfer each good and service, including the software licence, is separately identifiable. In reaching this determination, the entity considers that the installation services are routine and can be obtained from other providers. In addition, the entity considers that, although it integrates the software into the customer's system, the software updates do not significantly affect the customer's ability to use and benefit from the software licence during the licence period. Therefore, neither the installation services nor the software updates significantly affect the customer's ability to use and benefit from the software licence. The entity further observes that none of the promised goods or services significantly modify or customise one another and the entity is not providing a significant service of integrating the software and services into one combined output. Lastly, the software and the services are not deemed to be highly interdependent or highly interrelated because the entity would be able to fulfil its promise to transfer the initial software licence independent from its promise to subsequently provide the installation service, software updates and the technical support.

The illustration below, which is based on Case B within Example 56 in IFRS 15, is another example that illustrates a contract for which a licence of intellectual property is determined to be distinct from other promised goods or services: *[IFRS 15.IE Example 56 Case B, IFRS 15.IE281, IFRS 15.IE285-IE288]*

Illustration 9-1: Identifying a distinct licence

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore, the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

In this case, the manufacturing process used to produce the drug is not unique or specialised and several other entities can also manufacture the drug for the customer.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 23.21 (see 5.2.1 above) are met for each of the licence and the manufacturing service. The entity concludes that the criterion in paragraph 23.21(a) (see 5.2.1.A above) is met because the customer can benefit from the licence together with readily available resources other than the entity's manufacturing service (because there are other entities that can provide the manufacturing service), and can benefit from the manufacturing service together with the licence transferred to the customer at the start of the contract.

The entity also concludes that its promises to grant the licence and to provide the manufacturing service are separately identifiable (i.e., the criterion in paragraph 23.21(b) is met – see 5.2.1.B above). The entity concludes that the licence and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 23.24 (see 5.2.1.B above). In reaching this conclusion, the entity considers that the customer could separately purchase the licence without significantly affecting its ability to benefit from the licence. Neither the licence, nor the manufacturing service, is significantly modified or customised by the other and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the licence and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfil its promise to transfer the licence independently of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the licence and initially utilised a different manufacturer. Thus, although the manufacturing service necessarily depends on the licence in this contract (i.e., the entity would not provide the manufacturing service without the customer having obtained the licence), the licence and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the licence and to provide the manufacturing service are distinct and that there are two performance obligations:

(a) Licence of patent rights

And

(b) Manufacturing service

The entity assesses, in accordance with paragraph 23.108, the nature of the entity's promise to grant the licence (see 9.2 below). The drug is a mature product (i.e., it has been approved, is currently being manufactured and has been sold commercially for the last several years). For these types of mature products, the entity's customary business practices are not to undertake any activities to support the drug. The drug compound has significant stand-alone functionality (i.e., its ability to produce a drug that treats a disease or condition). Consequently, the customer obtains a substantial portion of the benefits of the drug compound from that functionality, rather than from the entity's ongoing activities. The entity concludes that neither of the criteria in paragraph 23.108 are met because the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the intellectual property to which the customer has rights. In its assessment of the criteria in paragraph 23.108, the entity does not take into consideration the separate performance obligation of promising to provide a manufacturing service. Consequently, the nature of the entity's promise in transferring the licence is to provide a right to use the entity's intellectual property in the form and the functionality with which it exists at the point in time that it is granted to the customer. Consequently, the entity accounts for the licence as a performance obligation satisfied at a point in time.

The entity applies paragraphs 23.78 to 23.89 to determine whether the manufacturing service is a performance obligation satisfied at a point in time or over time (see 8.1 and 8.2 above).

9.1.2 Licences of intellectual property that are not distinct

The licences of intellectual property included in the examples in 9.1.1 above were determined to be distinct because they met the two criteria of paragraph 23.21 (see 5.2.1 above). In other situations, a licence of intellectual property might not be distinct from other promised goods or services in a contract, either because it is not capable of being distinct and/or it is not separately identifiable.

Accordingly, a licence that is not distinct from other promised goods or services in a contract must be combined into a single performance obligation (i.e., into a bundle of goods or services that is distinct).

[FRS 102.23.25]. IFRS 15 identifies two examples of licences of intellectual property that are not distinct from other goods or services, as follows: [IFRS 15.B54]

- A licence that is a component of, and integral to the functionality of, a tangible good.
- A licence that the customer can benefit from, but only in conjunction with a related service (e.g., as a result of the entity granting a licence, the customer has access to an online service provided by the entity).

In both examples, a customer only benefits from the combined output of the licence of intellectual property and the related good or service. Therefore, the licence is not distinct and would be combined with those other promised goods or services in the contract.

Illustration 9-3 in 9.2.1 below is another example which illustrates contracts that include licences of intellectual property that are not distinct from other goods or services promised to the customer.

When an entity is required to bundle a licence of intellectual property with other promised goods or services in a contract, it often needs to consider the licensing guidance to help determine the nature of its promise to the customer when the licence is the predominant item in the combined performance obligation.

See 9.2.1 below for further discussion on applying the licensing guidance to such performance obligations.

9.1.3 Contractual restrictions

Some licences contain substantive contractual restrictions on how the customer can employ a licence. Section 23 does not include guidance on how contractual restrictions impact the determination of the nature of the entity's promise in granting the licence.

IFRS 15 explicitly states that restrictions of time, geography or use do not affect the licensor's determination of whether the promise to transfer a licence is satisfied over time or at a point in time. These are, therefore, disregarded in the assessment because restrictions of time, geographical region or use define the attributes of the promised licence, rather than define whether the entity satisfies its performance obligation at a point in time or over time. [IFRS 15.B62(a)].

Entities applying Section 23 could consider the related guidance in IFRS 15 and a detailed discussion of that guidance is available in the EY publication, International GAAP®.

9.1.4 Guarantees to defend or maintain a patent

An entity might provide a guarantee that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use. Section 23 does not provide further guidance regarding the treatment of such guarantees but an entity could consider the related guidance in IFRS 15.

IFRS 15 states that a guarantee to defend or maintain a patent does not represent a performance obligation in a licensing contract. Furthermore, this type of guarantee does not affect the licensor's determination as to whether the licence provides a right to access intellectual property (satisfied over time) or a right to use intellectual property (satisfied at a point in time). This is because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the licence transferred meets the specifications of the licence promised in the contract.

[IFRS 15.B62(b)].

Entities applying Section 23 could consider the related guidance in IFRS 15 and a detailed discussion of that guidance is available in the EY publication, International GAAP®.

Frequently asked questions

Question 9-1: How do entities account for modifications and other changes to licences of intellectual property?

A licence provides a customer with a right to use or a right to access the intellectual property of an entity. The terms of each licence of intellectual property are defined by the contract, which establishes the customer's rights (e.g., period of time, area of use). Parties to a licensing arrangement might agree to renew (or extend) the terms and conditions of an existing licence (see 9.4 below for further discussion on the accounting for licence renewals).

However, parties to a licensing arrangement might agree to extend the licence term, but the extension is not solely a renewal of the terms and conditions of a licence (i.e., the parties could add goods or services, change the pricing, or do both). Neither Section 23 nor IFRS 15 explicitly address the accounting for these types of licence changes.

How we see it

The following are two approaches entities have applied in practice under IFRS 15, that we believe would be acceptable under Section 23. The approaches described below assume a right-to-use licence (see 9.3.2 below). Approach A is based on the use and benefit requirement in paragraph 23.112 (discussed in 9.3.3 below) and Approach B is based on the contract modification requirements in paragraphs 23.13-23.16 (discussed in 4.4 above).¹⁸⁴

While we believe both approaches are acceptable, an entity must make a policy choice to select one approach and apply it consistently to similar transactions. We believe other approaches could also be acceptable, depending on the facts and circumstances.

Approach A

New rights granted in a licensing arrangement (i.e., an extension for existing rights and the granting of additional rights) do not constitute a contract modification but, instead, create a new contract. Under this approach, because the performance related to the existing right-to-use licence was completed at the beginning of the original licence period (when the customer was able to use and benefit from the licence), any changes to the terms or pricing (or both) of the licence cannot modify or revoke the existing licence.

Instead, new rights granted in the licensing arrangement would be accounted for using the licensing guidance (i.e., the use and benefit requirement in paragraph 23.112 that is discussed in 9.3.3 below). As a result, revenue related to the renewal or extension of the existing licence would be recognised when (or as) that performance obligation is satisfied, which might not be until the beginning of the renewal or extension period (see 9.4 below) or some other date.

Approach B

The contract modification requirements in paragraphs 23.13 to 23.16 (discussed in 4.4 above) are applied to the licence extension. Under this approach, the accounting for the renewed licence follows the form of the contract modification.

How we see it

We believe that when a contract that only includes a licence of intellectual property is modified, the additional and/or modified licence of intellectual property is distinct from the existing licence because the new and/or modified rights will always differ from those conveyed by the existing licence.

¹⁸⁴ These approaches are consistent with the alternatives described in the FASB staff's memo, *Issue Summary No. 1*, when the FASB's Emerging Issues Task Force (EITF) considered the accounting for contract modifications of licenses of intellectual property. For further details about these alternatives, refer to *Issue 1: Accounting for contract modifications under which the contract term for existing rights is extended, while also adding rights* in the staff's memo, available on the [FASB's website](#). The FASB will consider this issue as part of the post-implementation review process of ASC 606.

Section 23 contains requirements for accounting for contract modifications and it requires a modification in which the additional promised goods or services are distinct to be accounted for on a prospective basis, as follows:

- The modification is accounted for as a separate contract if the additional consideration from the modification reflects the new licence's stand-alone selling price in accordance with paragraph 23.15(b) (see 4.4.1 above). [FRS 102.23.15(b)].
- If the additional consideration does not reflect the stand-alone selling price of the new licence, the modification is accounted for in accordance with paragraph 23.16(a) (see 4.4.2.A above). [FRS 102.23.16(a)].

If the modification is determined to be a separate contract in accordance with paragraph 23.15(b), the existing contract is not considered terminated. As a result, any revenue allocated to a performance obligation created at the modification date for the renewal or extension of a licence would be recognised when (or as) that performance obligation is satisfied, which might not occur until the beginning of the renewal or extension period (consistent with Approach A above).

If the modification is determined to be a termination of the existing contract and the creation of a new contract in accordance with paragraph 23.16(a), any revenue recognised to date under the original contract would not be adjusted. At the date of the modification, the remaining unrecognised transaction price from the existing contract (if any) and the additional transaction price from the new contract are allocated to the remaining performance obligation(s) in the new contract. Any revenue allocated to a performance obligation created at the modification date for the renewal or extension of a licence would be recognised when (or as) that performance obligation is satisfied, which might occur as early as the modification date (if the customer can use and benefit from the licences) because the existing contract (including the existing licence) would be considered terminated.

Example

The following Illustration shows the application of each of the approaches discussed above:

Illustration 9-2: Additional rights under a right-to-use licence granted to a licensee

Entity A enters into a contract on 1 January 20X6 with Customer B to transfer a right-to-use licence of software. The licence provides 100 seats (i.e., a right-to-use licence for 100 users to access the software) of Product C for a two-year term for £200,000. The consideration is paid annually in two equal instalments (i.e., £100,000 is due 30 January 20X6 and the remaining £100,000 is due on 30 January 20X7). The price reflects the stand-alone selling price of Product C.

On 1 January 20X7, Entity A and Customer B agree to add more seats to the licence. The existing licence is terminated, and the customer is granted a new licence for 150 seats for a two-year term for £276,000, which represents the second £100,000 payment from the original contract plus an additional £176,000. That is, Customer B receives an 8% discount per seat on the original price because of the added volume.

Entity A determines that the additional seats are distinct from the existing seats and the additional seats are not priced at their stand-alone selling prices because the price has decreased by 8%.

Since it is a right-to-use licence under Section 23, Entity A needs to evaluate when Customer B can use and benefit from the new software licence because that determines the point before which control cannot transfer (and Entity A cannot recognise revenue) related to the new software licence. Entity A also needs to evaluate ongoing services, such as post-contract customer support, which could change the allocation of consideration to the performance obligations and, therefore, the timing of revenue recognition.

To illustrate the different approaches that would be acceptable, the analysis below focuses only on the creation of the new licence itself:

Approach A

Entity A determines that the new licence is: (1) the addition of 50 new seats for a two-year term (from 1 January 20X7 through to 31 December 20X8); (2) a one-year renewal of the original 100 seats (from 1 January 20X8 through to 31 December 20X8); and (3) an 8% reduction from the original price for each of the 100 original seats for the second year (from 1 January 20X7 through to 31 December 20X7).

Entity A allocates the additional consideration of £176,000 between the 50 new seats and the renewal of the original 100 seats. The consideration allocated to the new seats is recognised on 1 January 20X7, which is the date when Customer B can use and benefit from the new seats (and assuming control has transferred at the beginning of licence period). Entity A would then need to determine when it has satisfied its performance obligation for the renewal (which cannot be before Customer B can use and benefit from the renewed licence) to determine when to recognise the consideration allocated to the renewal. Entity A might, for example, determine that this is at the time the new licence is granted (1 January 20X7), not before the beginning of the licence renewal period (1 January 20X8) or some other date.

Approach B

Entity A determines that a contract modification has occurred in accordance with paragraph 23.16(a), whereby a new licence for 150 seats for a two-year term has been granted and the original licence has been terminated as at 1 January 20X7 when the additional, distinct seats were added to the contract. Entity A concludes that Customer B can use the software and benefit from the modified licence immediately because the customer is not renewing a licence with the same terms and conditions as the original contract due to the addition of 50 new seats and change in pricing. It also determines control has transferred to Customer B at the same date. As a result, Entity A recognises the entire £176,000 on 1 January 20X7.

Question 9-2: How do entities account for an option to revoke licensing rights?

Certain licensing arrangements include, either at inception or as a result of a modification, an option that allows the customer to revoke licensing rights in the future. For example, a contract for an on-premise software licence might include an option that allows the customer to migrate the on-premise software to a SaaS arrangement (i.e., the on-premise licence is revoked).

Neither Section 23 nor IFRS 15 provides guidance on how to account for an option that allows a customer to revoke rights to a licence of intellectual property. We believe there are two acceptable alternatives, if the option is determined not to be a material right:¹⁸⁵

- Account for the option as a right of return (see 5.7 above for further details about the accounting for rights of return).
- Or
- Account for the conversion prospectively when it occurs applying the contract modification requirements (see 4.4 above for further details about the accounting for contract modifications).

However, if the option is determined to be a material right, see 5.6 above for further details about accounting for material rights.

How we see it

We believe entities must select one of the two alternatives above to account for the revocation of a licence and apply it consistently to similar transactions.

Question 9-3: How does an entity account for contracts that grant both permission for past use of intellectual property and a licence to use the intellectual property in the future?

An entity might enter into a contract with a customer that grants the right to use intellectual property and the customer also agrees to pay consideration for past use of that intellectual property. Such an agreement might be in part a settlement for the use of the intellectual property in the past without the entity's permission.

In such circumstances, it would require judgement to determine what aspects of the contract are within the scope of Section 23. This would include consideration of whether, and to what extent, the counterparty is acting as a customer as defined in FRS 102 (see 3.1.3 above).

If the contract is only partially within the scope of Section 23, an entity would need to use judgement when applying the requirements in paragraph 23.3 (see 3.1.5 above) to separate the consideration between the revenue in exchange for the licence, any amount received for the past use and any other components. [FRS 102.23.3].

If, or to the extent, the contract is outside the scope of Section 23, an entity considers whether the income is arising in the course of the entity's ordinary activities in order to determine whether presentation as (other) revenue is appropriate (see 3.1.3 above and Question 11-7 in 11.2 below).

Question 9-4: Does a licence to a content library include more than one performance obligation?

Whether a contract that includes the transfer of one or more licences of intellectual property to a content library includes more than one performance obligation depends on facts and circumstances, and requires an entity to apply significant judgement. For example, an entity might enter into a licensing arrangement that provides the customer with a right to use all of the entity's existing content at contract inception, together with a right to use unspecified future updates to the content library (e.g., a licence for a film producer's completed titles and any titles produced in the future, a licence for an existing music library and any songs added or removed in the future). Typically, the contractual licence fee is not adjusted if the licensor does not obtain or create new content to provide to the licensee over the term of the contract.

¹⁸⁵ These alternatives are consistent with the alternatives described in the FASB staff's memo, *Issue Summary No. 1*, when the EITF considered this issue. For further details about these alternatives, refer to *Issue 2: Accounting for the revocation of licensing rights (including conversion of term software licences to SaaS arrangements)* in the staff's memo, available on the [FASB's website](#). The FASB will consider the issue as part of the post-implementation review process of ASC 606.

In these arrangements, the licensor needs to evaluate the promised goods or services in the contract to determine the number of performance obligations (e.g., whether the licence for the existing content library provided at inception of the arrangement is distinct from other promises in the contract, including the obligation to provide updates to the content library on a when-and-if-available basis). That is, entities need to consider whether each individual good or service is both capable of being distinct and distinct in the context of the contract.

The licence for the existing content library is considered distinct from the other promised goods or services in the contract if it is separately identifiable from them. That might be the case if the licensor does not provide a significant service of integrating the existing content library with other promised goods or services in the contract (e.g., unspecified future updates to the content library), the promise goods or services do not significantly modify or customise each other, or the existing content library is not highly interdependent or interrelated with the other promised goods or services.

In many cases, a licensing arrangement that provides the customer with a right to use all of the entity's existing content at contract inception, together with a right to use unspecified future updates to the content library will generally be both capable of being distinct and distinct within the context of the contract (i.e., separately identifiable). Therefore, these promises are generally two separate performance obligations.

When an entity determines that there is more than one performance obligation (e.g., one for the licence to the content library provided at the inception of the arrangement, and another for the obligation to provide updates to the content library in the future, when and if available), the licensor will need to allocate the transaction price to the separate performance obligations on a relative stand-alone selling price basis.¹⁸⁶

9.2 Determining the nature of the entity's promise in granting a licence

Entities need to evaluate the nature of a promise to grant a licence of intellectual property in order to determine whether the promise is satisfied (and revenue is recognised) over time or at a point in time. An entity considers whether the nature of the entity's promise in granting the licence provides the customer with: *[FRS 102.23.107]*

- A right to access the entity's intellectual property as it exists throughout the licence period.
- Or
- A right to use the entity's intellectual property as it exists at the point in time in which the licence is granted.

In order to help entities in determining whether a licence provides a customer with a right to access or a right to use the intellectual property (which is important when determining the period of performance and, therefore, the timing of revenue recognition - see 9.3 below), Section 23 provides the following guidance: *[FRS 102.23.108, FRS 102.23.109, FRS 102.23.110]*

¹⁸⁶ Licences of content library arrangements are typically provided in exchange for fixed consideration and/or variable consideration in the form of a sales-based or usage-based royalty. This paragraph assumes the transaction price does not include any other form of variable consideration that could be subject to the variable consideration allocation exception in FRS 102.23.73-23.74 (see 7.3 above).

Extract from Section 23

- 23.108** A licence provides a customer with a right to access an entity's intellectual property if the entity expects to undertake activities that either:
- (a) will significantly affect the benefit the customer obtains from the intellectual property by changing the substance of the intellectual property; or
 - (b) could significantly affect the benefit the customer obtains from the intellectual property by directly exposing the customer to any positive or negative effects of those activities.
- 23.109** An entity's expected activities may be included in the terms of a contract or arise from those activities that the customer reasonably expects the entity will undertake. The assessment of whether a licence provides a customer with a right to access an entity's intellectual property shall not include activities that result in the transfer of a good or service to the customer as those activities occur.
- 23.110** Activities that change the substance of the intellectual property include activities that change the intellectual property's design, content or ability to perform a function or task (eg development activities that change the content to which the customer has rights). Activities that expose the customer to positive or negative effects of those activities include activities that support or maintain the value of intellectual property (eg ongoing activities that maintain the value of the brand to which the customer has rights).

When applying this guidance, the focus is on the characteristics of a licence that provides a right to access the entity's intellectual property. If the licensed intellectual property does not have those characteristics, it provides a right to use the entity's intellectual property, by default. This analysis is focused on situations in which the underlying intellectual property is subject to change over the licence period.

As discussed in 9 above, Section 23 includes a more straightforward description of the requirements for licences of intellectual property, but the overall accounting requirements are consistent with those in IFRS 15. However, IFRS 15 provides more detailed guidance which an entity could consider in applying the requirements of Section 23.

A licence establishes a customer's rights to the intellectual property of an entity. [FRS 102.23.105, IFRS 15.B52]. Consequently, activities that significantly affect the intellectual property and the rights granted by the licence to the customer, directly exposes the customer to any effects of such activities. In this case, such activities will or could significantly affect the benefit the customer obtains from the intellectual property to which the customer has rights.

Note that under IFRS 15, the key determinants of whether the nature of an entity's promise is a right to access the entity's intellectual property are whether: (1) the entity is required to undertake activities that affect the licensed intellectual property (or the customer has a reasonable expectation that the entity will do so); and (2) the customer is exposed to positive or negative effects resulting from those changes. This is consistent with the requirements in Section 23, that is, an entity must determine whether it expects to undertake activities that either will or could significantly affect the benefit the customer obtains from the intellectual property. [FRS 102.23.108].

It is important to note that when an entity is making this assessment, it excludes the effect of any other performance obligations in the contract. For example, if an entity enters into a contract to licence software and provide access to any future upgrades to that software during the licence period, the entity first determines whether the licence and the promise to provide future updates are separate performance obligations. If they are separate, when the entity considers whether it has a contractual (explicit or implicit) obligation to undertake activities to change the software during the licence period, it excludes any changes and activities associated with the performance obligation to provide future upgrades.

While the activities considered in this assessment do not include those that are a performance obligation, these activities can be part of an entity's ongoing ordinary activities (see 3.1.3 above) and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer). [FRS 102.23.108, FRS 102.23.109]. In addition, the IASB noted in the Basis for Conclusions on IFRS 15 that the existence of a shared economic interest between the parties (e.g., sales-based or usage-based royalties) could be an indicator that the customer has a reasonable expectation that the entity will undertake such activities. [IFRS 15.BC413].

After an entity has identified the activities for this assessment, it must determine if those activities will or could significantly affect the benefit the customer obtains from the intellectual property to which the customer has rights. Section 23 clarifies that such activities: *[FRS 102.23.108, FRS 102.23.110]*

- Will significantly affect the benefit the customer obtains from the intellectual property by changing the substance of the intellectual property – these are activities that significantly change the form (e.g., design or content) or functionality (e.g., the ability to perform a function or task) of the intellectual property.
- Or
- Could significantly affect the benefit the customer obtains from the intellectual property by directly exposing the customer to positive or negative effects of those activities – these are activities that could affect the ability of the customer to obtain benefit from the intellectual property because such benefit is substantially derived from, or dependent upon, those activities (e.g., the benefit from a brand is often derived from, or dependent upon, the entity's ongoing activities that support or maintain the value of the intellectual property).

Note also that IFRS 15 provides further guidance which states that if the intellectual property has significant stand-alone functionality, the customer derives a substantial portion of the benefit of that intellectual property from that functionality. As such, the ability of the customer to obtain benefit from that intellectual property would not be significantly affected by the entity's activities unless those activities significantly change its form or functionality. Therefore, if the intellectual property has significant stand-alone functionality, revenue is recognised at a point in time. Examples of types of intellectual property that often have significant stand-alone functionality that are mentioned in IFRS 15 include software, biological compounds or drug formulas, and completed media content (such as films, television shows and music recordings). *[IFRS 15.B59A]*.

The IASB has not defined the term 'significant stand-alone functionality', but has made clarifications to the examples in IFRS 15 to illustrate when the intellectual property to which the customer has rights might have significant stand-alone functionality. In some cases, it will be clear when intellectual property has significant stand-alone functionality. If there is no significant stand-alone functionality, the benefit to the customer might be substantially derived from the value of the intellectual property and the entity's activities to support or maintain that value. The IASB noted, however, that an entity might need to apply judgement to determine whether the intellectual property to which the customer has rights has significant stand-alone functionality. *[IFRS 15.BC414]*.

How we see it

It is important for entities that provide licences of intellectual property to their customers to appropriately identify the performance obligations as part of Step 2 of the model because those conclusions will directly affect their evaluation of whether the entity's activities significantly change the form or functionality of the intellectual property or affect the ability of the customer to obtain benefit from the intellectual property.

9.2.1 Applying the licensing guidance to a single (bundled) performance obligation that includes a licence of intellectual property

If a licence is not distinct from the other goods or services in the contract, entities are required to follow the requirements in paragraphs 23.78 to 23.89 to determine whether the single (bundled) performance obligation (which includes the licence) is satisfied over time or at a point in time (i.e., the general requirements in Step 5 of the model, as discussed in 8.1 and 8.2 above). *[FRS 102.23.106]*.

Neither Section 23 nor IFRS 15 explicitly states that an entity needs to consider the nature of its promise in granting a licence when applying the general revenue recognition model to performance obligations that are comprised of both a licence (that is not distinct) and other goods or services. However, the IASB clarified in the Basis for Conclusions on IFRS 15 that to the extent that an entity is required to combine a licence with other promised goods or services in a single performance obligation and the licence is the primary or dominant component (i.e., the predominant item) of that performance obligation, the entity needs to consider the licensing guidance to help determine the nature of its promise to the customer. *[IFRS 15.BC407]*. If the licence is the predominant item of a single performance obligation, entities need to consider the licensing guidance when:

- (a) Determining whether the performance obligation is satisfied over time or at a point in time.

And

- (b) Selecting an appropriate method for measuring progress of that performance obligation if it is satisfied over time.

Considering the nature of an entity's promise in granting a licence that is part of a single combined performance obligation is not a separate step or evaluation in the revenue model. Rather, it is part of the overall requirements in Step 5 of the model to determine whether that single performance obligation is satisfied over time or at a point in time and the appropriate measure of progress toward the satisfaction, if it is satisfied over time.

Under IFRS 15, the IASB did not provide application guidance or bright lines for determining when a licence is the primary or dominant (i.e., the predominant) component. However, the IASB explained in the Basis for Conclusions on IFRS 15 that, in some instances, not considering the nature of the entity's promise in granting a licence that is combined with other promised goods or services in a single performance obligation would result in accounting that does not best reflect the entity's performance. For example, consider a situation where an entity grants a 10-year licence that is not distinct from a one-year service arrangement. The IASB noted that a distinct licence that provides access to an entity's intellectual property over a 10-year period could not be considered completely satisfied before the end of the access period. The IASB observed in that example that it is, therefore, inappropriate to conclude that a single performance obligation that includes that licence is satisfied over the one-year period of the service arrangement.

[IFRS 15.BC414X].

IFRS 15 includes examples that illustrate how an entity applies the licensing application guidance to help determine the nature of a performance obligation that includes a licence of intellectual property and other promised goods or services.

In Illustration 9-3 below, which is based on Case A within Example 56 in IFRS 15, an entity licences the patent rights for an approved drug compound to its customer and also promises to manufacture the drug for the customer. The entity considers that no other entity can perform the manufacturing service because of the highly specialised nature of the manufacturing process. Therefore, the licence cannot be purchased separately from the manufacturing service and the customer cannot benefit from the licence on its own or with other readily available resources (i.e., the licence and the manufacturing service are not capable of being distinct). Accordingly, the entity's promises to grant the licence and to manufacture the drug are accounted for as a single performance obligation, as set out below. [IFRS 15.IE Example 56 Case A, IFRS 15 IE281-IE284]

Illustration 9-3: Identifying a distinct licence

An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer. The drug is a mature product; therefore, the entity will not undertake any activities to support the drug, which is consistent with its customary business practices.

In this case, no other entity can manufacture this drug because of the highly specialised nature of the manufacturing process. As a result, the licence cannot be purchased separately from the manufacturing services.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with IFRS 102.23.21 (see 5.2.1 above). The entity determines that the customer cannot benefit from the licence without the manufacturing service; therefore, the criterion in paragraph 23.21(a) (see 5.2.1.A above) is not met. Consequently, the licence and the manufacturing service are not distinct and the entity accounts for the licence and the manufacturing service as a single performance obligation.

The entity applies paragraphs 23.78 to 23.89 to determine whether the performance obligation (i.e., the bundle of the licence and the manufacturing services) is a performance obligation satisfied at a point in time or over time (see 8.1 and 8.2 above).

Illustration 9-3 above demonstrates the importance of applying the licensing guidance when determining the nature of an entity's promise in granting a licence that is combined into a single performance obligation with other promised goods or services. This is because the conclusion of whether a non-distinct licence provides the customer with a right to use intellectual property or a right to access intellectual property might have a significant effect on the timing of revenue recognition for the single combined performance obligation. In Illustration 9-3 above, the entity needs to determine the nature of its promise in granting the licence within the single performance obligation (comprising the licence and the manufacturing service) to appropriately apply the general principle of recognising revenue when (or as) it satisfies its performance obligation to the customer. If the licence in this example provided a right to use the entity's intellectual property that on its own would be recognised at the point in time in which control of the licence is

transferred to the customer, it is likely that the combined performance obligation would only be fully satisfied when the manufacturing service is complete. In contrast, if the licence provided a right to access the entity's intellectual property, the combined performance obligation would not be fully satisfied until the end of the 10-year licence period, which could extend the period of revenue recognition beyond the date when the manufacturing service is complete.

9.3 Transfer of control of licensed intellectual property

When determining whether a licence of intellectual property transfers to a customer (and revenue is recognised) over time or at a point in time, Section 23 states that an entity provides a customer with either: *[FRS 102.23.107]*

- A right to access the entity's intellectual property throughout the licence period for which revenue is recognised over the licence period.
- Or
- A right to use the entity's intellectual property as it exists at the point in time the licence is granted for which revenue is recognised at the point in time the customer can first use and benefit from the licensed intellectual property.

Section 23 provides the following guidance on the timing of revenue recognition for right-to-access and right-to-use licences: *[FRS 102.23.111, FRS 102.23.112]*

Extract from Section 23

23.111 If either of the criteria in paragraph 23.108 are met, the licence transfers over time because a customer receives and consumes the benefits of an entity's performance of providing access to its intellectual property as the entity performs. An entity shall apply paragraphs 23.98 to 23.104 to select an appropriate method to measure its progress towards complete satisfaction of the performance obligation.

23.112 If neither of the criteria in paragraph 23.108 are met, the licence provides the customer with a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted. An entity shall apply paragraphs 23.85 to 23.89 to determine the point in time at which the licence transfers to the customer. Revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence.

9.3.1 Right to access

The explanation in paragraph 23.111 (see 9.3 above) stating that the licence transfers over time if either of the criteria in paragraph 23.108 are met is consistent with the principles in IFRS 15. *[FRS 102.23.111]*

The IASB concluded that a licence that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance as the performance occurs", including the related activities undertaken by entity. *[IFRS 15.B60, IFRS 15.BC414]*. This conclusion is based on the determination that when a licence is subject to change (and that change will or could significantly affect the benefit the customer obtains from the intellectual property – see 9.2 above), the customer is not able to fully gain control over the licence of intellectual property at any given point in time, but rather gains control over the licence period. Entities need to apply the general Step 5 requirements in paragraphs 23.98 to 23.104 to determine the appropriate method to measure progress (see 8.1.4 above) in addition to paragraph 23.112 (i.e., the use and benefit requirement, which is discussed in 9.3.3 below).

In performing this analysis, an entity would not default to a straight-line revenue attribution model. However, the customer often receives and consumes the benefits of a right-to-access licence evenly over the contract period and, therefore, a time-based measure of progress that results in a straight-line recognition of revenue would be appropriate.

The illustration below, which is based on Example 58 in IFRS 15, is an example of a right-to-access licence:
[IFRS 15.IE Example 58, IFRS 15.IE297-IE302]

Illustration 9-4: Access to intellectual property

An entity, a creator of comic strips, licenses the use of the images and names of its comic strip characters in three of its comic strips to a customer for a four-year term. There are main characters involved in each of the comic strips. However, newly created characters appear regularly and the images of the characters evolve over time. The customer, an operator of cruise ships, can use the entity's characters in various ways, such as in shows or parades, within reasonable guidelines. The contract requires the customer to use the latest images of the characters.

In exchange for granting the licence, the entity receives a fixed payment of £1 million in each year of the four-year term.

In accordance with paragraph 23.21 (see 5.2.1 above), the entity assesses the goods and services promised to the customer to determine which goods and services are distinct. The entity concludes that it has no other performance obligations other than the promise to grant a licence. That is, the additional activities associated with the licence do not directly transfer a good or service to the customer because they are part of the entity's promise to grant a licence.

The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph 23.108 (see 9.2 above). In assessing the criteria the entity considers the following:

- The customer reasonably expects (arising from the entity's customary business practices) that the entity will undertake activities that will significantly affect the intellectual property to which the customer has rights (i.e., the characters). This is because the entity's activities (i.e., development of the characters) change the form of the intellectual property to which the customer has rights. In addition, the ability of the customer to obtain benefit from the intellectual property to which the customer has rights is substantially derived from, or dependent upon, the entity's ongoing activities (i.e., the publishing of the comic strip).
- The rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities because the contract requires the customer to use the latest characters.
- Even though the customer could benefit from those activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.

Consequently, the entity concludes that either of the criteria in paragraph 23.108 are met i.e., the entity is expected to undertake activities that will, or could, significantly affect the benefit the customer obtains from the intellectual property. Therefore, the entity concludes that the nature of the entity's promise to transfer the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (i.e., the criterion in paragraph 23.81(a) is met - see 8.1.1 above).

The entity applies paragraphs 23.98 to 23.104 to identify the method that best depicts its performance in the licence. Because the contract provides the customer with unlimited use of the licensed characters for a fixed term, the entity determines that a time-based method would be the most appropriate measure of progress towards complete satisfaction of the performance obligation.

Frequently asked questions

Question 9-5: Is a licence that provides a right to access intellectual property a series of distinct goods or services that would be accounted for as a single performance obligation?

Step 2 of the model requires an entity to identify the performance obligations in a contract. This includes determining whether multiple distinct goods or services would be accounted for as a single performance obligation under the series requirement (see 5.2.2 above). It is likely that many licences that provide a right to access intellectual property are a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property, such as monthly access or quarterly access).

A TRG agenda paper included an example of a licence that provides a right to access intellectual property that is accounted for as a series of distinct goods or services.¹⁸⁷ In the example, a franchisor grants a licence of intellectual property to a franchisee allowing the franchisee to use its trade name and sell its product for a period of 10 years. As discussed in Question 5-11 in 5.2.2 above, if the nature of an entity's promise is to provide a single service for a period of time, the evaluation of whether goods or services are distinct and substantially the same considers whether each time increment of access to the intellectual property (e.g., hour, day) is distinct and substantially the same. In this example, the nature of the franchisor's promise is to provide a right to access the intellectual property throughout the licence period. Each time increment is distinct because the customer benefits from the right to access each day on its own (i.e., each time increment is capable of being distinct). In addition, each day is separately identifiable (i.e., each time increment is distinct in the context of the contract) because: there is no integration service provided between the days of access provided; no day modifies or customises another; and the days of access are not highly interdependent or highly interrelated. In addition, each distinct daily service is substantially the same because the customer receives access to the intellectual property each day.

If a licence meets the criteria to be accounted for as a series of distinct goods or services, an entity needs to consider whether any variable consideration in the contract (e.g., royalties, milestone payments) must be allocated to the distinct periods of access, if certain allocation criteria are met. See 7.3 above for a discussion of the variable consideration allocation exception and 9.5 below for a discussion of the accounting for sales-based or usage-based royalties.

9.3.2 Right to use

In contrast, when the licence represents a right to use the intellectual property as it exists at a specific point in time, the customer gains control over that intellectual property at the beginning of the period for which it has the right to use the intellectual property. [FRS 102.23.112]. This timing might differ from when the licence was granted. For example, an entity could provide a customer with the right to use intellectual property but indicate that right to use does not start until 30 days after the agreement is finalised. For the purpose of determining when control transfers for the right-to-use licence, Section 23 is clear that the assessment is from the customer's perspective (i.e., when the customer can use the licensed intellectual property), rather than the entity's perspective (i.e., when the entity transfers the licence). Entities need to apply the general Step 5 requirements in FRS 102.23.85-23.89 to determine the point in time that control of the licence transfers to the customer (see 8.2 above) in addition to paragraph 23.112 (i.e., the use and benefit requirement, which is discussed below in 9.3.3 below). [FRS 102.23.112].

¹⁸⁷ TRG Agenda paper no. 39, *Application of the Series Provision and Allocation of Variable Consideration*, dated 13 July 2015.

The illustration below, which is based on Example 59 in IFRS 15, is an example of a right-to-use licence:
[IFRS 15.IE Example 59, IFRS 15.IE303-IE306]

Illustration 9-5: Right to use intellectual property

An entity, a music record label, licenses to a customer a 1975 recording of a classical symphony by a noted orchestra. The customer, a consumer products company, has the right to use the recorded symphony in all commercials, including television, radio and online advertisements for two years in Country A. In exchange for providing the licence, the entity receives fixed consideration of £10,000 per month. The contract does not include any other goods or services to be provided by the entity. The contract is non-cancellable.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 23.21 (see 5.2.1 above). The entity concludes that its only performance obligation is to grant the licence. The entity determines that the term of the licence (two years), its geographical scope (the customer's right to use the recording only in Country A), and the defined permitted use for the recording (in commercials) are all attributes of the promised licence in the contract (see discussion in 9.1.3 above).

In accordance with paragraph 23.108 (see 9.2 above), the entity assesses the nature of the entity's promise to grant the licence. The entity does not have any contractual or implied obligations to change the licensed recording. The licensed recording has significant stand-alone functionality (i.e., the ability to be played) and, therefore, the ability of the customer to obtain the benefits of the recording is not substantially derived from the entity's ongoing activities. The entity therefore determines that the contract does not require, and the customer does not reasonably expect, the entity to undertake activities that significantly affect the licensed recording (i.e., neither of the criteria in paragraph 23.108 are met). Consequently, the entity concludes that the nature of its promise in transferring the licence is to provide the customer with a right to use the entity's intellectual property as it exists at the point in time that it is granted. Therefore, the promise to grant the licence is a performance obligation satisfied at a point in time. The entity recognises all of the revenue at the point in time when the customer can direct the use of, and obtain substantially all of the remaining benefits from, the licensed intellectual property.

Because of the length of time between the entity's performance (at the beginning of the period) and the customer's monthly payments over two years (which are non-cancellable), the entity considers the requirements in paragraphs 23.58 to 23.60 to determine whether a financing component exists (see 6.5 above).

9.3.3 Use and benefit requirement

Both Section 23 and IFRS 15 state that revenue from a right-to-use licence cannot be recognised before the beginning of the period during which "the customer is able to use and benefit from the licence".

[FRS 102.23.112, IFRS 15.B61]. Note also that the IASB explained in the Basis for Conclusions on IFRS 15 that if the customer cannot use and benefit from the licensed intellectual property then, by definition, it does not control the licence. *[IFRS 15.BC414]*. See 9.4 below for discussion on licence renewals.

Consider an example where an entity provides a customer with a right to use its software, but the customer requires a code before the software will function, which the entity will not provide until 30 days after the agreement is finalised. In this example, it is likely that the entity would conclude that control of the licence does not transfer until 30 days after the agreement is finalised because that is when the customer has the right to use and can benefit from the software.

9.4 Licence renewals

As discussed in 9.3.3 above, Section 23 states that revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. *[FRS 102.23.112]*. A question could arise whether the above requirement applies to the renewal of an existing licence or whether the entity could recognise revenue for the renewal when the parties agree to the renewal.

The above requirement is consistent with the requirement in IFRS 15.B61. Note that the TRG discussed the application of IFRS 15.B61 within the context of renewals or extensions of existing licences. [IFRS 15.BC414S]. The discussion at the TRG indicated that this is an area in which judgement is needed and, therefore, this topic was further discussed by the IASB.¹⁸⁸

The IASB decided that a clarification about the application of the contract modification requirements specifically for renewals of licensing arrangements was not necessary. The IASB noted that, although some diversity might arise, IFRS 15 provides an extensive framework for applying judgement.

Therefore, when an entity and a customer enter into a contract to renew (or extend the period of) an existing licence, the entity needs to evaluate whether the renewal or extension has to be treated as a new licence or as a modification of the existing contract. A modification would be accounted for in accordance with the contract modifications requirements in paragraphs 18 to 21 of IFRS 15. [IFRS 15.BC414T]. These requirements are consistent with the contract modifications requirements in paragraphs 23.13 to 23.16 (see 4.4 above).

See Question 9-1 in 9.1.4 above for further discussion on modifications of licences.

Frequently asked questions

Question 9-6: How do entities account for modifications and other changes to licences of intellectual property?

See response to Question 9-1 in 9.1.4 above.

Question 8-7: How do entities account for an option to revoke licensing rights?

See response to Question 9-2 in 9.1.4 above.

9.5 Sales-based or usage-based royalties on licences of intellectual property

Section 23 provides guidance on the recognition of revenue for sales-based or usage-based royalties on licences of intellectual property, which differs from the requirements that apply to other revenue from licences. Section 23 states that an entity must not apply the requirements related to variable consideration described in paragraphs 23.44 to 23.47 (see 6.2.2 to 6.2.4 above) to a sales-based or usage-based royalty provided in exchange for a licence of intellectual property when the licence of intellectual property is the sole or predominant item to which the royalty relates. Instead, consistent with IFRS 15, Section 23 requires royalties received in exchange for licences of intellectual property to be recognised at the later of when: [FRS 102.23.48]

(a) The subsequent sale or usage takes place

And

(b) The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)

That is, an entity recognises the royalties as revenue for such arrangements when (or as) the customer's subsequent sales or usage occurs, unless that pattern of recognition accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates, based on an appropriate measure of progress (see 8.1.4 above).

The IASB explained in the Basis for Conclusions on IFRS 15 that for a licence of intellectual property for which the consideration is based on the *customer's* subsequent sales or usage, an entity does not recognise any revenue for the variable amounts until the uncertainty is resolved (i.e., when a customer's subsequent sales or usage occurs). [IFRS 15.BC219].

The application guidance addresses the *recognition* of sales-based or usage-based royalties received in exchange for a licence of intellectual property, rather than when such amounts are included in the transaction price of the contract. [IFRS 15.BC421I]. As a result, this exception is a recognition constraint and the constraint on variable consideration (see 6.2.3 above) does not apply.

188 TRG Agenda paper no. 45, *Licences - Specific Application Issues About Restrictions and Renewals*, dated 9 November 2015.

Under Section 23, the general requirements related to variable consideration (see 6.2 above) do not apply to a sales-based or usage-based royalty provided in exchange for a licence of intellectual property when the licence of intellectual property is the sole or predominant item to which the royalty relates. [FRS 102.23.48]. Under IFRS 15, the variable consideration constraint does not apply, but the other requirements for estimating variable consideration still apply. [IFRS 15.B63]. However, this might be one of the situations where an entity would not need to estimate variable consideration at contract inception (see also discussion in Question 6-10 in 6.2.2 above). This is because, in many cases, using this application guidance will result in the same pattern of revenue recognition as fully constraining the estimate of variable consideration associated with the future royalty stream (also see 9.5.1 below for more information about recognition of royalties for a licence that provides a right to access the entity's intellectual property). However, under Section 23 and IFRS 15, in cases where an entity is required to allocate sales-based or usage-based royalties to separate performance obligations in a contract, it would need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations.

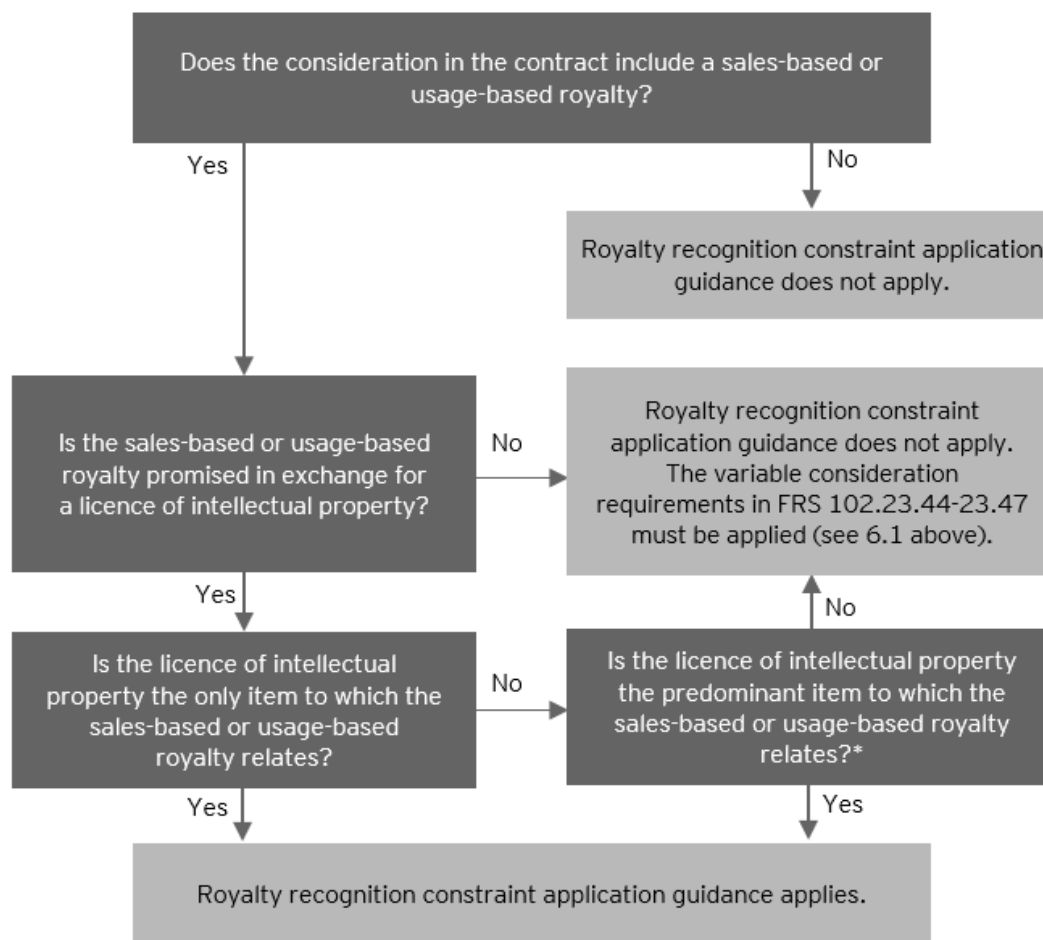
The IASB explained that it added the royalty recognition constraint because both users and preparers of financial statements indicated that it would not be useful for entities to recognise a minimum amount of revenue for sales-based or usage-based royalties received in exchange for licences of intellectual property (following the requirements in the general model on estimating the transaction price). This is because that approach would inevitably require the entity to report significant adjustments to the amount of revenue recognised throughout the life of the contract as a result of changes in circumstances that are not related to the entity's performance. The IASB observed that this would not result in relevant information, especially for contracts in which the sales-based or usage-based royalties are paid over a long period of time.

[IFRS 15.BC415].

In some contracts, a sales-based or usage-based royalty might be related to both a licence of intellectual property and another good or service that is, or is not, be distinct. Section 23 requires that the royalty recognition constraint be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property. [FRS 102.23.48]. Note also that in the Basis for Conclusions on IFRS 15, the IASB observed that the royalty recognition constraint would also apply when no single licence of intellectual property is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences of intellectual property in the contract. [IFRS 15.B63A, IFRS 15.BC421G]. That is, this application guidance is applicable to all licences of intellectual property, regardless of whether they have been determined to be distinct. Neither Section 23 nor IFRS 15 provides a bright line for determining the 'predominant' item in a contract that includes a licence of intellectual property. The IASB acknowledged in the Basis for Conclusions on IFRS 15 that significant judgement is required to determine when a licence is the predominant item to which a royalty relates. However, the judgement for determining whether a licence is the predominant item is likely to be less than the judgement needed to apply the general requirements for variable consideration to such contracts. [IFRS 15.BC421E]. See Question 9-18 in 9.5.1 below for further discussion.

It is important to note that the guidance in paragraph 23.48, or in paragraphs B63-B63B of IFRS 15, applies only to licences of intellectual property for which some or all of the consideration is in the form of a sales-based or usage-based royalty. The IASB said in the Basis for Conclusions on IFRS 15 that the royalty recognition constraint was structured to apply only to a particular type of transaction (i.e., a licence of intellectual property). Therefore, other transactions that might be economically similar would be accounted for differently. [IFRS 15.BC416]. That is, entities cannot analogise to the royalty recognition constraint for other types of transactions. For example, it cannot be applied if consideration in a contract is in the form of a sales-based or usage-based royalty, but there is either: (a) no licence of intellectual property; or (b) the licence of intellectual property to which the sales-based or usage-based royalty relates is not the predominant item in the contract (e.g., the sale of a tangible good that includes a significant amount of intellectual property). Under Section 23 and IFRS 15, when the royalty recognition constraint cannot be applied, an entity follows the general requirements on variable consideration (see 6.2 above). [FRS 102.23.48, IFRS 15.B63B]. In some cases, it will not be obvious whether the arrangement is an in-substance sale of intellectual property (i.e., a promise that is in the form of a licence, but, in substance, has the characteristics of a sale) or a licence of intellectual property. In such instances, entities would have to exercise judgement to determine whether the control over the underlying intellectual property has been transferred from the entity to the customer and therefore, has been sold.

The following flow chart illustrates an entity's evaluation when determining whether the royalty recognition constraint must be applied to a royalty stream:

Figure 9-1: Determining whether the royalty recognition constraint applies to a royalty stream

* This includes situations in which no single licence is the predominant item to which the sales-based or usage-based royalty relates, but the sales-based or usage-based royalty predominantly relates to two or more licences in the contract.

The illustration below, which is based on Example 60 in IFRS 15, is an example of a contract that includes two performance obligations, including a licence that provides a right to use the entity's intellectual property and consideration in the form of sales-based royalties. In the example, the licence is determined to be the predominant item to which the royalty relates: [IFRS 15.IE Example 60, IFRS 15.IE307-IE308]

Illustration 9-6: Sales-based royalty for a licence of intellectual property

An entity, a movie distribution company, licenses Movie XYZ to a customer. The customer, an operator of cinemas, has the right to show the movie in its cinemas for six weeks. Additionally, the entity has agreed to (a) provide memorabilia from the filming to the customer for display at the customer's cinemas before the beginning of the six-week screening period; and (b) sponsor radio advertisements for Movie XYZ on popular radio stations in the customer's geographical area throughout the six-week screening period. In exchange for providing the licence and the additional promotional goods and services, the entity will receive a portion of the operator's ticket sales for Movie XYZ (i.e., variable consideration in the form of a sales-based royalty).

The entity concludes that the licence to show Movie XYZ is the predominant item to which the sales-based royalty relates because the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the related promotional goods or services (see discussion in Question 9-18 in 9.5.1 below). The entity recognises revenue from the sales-based royalty, the only consideration to which the entity is entitled under the contract, wholly in accordance with paragraph 23.48. If the licence, the memorabilia and the advertising activities are separate performance obligations, the entity would allocate the sales-based royalty to each performance obligation.

As shown in the illustration above, when the criteria for applying the royalty recognition constraint are applied, the royalty stream must be accounted for entirely under the royalty recognition constraint. [FRS 102.23.48]. That is, an entity would not split a single royalty and apply the royalty recognition constraint to a portion of the sales-based royalty and the general constraint requirements for variable consideration (see 6.2.3 above) to the remainder. Note also that the IASB indicated in the Basis for Conclusions on IFRS 15 that it would be more complex to account for part of a royalty under the royalty recognition constraint and another part under the general requirements for variable consideration and that doing so would not provide any additional useful information to users of financial statements. This is because splitting a royalty would result in an entity recognising an amount at contract inception that would reflect neither the amount to which the entity expects to be entitled, based on its performance, nor the amount to which the entity has become legally entitled during the period. [IFRS 15.BC421J].

Regardless of whether an entity applies the royalty recognition constraint or the general requirements for variable consideration, it is still required to allocate sales-based or usage-based royalties to separate performance obligations in a contract (as noted in Illustration 9-6 above) in a manner consistent with the allocation objective in Section 23 – see discussion in 7 above. In order to perform such an allocation, an entity would need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations. Illustration 7-11 in 7.3.3 above also illustrates the allocation of the transaction price (including sales-based or usage-based royalties) to the performance obligations in the contract.

9.5.1 Recognition of royalties for a licence that provides a right to access intellectual property

The royalty recognition constraint is intended to align the recognition of sales or usage-based royalties with the key principle that revenue is recognised when (or as) an entity satisfies a performance obligation. As discussed in 9.5 above, Section 23 requires that royalties received in exchange for licences of intellectual property are recognised at the later of when: (1) the subsequent sales or usage occurs; and (2) the performance obligation to which the sales-based or usage-based royalties relate has been satisfied (or partially satisfied). That is, an entity recognises the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that pattern of recognition accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely or partially relates, based on an appropriate measure of progress (see 8.1.4 above).

Consider the following Illustration, based on an example provided by the FASB¹⁸⁹, that is an example of when revenue recognition would be inappropriately accelerated ahead of an entity's performance, if revenue was recognised under paragraph 23.48(a) for a right-to-access licence:

Illustration 9-7: Licensing contract with a declining royalty rate

A contract provides a customer with the right to access an entity's intellectual property and the entity receives royalties of 8% on total sales up to £1 million, 4% on the next £3 million in sales and 2% on all sales above £4 million. The declining royalty rate does not reflect changing value to the customer.

In this example, the FASB noted that recognising royalties as they are due (i.e., according to the contractual formula) would not be aligned with the principle of recognising revenue only when (or as) an entity satisfies a performance obligation because the right to access the intellectual property is provided evenly over the licence term while the declining royalty rate does not reflect the value to the customer. However, the FASB stated that the existence of a declining royalty rate in a contract does not always mean that recognising revenue for sales-based or usage-based royalties as the customer's underlying sales or usage occur is inappropriate. In fact, it would be appropriate if the declining royalty rate reflects the changing value to the customer.

¹⁸⁹ ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, April 2016, paragraph BC71.

The above example notwithstanding, for many contracts with licences that provide a right to access an entity's intellectual property, applying the royalty recognition constraint results in an entity recognising revenue from sales-based or usage-based royalties when (or as) the customer's underlying sales or usage occurs in accordance with paragraph 23.48(a). An output-based measure of progress that is the same as, or similar to, the application of the practical expedient in paragraph 23.103 (i.e., when the right to consideration corresponds directly with the value to the customer of the entity's performance to date) is appropriate because the entity's right to consideration (i.e., the sales-based or usage-based royalties earned) often corresponds directly with the value to the customer of the entity's performance completed to date. The practical expedient in paragraph 23.103 is discussed further in 8.1.4 above.

In addition, an output-based measure could also be appropriate for a licence that provides a right to access intellectual property in which the consideration is in the form of a fixed fee and royalties. The following example, which is based on Example 61 in IFRS 15, illustrates this: [IFRS 15.IE Example 61, IFRS 15.IE309-IE313]

Illustration 9-8: Access to intellectual property

An entity, a well-known sports team, licenses the use of its name and logo to a customer. The customer, an apparel designer, has the right to use the sports team's name and logo on items including t-shirts, caps, mugs and towels for one year. In exchange for providing the licence, the entity will receive fixed consideration of £2 million and a royalty of 5% of the sales price of any items using the team name or logo. The customer expects that the entity will continue to play games and provide a competitive team.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 23.21 (see 5.2.1 above). The entity concludes that its only performance obligation is to transfer the licence. The additional activities associated with the licence (i.e., continuing to play games and provide a competitive team) do not directly transfer a good or service to the customer because they are part of the entity's promise to grant the licence.

The entity assesses the nature of the entity's promise to transfer the licence in accordance with paragraph 23.108 (see 9.2 above). In assessing the criteria the entity considers the following:

- The entity concludes that the customer would reasonably expect that the entity will undertake activities that will significantly affect the benefit the customer obtains from intellectual property (i.e., the team name and logo) to which the customer has rights. This is on the basis of the entity's customary business practice to undertake activities that support and maintain the value of the name and logo such as continuing to play and providing a competitive team. The entity determines that the ability of the customer to obtain benefit from the name and logo is substantially derived from, or dependent upon, the expected activities of the entity. In addition, the entity observes that because some of its consideration is dependent on the success of the customer (through the sales-based royalty), the entity has a shared economic interest with the customer, which indicates that the customer will expect the entity to undertake those activities to maximise earnings.
- The entity observes that the rights granted by the licence (i.e., the use of the team's name and logo) directly expose the customer to any positive or negative effects of the entity's activities and thus, the activities the entity is expected to undertake could significantly affect the benefit the customer obtains from the licence to which the customer has rights.
- The entity also observes that even though the customer could benefit from the activities through the rights granted by the licence, they do not transfer a good or service to the customer as those activities occur.

The entity concludes that one of the criteria in paragraph 23.108 is met i.e., the entity is expected to undertake activities that could significantly affect the benefit the customer obtains from the intellectual property by directly exposing the customer to any positive or negative effects of those activities, which include activities that support or maintain the value of intellectual property. [IFRS 102.23.108, IFRS 102.23.110]. Therefore, the entity concludes that the nature of the entity's promise to grant the licence is to provide the customer with access to the entity's intellectual property as it exists throughout the licence period. Consequently, the entity accounts for the promised licence as a performance obligation satisfied over time (i.e., the criterion in paragraph 23.81(a) is met - see 8.1.1 above).

The entity then applies paragraphs 23.98 to 23.104 to determine a measure of progress that will depict the entity's performance. For the consideration that is in the form of a sales-based royalty, paragraph 23.48 applies because the sales-based royalty relates solely to the licence (see 9.5 above), which is the only performance obligation in the contract. The entity concludes that recognition of the £2 million fixed consideration as revenue rateably over time plus recognition of the royalty as revenue as and when the customer's sales of items using the team name or logo occur reasonably depicts the entity's progress towards complete satisfaction of the licence performance obligation.

In Illustration 9-8 above, the fixed consideration of £2 million is an explicit term in the contract with the customer. In some contracts, fixed consideration is implied, such as when a guaranteed minimum amount of royalties is part of the transaction price.

In addition, as discussed in Question 9-5 in 9.3.1 above, many licences that provide a right to access intellectual property constitute a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (e.g., a series of distinct periods of access to intellectual property, such as monthly access or quarterly access). In cases where the criteria for a performance obligation to be accounted for as a series of distinct goods or services have been met, an entity needs to consider whether any variable consideration in the contract (e.g., sales-based or usage-based royalties) must be allocated directly to the distinct periods of access, if the condition for the variable consideration allocation exception is met (see 7.3 above). The allocation of sales-based or usage-based royalties in this manner generally results in the recognition of royalties as revenue when (or as) the customer's underlying sales or usage occurs.

An entity might need to apply significant judgement to determine the appropriate pattern of revenue recognition for royalties received on a licence that provides a right to access intellectual property.

Frequently asked questions

Question 9-8: Can the recognition constraint for sales-based or usage-based royalties be applied to royalties that are paid in consideration for sales of intellectual property (rather than just licences of intellectual property)?

Section 23 specifies that the royalty recognition constraint only applies to sales-based or usage-based royalty provided in exchange for a licence of intellectual property when the licence of intellectual property is the sole or predominant item to which the royalty relates (see 9.5 above). [FRS 102.23.48]. This is consistent with IFRS 15. As noted in the Basis for Conclusions on IFRS 15, the IASB discussed but decided not to expand the scope of the royalty recognition constraint to include sales of intellectual property. The IASB also stated that the royalty recognition constraint is intended to apply only to limited circumstances (i.e., those circumstances involving licences of intellectual property) and, therefore, entities cannot apply it by analogy to other types of transactions. [IFRS 15.BC421, IFRS 15.BC421F].

Question 9-9: If a contract for a licence of intellectual property includes payments with fixed amounts (e.g., milestone payments) that are determined by reference to sales-based or usage-based thresholds, would the royalty recognition constraint need to be applied?

How we see it

We generally believe the royalty recognition constraint would apply to fixed amounts of variable consideration (i.e., fixed amounts of consideration that are contingent on the occurrence of a future event), such as milestone payments, provided the amounts are determined by reference to sales-based or usage-based thresholds. This is the case even if those payments are not referred to as 'royalties' under the terms of the contract. However, entities need to apply judgement and carefully evaluate the facts and circumstances of their contracts for licences of intellectual property to determine whether these types of payments need to be accounted for using the royalty recognition constraint.

Consider the following Illustration:

Illustration 9-9: Application of the royalty recognition constraint to a milestone payment

An entity enters into a contract to grant a customer a right to use the entity's intellectual property. The contract contains payment terms that include a £10 million milestone payment that is payable to the entity once the customer has achieved sales of £100 million associated with the licence.

The entity determines that the milestone payment is based on the customer's subsequent sales and represents variable consideration because it is contingent on the customer's sales reaching £100 million. The entity accounts for the £10 million milestone payment in accordance with the royalty recognition constraint and only recognises revenue for the milestone payment once the customer's sales reach £100 million.

Question 9-10: If a contract for a licence of intellectual property includes a milestone payment based on the first commercial sale, would the royalty recognition constraint apply?

How we see it

We generally believe it would be acceptable for an entity to apply the royalty recognition constraint to a milestone payment that is contingent on the customer's first commercial sale of a product using the entity's intellectual property. This is because the milestone payment is linked to a sales-based or usage-based threshold (i.e., the milestone payment is based on the customer's sales).

Consider the following Illustration:

Illustration 9-10: Application of the royalty recognition constraint to a milestone payment based on the first commercial sale

An entity enters into a contract to grant a customer a right to use the entity's intellectual property. The contract contains payment terms that include a £10 million milestone payment that is payable to the entity upon the customer's first commercial sale of a product that uses the entity's intellectual property. The entity determines that the milestone payment is based on the customer's subsequent sales and represents variable consideration because it is contingent on the customer's first commercial sale. It accounts for the £10 million milestone payment in accordance with the royalty recognition constraint and only recognises revenue for the milestone payment upon the customer's first commercial sale.

In contrast, if a milestone payment is contingent on metrics that are not determined by reference to sales-based or usage-based thresholds and that are substantive (e.g., regulatory approval), the royalty recognition constraint must not be applied (i.e., the milestone payment is not based on the customer's sales). Rather, the general variable consideration requirements need to be applied.

As discussed in Question 6-12 in 6.2.3 above, we expect entities to conclude, in many instances, that milestone payments contingent on regulatory approval (e.g., regulatory approval of a new drug) are constrained, preventing them from recognising these payments until the uncertainty associated with the payments is resolved.

Question 9-11: Does the application of the royalty recognition constraint preclude the requirement to adhere to the allocation objective in Section 23?

If an entity applies the royalty recognition constraint, it still needs to adhere to the allocation objective in Section 23 (discussed in 7 above) if the contract contains multiple performance obligations. This is consistent with IFRS 15.

Under IFRS 15, it is clear from paragraphs IFRS 15.BC421A and BC421G that allocation of sales-based or usage-based royalties to two or more different performance obligations was contemplated by the IASB. This is also consistent with Example 60 in IFRS 15 (see Illustration 9-6 above), which clarifies sales-based or usage-based royalties need to be allocated to each performance obligation. [IFRS 15.IE Example 60, IFRS 15.IE308]. Therefore, regardless of whether an entity applies the royalty recognition constraint or the general constraint on variable consideration, it is still required to allocate sales-based or usage-based royalties to separate performance obligations in a contract in a manner consistent with the allocation objective (see 7 above). To perform such an allocation, an entity might need to include expected royalties in its estimate of the stand-alone selling price of one or more of the performance obligations.

Question 9-12: Can an entity recognise revenue for sales-based or usage-based royalties for licences of intellectual property on a lag if actual sales or usage data is not available at the end of a reporting period?

Section 23 requires that sales-based or usage-based royalties promised in exchange for licences of intellectual property be recognised as revenue at the later of when: (1) the subsequent sales or usage occurs and (2) the performance obligation to which the sales-based or usage-based royalties relate has been satisfied (or partially satisfied). [FRS 102.23.48].

How we see it

After the conditions in the royalty recognition constraint guidance have been met (i.e., the underlying sales or usage has occurred and the performance obligation to which the royalties relate has been satisfied (or partially satisfied)), we believe that licensors without actual sales or usage data from the licensee need to make an estimate of royalties earned in the current reporting period.

Question 9-13: How does a minimum guarantee affect the recognition of sales-based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied at a point in time?¹⁹⁰

Generally, a minimum guaranteed amount of sales based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied at a point in time (i.e., a right-to-use licence) would need to be recognised as revenue at the point in time that the entity transfers control of the licence to the customer (see 9.3.2 above). Any royalties above the fixed minimum would be recognised in accordance with the royalty recognition constraint (i.e., at the later of when the sale or usage occurs or when the entity satisfies the performance obligation to which some or all of the royalty has been allocated).

Question 9-14: How does a minimum guarantee affect the recognition of sales-based or usage-based royalties promised in exchange for a licence of intellectual property that is satisfied over time?¹⁹¹

Generally, various recognition approaches could be acceptable for minimum guarantees promised in exchange for licences of intellectual property that are satisfied over time (i.e., right-to-access licences, see 9.3.1 above). This is because this question is asking what an appropriate measure of progress is for such contracts and Section 23 permits reasonable judgement when selecting a measure of progress. Because Section 23 does not prescribe a single approach that must be applied in all circumstances in which a sales-based or usage-based royalty is promised in exchange for a licence of intellectual property and the contract includes a minimum guaranteed amount, an entity needs to consider the nature of its arrangements and make sure that the measure of progress it selects does not override the core principle and objective of Section 23 which is for “an entity to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services”. [FRS 102.23.4]. An entity would need to disclose the accounting policy it selects because it is likely that this would affect the timing of revenue recognised.

An entity could consider two approaches. Under one approach, an entity would estimate the total consideration (i.e., the fixed minimum and the variable consideration from future royalties) and apply an appropriate measure of progress to recognise revenue as the entity satisfies the performance obligation, subject to the royalty recognition constraint. Alternatively, under the other approach, an entity could apply a measure of progress to the fixed consideration and begin recognising the variable component after exceeding the fixed amount on a cumulative basis.

The first approach can be applied in two different ways, as follows:

- View A: If an entity expects royalties to exceed the minimum guarantee, the entity might determine that an output-based measure is an appropriate measure of progress and apply the right-to-invoice practical expedient (i.e., paragraph 23.103, see 8.1.4.B above) because the royalties due for each period correlate directly with the value to the customer of the entity’s performance each period. As a result of applying the practical expedient for recognising revenue, the entity would not need to estimate the expected royalties beyond determining whether it expects, at contract inception, that the royalties will exceed the minimum guarantee. However, the entity would be required to update that assessment at the end of each reporting period. It is important to note that this view is likely to be appropriate if the entity expects cumulative royalties to exceed the minimum guarantee.
- View B: An entity estimates the transaction price for the performance obligation (including both fixed and variable consideration) and recognises revenue using an appropriate measure of progress, subject to the royalty recognition constraint. If an entity does not expect cumulative royalties to exceed the minimum guarantee, the measure of progress is applied to the minimum guarantee since the transaction price will at least equal the fixed amount.

The second approach can be summarised, as follows:

- View C: An entity recognises the minimum guarantee (i.e., the fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee.

¹⁹⁰ Based on FASB TRG Agenda paper no. 58, *Sales-Based or Usage-Based Royalty with Minimum Guarantee*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

¹⁹¹ Based on FASB TRG Agenda paper no. 58, *Sales-Based or Usage-Based Royalty with Minimum Guarantee*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

Note that, in order for an entity to apply View C, the over time licence would have to be considered a series of distinct goods or services (i.e., a series of distinct time periods) and the variable consideration (i.e., the royalties in excess of the minimum guarantee) would have to be allocated to the distinct time periods to which they relate.

To illustrate the application of these views, consider the following Illustration:

Illustration 9-11: Accounting for a licence of intellectual property that is satisfied over time in exchange for a minimum guarantee and sales-based royalty

An entity enters into a five-year arrangement to licence a trademark. The trademark is determined to be a licence of intellectual property that is satisfied over time (i.e., a right-to-access licence, see 9.3.1 above)). The licence requires the customer to pay a sales-based royalty of 5% of its gross sales associated with the trademark. However, the contract includes a guarantee that the entity will receive a minimum of £5 million for the entire five-year period.

The customer's actual gross sales associated with the trademark and the related royalties each year are, as follows (this information is not known at the beginning of the contract):

Year 1 - £15 million (royalties equal £750,000)

Year 2 - £30 million (royalties equal £1.5 million)

Year 3 - £40 million (royalties equal £2 million)

Year 4 - £20 million (royalties equal £1 million)

Year 5 - £60 million (royalties equal £3 million)

Total royalties equal £8.25 million.

View A: The entity expects total royalties to exceed the minimum guarantee. The entity determines that an output-based measure is an appropriate measure of progress and applies the right-to-invoice practical expedient because the royalties due for each period correlate directly with the value to the customer of the entity's performance for each period. The entity recognises revenue from the sales-based royalty when the customer's subsequent sales occur.

(in £'000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Annual revenue	750	1,500	2,000	1,000	3,000
Cumulative revenue	750	2,250	4,250	5,250	8,250

View B: The entity estimates the transaction price (including fixed and variable consideration) for the contract. The entity determines that time elapsed is an appropriate measure of progress and recognises revenue rateably over the five-year term of the contract, subject to the royalty recognition constraint (i.e., cumulative revenue recognised cannot exceed the cumulative royalties received once the minimum guarantee has been met).

(in £'000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Royalties (cumulative)	750	2,250	4,250	5,250	8,250
Fixed + Variable (rateable) ^a	1,650	1,650	1,650	1,650	1,650
Annual revenue	1,650	1,650	1,650	300	3,000
Cumulative revenue	1,650	3,300	4,950	5,250^b	8,250

a. Assuming the entity's estimated transaction price (including both fixed and variable consideration) is £8.25 million, the annual revenue that could be recognised is £1.65 million (£8.25 million divided by five years, being contract term).

b. In Year 4, the cumulative revenue using a time-elapsed measure of progress of £6.6 million (£4.95 million plus £1.65 million) exceeds the cumulative royalties received (£5.25 million). As such, the total cumulative revenue recognised through to the end of Year 4 is constrained to the total cumulative royalties received of £5.25 million.

View C: The entity recognises the minimum guarantee (i.e., the fixed consideration) using an appropriate measure of progress and recognises royalties only when cumulative royalties exceed the minimum guarantee. The entity determines that time elapsed is an appropriate measure of progress.

The entity applies the royalty recognition constraint to the sales-based royalties that are in excess of the minimum guarantee (i.e., recognise the royalties as revenue when the minimum guarantee is exceeded on a cumulative basis). The variable consideration (royalties in excess of the minimum guarantee) is allocated to the distinct periods using the variable consideration allocation exception (see 7.3 above). [FRS 102.23.74].

As previously discussed, in order for an entity to apply View C, the over time licence would have to be considered a series of distinct goods or services (i.e., a series of distinct time periods) and the variable consideration (i.e., the royalties that are in excess of the minimum guarantee) would have to be allocated to the distinct time periods to which they relate.

(in £'000s)	Year 1	Year 2	Year 3	Year 4	Year 5
Royalties received	750	1,500	2,000	1,000	3,000
Royalties (cumulative)	750	2,250	4,250	5,250	8,250
Fixed (rateable) ^a	1,000	1,000	1,000	1,000	1,000
Annual revenue	1,000	1,000	1,000	1,250 ^b	4,000 ^c
Cumulative revenue	1,000	2,000	3,000	4,250	8,250

- Because the minimum guarantee is £5 million over the contract term, the annual revenue (excluding royalties that are in excess of the minimum guarantee) is £1 million (£5 million divided by five years, being the contract term).
- In Year 4, the cumulative royalties received (£5.25 million) exceed the total minimum guarantee (£5 million) by £250,000. As such, the annual revenue recognised in Year 4 is £1.25 million (£1 million annual revenue plus £250,000 of royalties in excess of the minimum guarantee).
- In Year 5, the annual revenue recognised (£4 million) is calculated as the £1 million annual revenue plus the royalties for that year (£3 million) since the royalties exceeded the minimum guarantee in Year 4.

Note that other measures of progress, in addition to those set out above, could be acceptable because the Section 23 permits entities to use judgement in selecting an appropriate measure of progress. However, it would not be acceptable for entities to apply any measure of progress in any circumstance. For example, it would not be acceptable to apply multiple measures of progress to a single performance obligation, such as one measure for fixed consideration and a different one for variable consideration. It would also not be appropriate for an entity to apply the breakage model in paragraph 23.130 (see 8.9 above) because it is likely that a customer would not have an unexercised right in a licence arrangement if the entity were providing the customer with access to its intellectual property over the entire term of the arrangement. [FRS 102.23.130]. Another approach that would not be appropriate is one that ignores the royalty recognition constraint application guidance in paragraph 23.48 (see 9.5 above), which requires revenue to be recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (in whole or in part). [FRS 102.23.48].

Question 9-15: Can entities apply the royalty recognition constraint for sales-based or usage-based royalties if they do not own the intellectual property or control the intellectual property as a principal in the arrangement?

How we see it

We generally believe entities can apply the royalty recognition constraint if their revenue is based on a sales-based or usage-based royalty from a licence of intellectual property, but they do not own or control the intellectual property as a principal in the arrangement.

It is important to note that this view applies only to licences of intellectual property for which some or all of the consideration received by both the licensor and the agent is in the form of a sales-based or usage-based royalty. Entities cannot analogise to this view for other situations.

Entities need to disclose their use of the royalty recognition constraint because it is likely to affect the amount and timing of revenue recognised.

Consider the following Illustration:

Illustration 9-12: Application of the royalty recognition constraint as an agent

University U has intellectual property for its logo. Company Z, acting as an agent for University U, identifies an apparel company looking to licence University U's logo to put it on merchandise. University U is paid a royalty based on sales and usage of its intellectual property (the logo) by the licensee (the apparel company). Company Z receives a portion of the royalty earned by University U. Company Z does not control the intellectual property at any point during the arrangement and its ability to receive consideration from University U depends on the licensing of University U's intellectual property. We believe that application of the royalty recognition constraint would be appropriate in this example because the royalties earned by University U and, in effect, the amount Company Z expects to be entitled to receive, are directly tied to the usage of the intellectual property.

Question 9-16: Can entities recognise sales-based or usage-based royalties before the sale or usage of the intellectual property occurs if they have historical information that is highly predictive of future royalty amounts?

In accordance with paragraph 23.48 (see 9.5 above), revenue from a sales-based or usage-based royalty promised in exchange for a licence of intellectual property is recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (in whole or in part).

How we see it

Revenue recognition cannot be accelerated even if an entity has historical information that is highly predictive of future royalty amounts. That is, the use of the royalty recognition constraint is not optional.

Question 9-17: Must an entity apply the royalty recognition constraint when the royalty is calculated on a financial metric that is not solely based on sales or usage?

How we see it

In certain circumstances, we believe the royalty recognition constraint can be applied when the royalty is calculated on a financial metric that is not solely based on sales or usage.

We believe that a metric such as gross profit (commonly defined as sales less cost of goods sold) is largely attributable to sales. Judgement will be required to determine whether the royalty recognition constraint needs to be applied if the royalty is based on a different financial metric that is not solely based on sales or usage.

A licensor, for example, might be entitled to a fee based on a fixed percentage of gross profit generated by the licensee for the entire term of the contract. If the royalty is calculated using gross profit, the royalty recognition constraint might be applied.

Question 9-18: Does the royalty recognition constraint apply if the licence of intellectual property is not distinct from other goods or services in the contract?

If the licence of intellectual property is not distinct from other goods or services in the contract, the royalty recognition constraint applies only if the licence is the predominant item to which the royalty relates. As discussed in 9.5 above, paragraph 23.48 requires that the royalty recognition constraint be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a licence of intellectual property. As an example, IFRS 15 states that the licence of intellectual property might be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates. [IFRS 15.B63A]. The Basis for Conclusions on IFRS 15 further observed that the royalty recognition constraint would also apply when there is no single licence of intellectual property is the predominant item to which the royalty relates, but the royalty predominantly relates to two or more licences of intellectual property in the contract. [IFRS 15.BC421G].

The IASB noted in the Basis for Conclusions on IFRS 15 that applying the royalty recognition constraint only when the royalty solely relates to a licence that is a separate performance obligation would have excessively restricted its application. Furthermore, it noted that applying the royalty recognition constraint to those royalty arrangements in which the licence is the predominant feature to which the royalty relates provides more useful information to users that are likely to view those arrangements as licensing arrangements. [IFRS 15.BC421D].

Neither Section 23 nor IFRS 15 provides a bright line for determining the 'predominant' item in a contract that includes a licence of intellectual property. The IASB acknowledged in the Basis for Conclusions on IFRS 15 that significant judgement is required to determine when a licence is the predominant item to which a royalty relates. However, the judgement for determining whether a licence is the predominant item is likely to be less than the judgement needed to apply the general requirements for variable consideration to such contracts. [IFRS 15.BC421E].

Question 9-19: Can an entity recognise revenue at an expected average rate when a licence of intellectual property has royalty rates that increase over time?

As discussed in 9.5 above, paragraph 23.48 requires that sales-based or usage-based royalties received in exchange for licences of intellectual property be recognised at the later of when: (1) the subsequent sale or usage occurs; or (2) the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated is satisfied (wholly or partially). That is, an entity recognises the royalties as revenue when (or as) the customer's subsequent sales or usage occurs, unless that recognition pattern accelerates revenue recognition ahead of the entity's satisfaction of the performance obligation to which the royalty solely (or partially) relates based on an appropriate measure of progress.

In contrast to the declining royalty rate scenario discussed by the FASB in the Basis for Conclusions to its revenue standard, and discussed above,¹⁹² we would not expect an increasing royalty rate to cause revenue to be recognised ahead of an entity's performance if an entity's recognises revenue as the related sales or usage occurs at the contractual rate in place at the time. However, if an entity were to use an output measure based on an average expected royalty rate over the full contract term, it would be accelerating revenue recognition ahead of the related sales or usage, which would be counter to the principle of the royalty recognition constraint. In this case, it would be inappropriate to recognise revenue using an output measure based on an average expected royalty rate over the full contract term.

Question 9-20: How would an entity distinguish between a contract that contains an option to purchase additional licences and a contract in which additional licence usage might be subject to the royalty recognition constraint?¹⁹³

A technology entity might, for example, provide the customer with the option to purchase or use additional copies of software in exchange for additional consideration, and the customer might have the ability to replicate the software or download additional copies without further assistance from the technology entity. Questions have been raised about whether this type of option is an option to acquire additional software rights (i.e., an option for additional goods, as discussed in 5.6 above) or whether the extra copies represent additional usage of the software licence and, therefore, whether the additional usage gives rise to a sales-based or usage-based royalty that is likely to be subject to the royalty recognition constraint.

The entity has to exercise judgement to determine whether the contract is for a single licence or for multiple licences. In doing so, the entity considers whether the additional copies are distinct goods or services. Additional licences are typically distinct because the customer can benefit from the additional licence on its own, providing it does not modify, customise or have an interdependency with existing licences. Further, while the customer might be able to replicate the software or download additional copies without the assistance of the technology entity, the entity might still be required to grant additional rights to the customer for the use of the additional copies of software.

An entity has provided a customer with an option if the customer can decide to purchase additional distinct copies of the software, and the entity is required to transfer those additional rights to the customer. See 5.6 above for further discussion of the accounting for customer options for additional goods and services, including how to evaluate whether the option represents a material right. Conversely, if the contract requires the customer to pay usage-based fees to compensate the vendor for the rights to use the software that have already been transferred, these fees are treated as variable consideration (see 6.2 above). This conclusion is consistent with the discussion in Question 5-20 in 5.6 above. However, when the software licence is the sole or predominant item to which the usage-based fees relate, in accordance with paragraph 23.48, the fees are accounted for as sales-based and usage-based royalties (as discussed in 9.5 above) rather than the general variable consideration requirements.

¹⁹² ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, April 2016, paragraph BC71.

¹⁹³ Based on TRG Agenda paper no. 45, *Licences - Specific Application Issues About Restrictions and Renewals*, dated 9 November 2015.

10 Other measurement and recognition topics

10.1 Warranties

Warranties are commonly included in arrangements to sell goods or services. [FRS 102.23.26]. They might be explicitly included in the contractual arrangement with a customer or might be required by law or regulation. In addition, an entity might have established an implicit policy of providing warranty services to maintain a desired level of satisfaction among its customers. Whether explicit or implicit, warranties extend an entity's obligations beyond the transfer of control of the good or service to the customer, requiring it to stand ready to perform under the warranty over the life of the warranty obligation.

Warranties will normally meet the definition of an insurance contract, which is a contract in which "one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder". [FRS 102 Appendix I]. Therefore, before assessing warranties under Section 23, an entity needs to consider whether the warranty might be within the scope of FRS 103 (also see Chapter 38 at 3.2). To make this assessment, entities need to consider whether the scope exception in FRS 103 applies for "product warranties issued directly by a manufacturer, dealer or retailer". [FRS 103.1.7(a)]. For further discussion of the requirements of FRS 103, see Chapter 38.

The price of a warranty might be included in the overall purchase price or listed separately as an optional product. If the warranty is not separately purchased and it is within the scope of FRS 103, the contract consideration will need to be allocated between the standards - see 3.1.5 and 7.5 above for further discussion.

For warranties within the scope of Section 23, while the nature of a warranty can vary significantly across industries and contracts, it identifies two types of warranties:

- Warranty that provides assurance that the product complies with agreed-upon specifications (referred as 'assurance-type warranties').
- Warranty (or part of the warranty) that provides the customer with a service to the customer in addition to assurance that the product complies with agreed-upon specifications (referred as 'service-type warranties').

10.1.1 Determining whether a warranty is an assurance-type or service-type warranty

If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer, beyond ensuring that the product complies with agreed-upon specifications, the entity is providing a service-type warranty. Otherwise, it is an assurance-type warranty, which provides the customer with assurance that the product complies with agreed-upon specifications. [FRS 102.23.27].

In some cases, it might be difficult to determine whether a warranty provides a customer with a service in addition to the assurance that the delivered product is as specified in the contract. To help entities make that assessment, Section 23 provides the following guidance: [FRS 102.23.27]

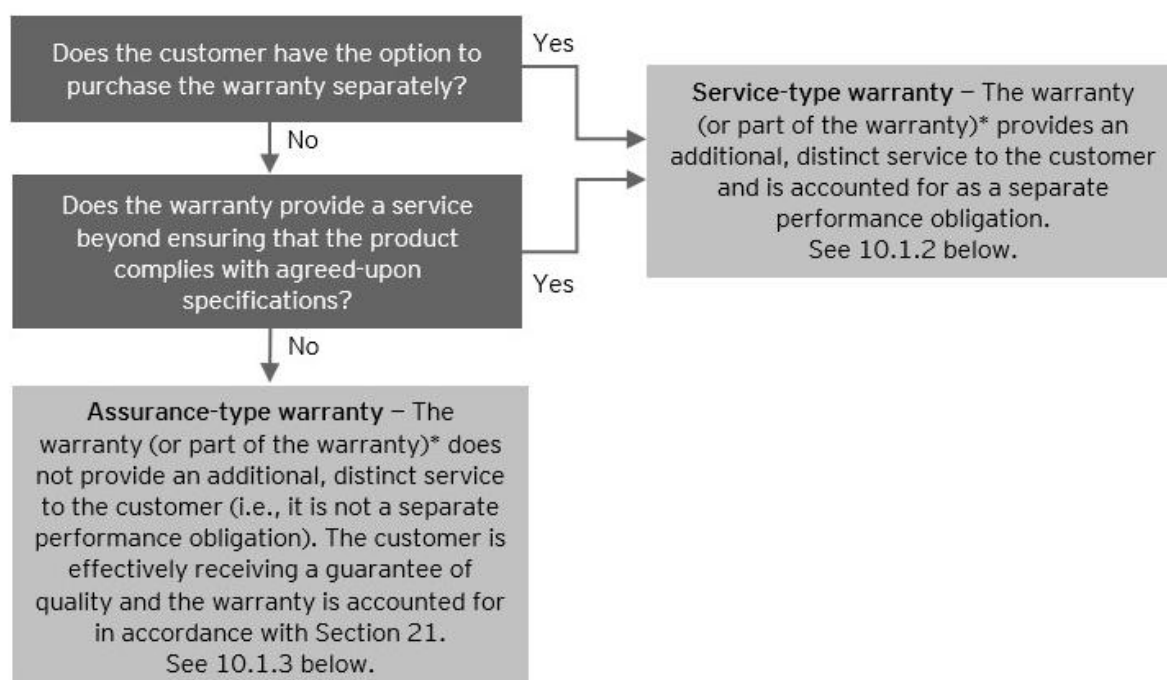
Extract from Section 23

- 23.27** An entity shall account for the warranty in accordance with Section 21 *Provisions and Contingencies* unless the warranty, or part of the warranty, provides the customer with an additional service. An additional service is a service in addition to the assurance that the product complies with agreed-upon specifications. In assessing whether a warranty provides the customer with an additional service, an entity shall consider:
- (a) Whether the warranty can be purchased separately - if the entity provides the customer with the option to purchase a warranty separately, the warranty provides the customer with an additional service.
 - (b) Whether the warranty is required by law - if the entity is required by law to provide a warranty, the warranty does not provide the customer with an additional service.
 - (c) The length of the warranty coverage - the longer the coverage period, the more likely it is that the warranty provides the customer with an additional service.
 - (d) The nature of the tasks that the entity promises to perform - if it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (eg a return shipping service for a defective product), then those tasks are unlikely to provide the customer with an additional service.

Section 23 and IFRS 15 are consistent in this area and entities reporting under FRS 102 could consider further guidance provided by IFRS 15. IFRS 15 states that a law that requires an entity to pay compensation if its products cause harm or damage does not give rise to a performance obligation. For example, a manufacturer might sell products in a jurisdiction in which the law holds the manufacturer liable for any damages (for example, to personal property) that might be caused by a consumer using a product for its intended purpose. Similarly, an entity's promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark or other infringement by the entity's products does not give rise to a performance obligation. [IFRS 15.B33]. The entity accounts for such obligations in accordance with Section 21.

The following flow chart illustrates these requirements:

Figure 10-1: Determining whether a warranty is an assurance-type or service-type warranty



* Some contracts may include both assurance-type and service-type warranties. See 10.1.4 below for further discussion.

How we see it

Entities might need to exercise significant judgement when determining whether a warranty is an assurance-type or service-type warranty. An entity's evaluation might be affected by several factors, including common warranty practices within its industry and the entity's business practices related to warranties. For example, consider an automotive manufacturer that provides a five-year warranty on a luxury vehicle and a three-year warranty on a standard vehicle. The manufacturer might conclude that the longer warranty period is not an additional service because it believes the materials used to construct the luxury vehicle are of a higher quality and that latent defects would take longer to appear. In contrast, the manufacturer might also consider the length of the warranty period and the nature of the services provided under the warranty and conclude that the five-year warranty period, or some portion of it, is an additional service that needs to be accounted for as a service-type warranty. Section 23 excludes assurance-type warranties, which are accounted for in accordance with Section 21.

As a reminder (and as discussed in 3.1.5 above), elements of a contract with a customer might be in the scope of other sections of FRS 102 or other standards and not within the scope of Section 23. Certain entities, particularly those that act as an agent in a revenue transaction and provide quality assurance or similar promises to a customer's customer, will need to consider whether such promises are in the scope of other sections of FRS 102 or other standards (e.g., Section 11, Section 12, FRS 103) before applying the warranty guidance in Section 23.

Frequently asked questions

Question 10-1: How does an entity evaluate whether a product warranty is a service-type warranty (i.e., a performance obligation) when it is not separately priced?¹⁹⁴

Generally, the evaluation of whether a warranty provides a service (in addition to the assurance that the product complies with agreed specifications) requires judgement and depends on the facts and circumstances. There is no bright line in the standard on what constitutes a service-type warranty, beyond it being separately priced.

However, paragraph 23.27 includes three other factors that need to be considered in each evaluation: (1) whether the warranty is required by law; (2) the length of the warranty coverage; and (3) the nature of the tasks that the entity promises to perform. Consider the following Illustration which shows the factors an entity considers in assessing whether a product warranty is a service-type warranty:

Illustration 10-1: Consideration of service-type warranty factors

A luggage company provides a life-time warranty to repair broken or damaged baggage free of charge. The luggage company evaluates the three factors in paragraph 23.27 and determines that the warranty is a performance obligation in addition to the assurance that the product complies with agreed-upon specifications because: (1) there is no law that requires the luggage company to make a promise for the lifetime of the product; (2) the length of the warranty is for the life of the baggage; and (3) the tasks include both repairs to baggage that does not meet the promised specifications and repairs for broken or damaged baggage.

Furthermore, entities need to evaluate each type of warranty offered to determine the appropriate accounting treatment.

Question 10-2: How would an entity account for a customary business practice of providing repairs provided outside the stated contractual warranty period?

An entity must consider all facts and circumstances, including the factors in paragraph 23.27 (e.g., the nature of the services provided, the length of the implied warranty period) to determine whether a customary business practice of providing repairs outside the stated contractual warranty period needs to be accounted for as an implied assurance-type or service-type warranty. For example, an equipment manufacturer might give its customers a standard product warranty that provides assurance that the product complies with agreed-upon specifications for one year from the date of purchase. However, the entity might also provide an implied warranty by frequently repairing products for free after the one-year standard warranty period has ended. See 5.1 above for a discussion of implied promises in a contract with a customer.

If the entity determines that the repairs made during the implied warranty period generally involve defects that existed when the product was sold and the repairs occur shortly after the assurance warranty period, it is likely that the entity would conclude that the repairs are covered by an assurance-type warranty. That is, the term of the assurance-type warranty might be longer than that stated in the contract. However, all facts need to be considered to reach a conclusion.

If the entity determines that the repairs made during the implied warranty period are covered by a service-type warranty (because the entity is providing a service to the customer beyond fixing defects that existed at the time of sale), it also needs to consider whether the term of the service-type warranty is longer than that stated in the contract.

Question 10-3: Does an entity account for a customer's return of a defective item in exchange for compensation (i.e., not for a replacement item) as a right of return or an assurance-type warranty?

How we see it

We believe that an entity that is the principal in the transaction must account for a customer's right to return a defective item in return for cash (instead of a replacement item) under the right of return guidance in paragraphs 23.51 to 23.57 (see 6.4 above), rather than as an assurance-type warranty.

¹⁹⁴ Based on TRG Agenda paper no. 29, *Warranties*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

In Example 4 in Section 20, a manufacturer recognises a provision for warranties that it gives to its customers at the time of sale of the product where it undertakes to make good, by repair or replacement, manufacturing defects that become apparent within the warranty period (see Chapter 24 at 3.8.1). [FRS 102.21A.4]. Similarly, the Basis for Conclusions on IFRS 15 states that "... the boards decided that an entity should recognise an assurance-type warranty as a separate liability to replace or repair a defective product". [IFRS 15.BC376]. This description of an assurance-type warranty does not include defective products that are returned for a refund. It only contemplates defective products that are replaced or repaired. See 6.4 above for a discussion of rights of return.

If an entity provides customers with an option to receive either a cash refund or a replacement product, the entity is required to estimate which options customers will choose and account for each option accordingly. That is, the entity needs to estimate the expected returns in exchange for cash as part of its accounting for estimated returns and account for the expected returns in exchange for a replacement product under the warranty guidance.

However, there might be limited circumstances in which the cash paid to a customer for a defective item would need to be accounted for in accordance with the warranty guidance, instead of as a right of return. For example, an entity might pay cash to a customer as reimbursement for third-party costs incurred to repair a defective item. In this case, the cash payment to the customer was incurred to fulfil the entity's warranty obligation. This assessment requires judgement and depends on the facts and circumstances.

Similarly, entities will need to apply judgement in determining the appropriate treatment for product recalls (also see Question 8-24 in 8.3.1 above).

Question 10-4: Are liquidated damages, penalties or compensation from other similar clauses accounted for as variable consideration or as warranties under Section 23?

See response to Question 6-4 in 6.2.1 above.

10.1.2 Service-type warranties

A service-type warranty represents a distinct service and is a separate performance obligation. [FRS 102.23.28]. Therefore, using the relative stand-alone selling price of the warranty, an entity allocates a portion of the transaction price to the service-type warranty (see 7 above, also see 7.1 above for a discussion on determining stand-alone selling prices, which might not be equal to the contractually stated price). The entity then recognises the allocated revenue over the period in which the service-type warranty service is provided. This is because it is likely that the customer receives and consumes the benefits of the warranty as the entity performs (i.e., it is likely that the warranty performance obligation is satisfied over time in accordance with paragraph 23.81(a), see 8.1.1 above).

Judgement might be required to determine the appropriate pattern of revenue recognition associated with service-type warranties. For example, an entity might determine that it provides the warranty service continuously over the warranty period (i.e., the performance obligation is an obligation to 'stand ready to perform' during the stated warranty period). An entity that makes this determination is likely to recognise revenue rateably over the warranty period. An entity might also conclude that a different pattern of recognition is appropriate based on data it has collected about when it provides such services. For example, an entity might recognise little or no revenue in the first year of a three-year service-type warranty if its historical data indicates that it only provides warranty services in the second and third years of the warranty period.

See discussions in 8.1.4 above which describe considerations for determining the appropriate pattern of revenue recognition, including those for stand-ready obligations. If payment for the service-type warranty is received upfront, an entity must also evaluate whether a financing component exists (see 6.5 above).

In some instances, entities that sell service-type warranties will buy insurance to protect themselves against the potential costs of performing under such warranties. Although the anticipated insurance proceeds might offset any costs that the entity might incur, immediate revenue recognition for the price of the service-type warranty is not appropriate. The entity has not been relieved of its obligation to perform under the terms of the warranty contract and, therefore, a liability still exists. Accordingly, the warranty obligation and any proceeds related to the insurance coverage need to be accounted for separately (unless the insurer has legally assumed the warranty obligation and the customer has acknowledged that fact).

As discussed in 7.1 above, stand-alone selling prices are determined at contract inception and are not updated to reflect changes in the period between contract inception and when performance is complete (unless the contract has been modified and the contract modification is accounted for as a new or separate contract - see 7.1.3 above). Accordingly, an entity generally would not change the amount of transaction price it originally allocated to the service-type warranty at contract inception. This would be the case even if, for example, an entity discovers two months after a product is shipped that the cost of a part acquired from a third-party manufacturer has tripled and that, as a result, it will cost the entity significantly more to replace that part if a warranty claim is made. However, for future contracts involving the same warranty, the entity would need to determine whether to revise the stand-alone selling price because of the increase in the costs to satisfy the warranty and, if so, use that revised price for future allocations (see 7.1.3 above).

10.1.3 Assurance-type warranties

Assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a guarantee of quality. These types of warranties are accounted for as warranty obligations and the estimated cost of satisfying them is recognised in accordance with the requirements in Section 21. [FRS 102.23.27]. Once recorded, the warranty liability is assessed on an ongoing basis in accordance with Section 21 (see Chapter 24).

An entity recognises revenue for sales of goods or services, including assurance-type warranties, when control of the goods or services is transferred to the customer, assuming that the arrangement meets the criteria to be considered a contract under Section 23 (see 4.1 above).

Assurance-type warranties are accounted for outside of the scope of Section 23. Therefore, if an entity elects to use a costs incurred measure of progress for over time revenue recognition of the related good or service, the costs of satisfying an assurance-type warranty are excluded (i.e., excluded from both the numerator and the denominator in the measure of progress calculation - see 8.1.4 above for further discussion on measuring progress over time).

10.1.4 Contracts that contain both assurance and service-type warranties

If an entity provides both an assurance-type and service-type warranty within a contract and the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognised over the period the warranty services are provided). [FRS 102.23.28]. This accounting ensures the entity does not overstate the recognition of revenue at the time the product is transferred to the customer.

When an assurance-type warranty and a service-type warranty are both present in a contract with a customer and can reasonably account for them separately, an entity is required to recognise a provision for the expected costs associated with the assurance-type warranty and defer the revenue for the service-type warranty, as illustrated below:

Illustration 10-2: Service-type and assurance-type warranties

An entity manufactures and sells computers that include an assurance-type warranty for the first 90 days. The entity offers an optional 'extended coverage' plan under which it will repair or replace any defective part for three years from the expiration of the assurance-type warranty. Since the optional 'extended coverage' plan is sold separately, the entity determines that the three years of extended coverage represent a separate performance obligation (i.e., a service-type warranty).

The total transaction price for the sale of a computer and the extended warranty is £3,600. The entity determines that the stand-alone selling prices of the computer and the extended warranty are £3,200 and £400, respectively. The inventory value of the computer is £1,440. Furthermore, the entity estimates that, based on its experience, it will incur £200 in costs to repair defects that arise within the 90-day coverage period for the assurance-type warranty. As a result, the entity will record the following entries:

Dr	Cash/Trade receivables	£3,600	
Dr	Warranty expense	£200	
	Cr Provisions for warranty costs (assurance-type warranty)		£200
	Cr Contract liability (service-type warranty)		£400
	Cr Revenue		£3,200

To record revenue and liabilities related to warranties.

Dr	Cost of goods sold	£1,440	
	Cr Inventory		£1,440

To relieve inventory and recognise cost of goods sold.

The entity derecognises the warranty liability associated with the assurance-type warranty as actual warranty costs are incurred during the first 90 days after the customer receives the computer. The entity recognises the contract liability associated with the service-type warranty as revenue during the contract warranty period and recognises the costs associated with providing the service-type warranty as they are incurred. The entity would need to be able to determine whether the repair costs incurred are applied against the warranty reserve it had already established for claims that occur during the first 90 days or recognised as an expense as incurred.

Accounting for both assurance-type warranties and service-type warranties in the same transaction can be complex. Entities might need to develop processes to match individual warranty claims with the specific warranty plans so that claims can be analysed for the appropriate accounting treatment. This individual assessment of warranty claims is necessary because the assurance-type warranty costs will have been provided for previously, while the service-type warranty costs are expenses that need to be recognised in the period in which they are incurred, as illustrated below:

Illustration 10-3: Service-type and assurance-type warranty costs

Assume the same facts as in Illustration 10-2 above, but assume the entity has sold 500 computers during the year. In January of the following year, £10,000 of warranty claims are submitted by customers. The entity analyses each claim and identifies the specific computer sale to which the claims relate. The entity needs to do this in order to determine eligibility under the warranty plans and the appropriate accounting treatment.

The entity determines that a portion of the claims, costing £2,500 for repair and replacement parts, are covered by the assurance-type warranty plan. As shown in Illustration 10-2 above, the expected cost of each assurance-type warranty was provided for at the time of the sale. The entity records the following entry to derecognise a portion of the warranty liability:

Dr	Provisions for warranty costs (assurance-type warranty)	£2,500	
	Cr Cash		£2,500

To derecognise the assurance-type warranty liability as the costs are incurred.

The entity also determines that a portion of the claims, costing £7,000 for repair and replacement parts, are eligible under the 'extended coverage' plan (i.e., the service-type warranty). The entity records the following entry to recognise the costs associated with the service-type warranty:

Dr	Warranty expense	£7,000	
	Cr Cash		£7,000

To record the costs of the service-type warranty as the costs are incurred.

The entity also determines that £500 of the claims are not eligible under either warranty plan. This is because the claims relate to incidents that occurred after the 90-day coverage period for the assurance-type warranty and the customers in those transactions did not purchase the extended warranty coverage. The entity rejects these customer claims.

10.2 Onerous contracts

Section 23 contains no specific requirements to address contracts with customers that are, or have become, onerous. Accordingly, Section 21 applies to such contracts. [FRS 102.21.1]. Entities are required to use the requirements in Section 21 to identify and measure onerous revenue contracts.

The requirements in Section 21 on onerous contracts are discussed generally in Chapter 24 at 3.3.1 and for contracts with customers specifically in Chapter 24 at 3.3.1.B.

If an entity determines a contract is onerous under Section 21, the provision for the onerous contract will reflect the lower of the penalty for terminating the contract or the present value of the net cost of fulfilling the contract. Contracts need to be reviewed to determine whether there are any special terms that might relieve an entity of its obligations (e.g., *force majeure*). Contracts that can be cancelled without paying compensation to the other party do not become onerous as there is no obligation.

Frequently asked questions

Question 10-5: How does an entity account for an onerous contract with a customer when the contract includes more than one performance obligation that is satisfied over time consecutively?

How we see it

Since the requirements for onerous contracts are outside the scope of Section 23, an entity's accounting for onerous contracts does not affect the accounting for its revenue from contracts with customers in accordance with Section 23.

Therefore, we believe that entities must use an 'overlay' approach, which consists of two steps:

1. Apply the requirements of Section 23 to measure progress in satisfying each performance obligation over time and account for the related costs when incurred in accordance with the applicable sections of FRS 102.
2. At the end of each reporting period, apply Section 21 to determine if the remaining contract as a whole is onerous (i.e., considering whether the revenue still to be recognised is less than the costs yet to be incurred). If an entity concludes that the remaining contract is onerous, it recognises a provision to the extent that the amount of the unavoidable costs under the contract exceed the economic benefits to be received under it.

The effect of the provision is recognised as an expense, not as an adjustment to revenue. A change in the provision is recognised in profit or loss in accordance with Section 21. [FRS 102.21.5].

Since the definition of an onerous contract in Appendix I to FRS 102 refers only to a contract, the unit of account to determine whether an onerous contract exists is the contract itself, rather than the performance obligations identified in accordance with Section 23. [FRS 102 Appendix I, FRS 102.21A.2]. As a result, the entity must consider the entire remaining contract, including remaining revenue to be recognised for unsatisfied, or partially unsatisfied, performance obligations and the remaining costs to fulfil those performance obligations.

10.3 Contract costs

Section 23 specifies the accounting treatment for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers as discussed below. An entity only applies those requirements to costs incurred that relate to a contract with a customer that is within the scope of Section 23 (see 3.1 above).

It is important to note that Section 23 provides guidance on certain costs relating to contracts with customers in the scope of Section 23 (i.e., the incremental costs of obtaining a contract and costs incurred to fulfil a contract). However, it does not provide comprehensive cost guidance and must only be applied if the costs are not in the scope of other sections of FRS 102 or other standards. That is, if other section of FRS 102 or other standard precludes the recognition of an asset for a particular cost, an asset cannot be recognised under Section 23. If the costs are not in the scope of other sections of FRS 102 or other standards, an entity would then evaluate whether the costs meet the criteria for capitalisation under Section 23 (discussed in 10.3.1 and 10.3.2 below). [FRS 102.23.113, FRS 102.23.117]. After initial recognition of contract costs as assets under Section 23, an entity measures these assets at cost less accumulated amortisation and any accumulated impairment losses (see 10.3.3 and 10.3.4 below). [FRS 102.23.119].

When an entity recognises capitalised contract costs under Section 23, any such assets must be presented separately from contract assets and contract liabilities (see 11.1 below) in the statement of financial position or disclosed separately in the notes to the financial statements. Furthermore, entities must consider the requirements in Section 4 *Statement of Financial Position* on classification of current assets when determining whether their contract cost assets are presented as current or non-current. See 11.1.2 below for a discussion on classification as current or non-current.

10.3.1 Costs to obtain a contract

Before applying the cost requirements in Section 23, entities need to consider the scoping provisions. If a payment is made to a customer, an entity first needs to consider whether the requirements on consideration payable to a customer under Section 23 apply to the costs (see 6.7 above).

For costs to obtain a contract that are within the scope of the requirements in Section 23, it allows an accounting policy choice to either expense incremental costs of obtaining a contract with a customer or recognise such costs as an asset if the entity expects to recover them (subject to practical expedient as discussed below). [FRS 102.23.113, FRS 102.23.114, FRS 102.23.115]. Unlike Section 23, IFRS 15 requires incremental costs of obtaining a contract with a customer to be recognised as an asset if the entity expects to recover them (subject also to similar practical expedient).

Incremental costs are those that an entity would not have incurred if the contract had not been obtained (e.g., a sales commission payable on obtaining a contract). [FRS 102.23.113]. An entity can expect to recover contract acquisition costs through direct recovery (i.e., reimbursement under the contract) or indirect recovery (i.e., through the margin inherent in the contract).

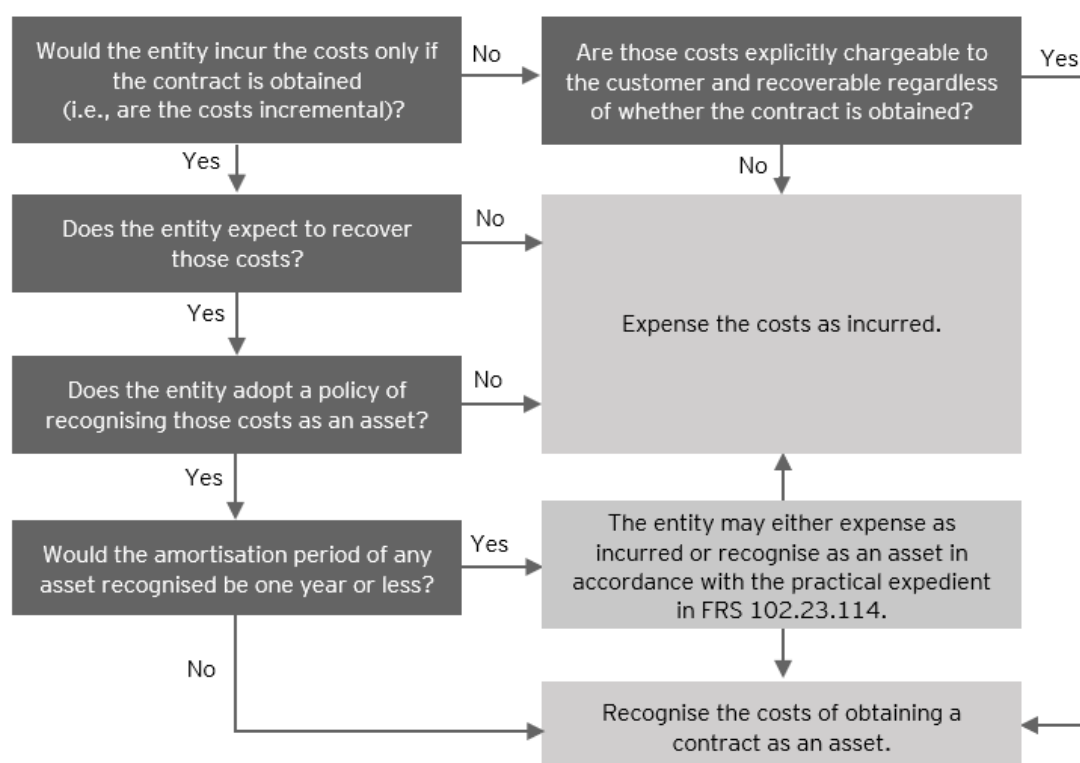
To determine whether a cost is recoverable, an entity needs to include the future cash inflows and outflows associated with the contract renewal or extension periods if the period of benefit of the costs under assessment is expected to extend beyond the present contract (see 10.3.3 below for further discussion on the period of benefit). Furthermore, when determining the amount it expects to receive as part of the recoverability assessment, an entity would not apply the requirements on constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract acquisition costs. The unconstrained transaction price also needs to be adjusted to reflect the customer's credit risk. This recoverability assessment for the costs to obtain a contract is similar to the impairment assessment discussed in 10.3.4 below.

Costs incurred to obtain a contract that are not incremental costs must be expensed as incurred, unless they are explicitly chargeable to the customer (regardless of whether the contract is obtained).

[FRS 102.23.114, FRS 102.23.115].

The following flow chart illustrates the requirements in Section 23:

Figure 10-2: Costs to obtain a contract



To determine whether a cost is incremental, an entity considers whether it would incur the cost if the customer (or the entity) decides, just as the parties are about to sign the contract, that it will not enter into the contract. If the costs would have been incurred even if the contract is not executed, the costs are not incremental to obtaining that contract. The objective of this requirement is not to allocate costs that are associated in some manner with an entity's marketing and sales activity, but only to identify those costs that an entity would not have incurred if the contract had not been obtained. For example, salaries and benefits of sales employees that are incurred regardless of whether a contract is obtained are not incremental costs.

Consider the following Illustration:

Illustration 10-4: Fixed employee salaries

An entity pays an employee an annual salary of £100,000. The employee's salary is based on the number of contracts he or she signed for the prior year, as well as the number of contracts the employee is expected to sign for the current year. The employee's current year salary will not change if the number of contracts the employee actually signs differs from the projected number. However, any difference would affect the employee's salary in the following year.

In this case, if the entity's accounting policy is to capitalise recoverable incremental costs of obtaining a contract, no portion of the employee's salary will be capitalised because it is not an incremental cost of obtaining a contract. The employee's salary would have been incurred regardless of the number of contracts the employee has actually signed during the current year.

Section 23 cites sales commissions as a type of an incremental cost that might require capitalisation under its requirements. For example, commissions that are related to sales from contracts signed during the period might represent incremental costs that would require capitalisation. Section 23 does not explicitly address considerations for different types of commission programmes. Therefore, entities have to exercise judgement to determine whether sales commissions are incremental costs and, if so, the point in time when the costs would be capitalised. However, an employee's title or level in the organisation or how directly involved the employee is in obtaining the contract, are not factors in assessing whether a sales commission is incremental. Consider the following Illustration:

Illustration 10-5: Commissions paid to different levels of employees

An entity's salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager.

All commissions are incremental because the commissions would not have been incurred if the contract had not been obtained. Section 23 does not distinguish between commissions paid to the employee(s) based on the function or the title of the employee(s) that receives a commission. It is the entity that decides which employee(s) are entitled to a commission as a result of obtaining a contract.

How we see it

We believe that commissions that are paid to a third party in relation to sales from contracts that were signed during the period might also represent incremental costs. That is, commissions paid to third parties must be evaluated in the same manner as commissions paid to employees in order to determine whether they represent incremental costs to obtain a contract.

In addition, entities need to carefully evaluate all compensation plans, not just sales commission plans, to determine whether any plans contain incremental costs. For example, payments under a compensation 'bonus' plan might be solely tied to contracts that are obtained. Such costs could be capitalised (as a policy choice) if they are recoverable incremental costs of obtaining a contract, irrespective of the title of the plan.

Illustration 10-6: Commissions paid to a pool of funds

Assume that an entity has a compensation plan for support personnel in its sales department. As a group, the employees are entitled to a pool of funds calculated based on 2% of all new contracts signed during the monthly period. Once the amount of the pool is known, the amount paid to each individual employee is determined based on each employee's rating.

While the amount paid to each employee is discretionary (based on each employee's rating), the total amount of the pool is considered an incremental cost to obtain a contract because the entity owes that amount to the employees (as a group) simply because a contract was signed.

Entities first need to refer to the applicable sections of FRS 102 (e.g., Section 11, Section 12, Section 21) to determine when they are required to accrue for certain costs. Entities then use the requirements in Section 23 to determine whether the related costs are incremental costs to obtaining contracts which could be recognised as an asset. Certain aspects of the cost requirements require entities to apply significant judgement in analysing the facts and circumstances and determining the appropriate accounting treatment.

In addition, incremental costs of obtaining a contract are not limited to initial incremental costs. Commissions recognised subsequent to contract inception (e.g., commissions paid on modifications, commissions subject to contingent events or clawback) because they did not meet the recognition criteria for liabilities at contract inception would still be considered as costs to obtain the contract when the liability is recognised. This would include costs related to contract renewals because a renewal is a contract and there is nothing in the requirements for costs to obtain a contract that suggests a different treatment for contracts that are renewals of existing contracts. That is, the only difference between the two costs would be the timing of recognition based on when a liability has been incurred. See Question 10-8 below for additional discussion of accounting for commissions paid on contract modifications.

Unlike many commissions, some incentive payments, such as bonuses and other compensation that are based on quantitative or qualitative metrics that are not related to contracts obtained (e.g., profitability, earnings per share (EPS), performance evaluations) are not incremental to obtaining a contract. However, a legal contingency cost might be an incremental cost of obtaining a contract, for example, when a lawyer is entitled to be paid only upon the successful completion of a negotiation. Determining which costs are incremental costs of obtaining a contract might require judgement and it is possible that some contract acquisition costs are determined to be incremental and others are not.

Consider the following Illustration:

Illustration 10-7: Incremental and non-incremental costs for the same contract

An entity pays a 5% sales commission to its employees when they obtain contracts with customers. An employee begins negotiating a contract with a prospective customer and the entity incurs £5,000 in legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a £500,000 contract and, as a result, the employee receives a sales commission of £25,000.

The entity will consider the commission paid to the employee of £25,000 as the only cost that is incremental to obtaining the contract. While the entity incurs other costs that are necessary to facilitate a sale (e.g., legal, travel), those costs would have been incurred even if the contract had not been obtained.

Note that the above discussions and guidance are consistent with the TRG and FASB TRG discussions on similar topic for purposes of applying IFRS 15 and ASC 606.¹⁹⁵ We consider that such discussions are also relevant in applying the related Section 23 requirements.

Illustration 10-8, which is based on Example 36 in IFRS 15, is an example regarding incremental costs of obtaining a contract: [IFRS 15.IE Example 36, IFRS 15.IE189-IE191]

Illustration 10-8: Incremental costs of obtaining a contract

An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

	£
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	<u>50,000</u>

The entity has selected an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset.

In accordance with paragraph 23.113, the entity recognises an asset for the £10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity and individual performance evaluations. In accordance with paragraph 23.113, the entity does not recognise an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.

The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 23.114, those costs are recognised as expenses when incurred, unless they are within the scope of another section of FRS 102, in which case, the relevant provisions of that section of FRS 102 apply.

¹⁹⁵ TRG agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015, FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

As a practical expedient, even if an entity elects an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset, Section 23 permits the entity to expense immediately contract acquisition costs, if the asset that would have resulted from capitalising those costs would have been amortised within one year or less. [FRS 102.23.114]. It is important to note that the amortisation period for incremental costs is not always the initial contract term (see further discussion on this in Question 10-13 below). See 10.3.3 below for discussion of the amortisation of capitalised contract costs.

Frequently asked questions

Question 10-6: Does the timing of commission payments affect whether they are incremental costs?¹⁹⁶

The timing of commission payments does not affect whether the costs would have been incurred if the contract had not been obtained. However, there could be additional factors or contingencies that would need to be considered in different commission plans that could affect the determination of whether all (or a portion) of a cost is incremental.

Consider the following Illustration:

Illustration 10-9: Timing of commission payments

An entity pays an employee a 4% sales commission on a £50,000 signed contract with a customer. For cash flow management purposes, the entity pays the employee half of the commission (i.e., 2% of the total contract value) upon completion of the sale and the remainder in six months' time. The employee is entitled to receive the unpaid commission even if he or she is no longer employed by the entity when payment is due.

If such costs are recoverable and if elected as a policy choice, the entity would capitalise the entire commission in this example (the timing of which would coincide with the recognition of the related liability). That is, the entity would not just capitalise the portion it paid immediately and expense the rest.

In this fact pattern, only the passage of time is required for the entity to pay the second half of the commission. For example, in some commission plans, the employee will only be entitled to the second half of the commission payment if the employee is still employed by the entity when the commission is due. For such plans, an entity needs to carefully evaluate whether the requirement to remain employed in order to receive the commission (i.e., the service vesting condition) is substantive.

How we see it

We believe that the second half of the commission payment would not be incremental if the service condition is substantive because other conditions are necessary, beyond simply obtaining the contract, for the entity to incur the cost.

If the entity's payment of a commission is only 'contingent' on a customer paying the amount due in the obtained contract, we do not believe this would influence the determination of whether the commission is an incremental cost, provided the contract meets the Step 1 criteria to be accounted for as a contract under the five-step model (see 4.1 above). However, if there is an extended payment term (i.e., there is a significant amount of time between contract signing and the date in which the contract consideration is due), the entity needs to consider whether there is a service condition or other contingency, as discussed above.

Question 10-7: Would commission payments subject to a threshold be considered incremental costs?¹⁹⁷

Generally, basing a commission on a pool of contracts, rather than paying a set percentage for each contract, would not affect the determination of whether the commissions would have been incurred, if the entity did not obtain the contracts with those customers.

¹⁹⁶ Based on FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

¹⁹⁷ Based on FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

Consider the following example:

Illustration 10-10: Commission payments subject to a threshold

An entity has a commission programme that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period, as follows:

0-9 contracts	0% commission
10-19 contracts	2% of value of contracts 1-19
20+ contracts	5% of value of contracts 1-20+

Generally, these costs are incremental costs of obtaining a contract with a customer. Therefore, if such costs are recoverable and if elected as a policy choice, the costs will be capitalised when the entity incurs a liability to pay these commissions. The costs are incremental because the entity will pay the commission under the programme terms, as a result of entering into the contracts. See Question 10-24 in 10.3.3 below for discussion about the period over which an entity would amortise a sales commission that is subject to a threshold and is considered an incremental cost of obtaining a contract.

Question 10-8: Would an entity capitalise commissions paid on contract modifications? ¹⁹⁸

If commissions paid on contract modifications are incremental (i.e., they would not have been incurred if there had not been a modification) and recoverable, an entity would capitalise them if the entity has elected an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset. Contract modifications are accounted for in one of three ways: (1) as a separate contract; (2) as a termination of the existing contract and the creation of a new contract; or (3) as part of the existing contract (see 4.4 above for further requirements on contract modifications). In all three cases, commissions paid on contract modifications are incremental costs of obtaining a contract and could be capitalised if they are recoverable. In the first two cases, a separate or new contract is created, so the costs of obtaining that contract would be incremental. The commissions paid on the modification of a contract that is accounted for as part of the existing contract are incremental costs even though they are not initial incremental costs.

Also see Question 10-11 below for further discussion of accounting for capitalised commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract.

Question 10-9: Would fringe benefits on commission payments be included in the capitalised amounts? ¹⁹⁹

If an entity elects to capitalise incremental costs of obtaining a contract as an asset, fringe benefits must be capitalised as part of the incremental cost of obtaining a contract if the additional costs are based on the amount of commissions paid and the commissions qualify as costs to obtain a contract. However, if the costs of fringe benefits would have been incurred regardless of whether the contract had been obtained (e.g., health insurance premiums), the fringe benefits cannot be capitalised. That is, an entity cannot allocate fringe benefits to the commission and, therefore, capitalise a portion of the costs of benefits it would provide, regardless of whether the commission was paid.

Question 10-10: Must an entity apply the practical expedient to expense contract acquisition costs to all of its qualifying contracts across the entity or can it apply the practical expedient to individual contracts?

How we see it

When an entity elects to capitalise incremental costs of obtaining a contract as an asset, we believe the practical expedient to expense contract acquisition costs (that would, otherwise, be amortised over a period of one year or less) must be applied consistently to contracts with similar characteristics and in similar circumstances.

¹⁹⁸ Based on TRG agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

¹⁹⁹ Based on TRG agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

Question 10-11: How would an entity account for capitalised commissions upon a modification of the contract that is treated as the termination of an existing contract and the creation of a new contract?

How we see it

When an entity elects to capitalise incremental costs of obtaining a contract as an asset, we believe an asset recognised for incremental costs to obtain a contract that exists when the related contract is modified must be carried forward into the new contract, if the modification is treated as the termination of an existing contract and the creation of a new contract and the goods or services to which the original contract cost asset relates are part of the new contract.

This is because the contract cost asset relates to goods or services that have not yet been transferred and the accounting for the modification is prospective. This conclusion is similar to the accounting for contract assets upon a contract modification, as discussed in Question 11-5 in 11.1.5 below.

The contract cost asset that remains on the entity's statement of financial position at the date of modification would continue to be evaluated for impairment in accordance with Section 23 (see 10.3.4 below). In addition, an entity must determine an appropriate amortisation period for the contract cost asset (see 10.3.3 below).

Question 10-12: Would an entity consider contract renewals when assessing whether the practical expedient applies?

Contract renewals are considered when assessing whether the practical expedient for incremental costs to obtain a contract applies. Even if an entity elects an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset, as a practical expedient, entities could recognise such costs as an expense if the asset that would have resulted from capitalising these costs would have been amortised in one year or less.

As discussed further in 10.3.3 below, in order to determine the amortisation period for capitalised incremental costs to obtain a contract, an entity needs to consider whether the capitalised contract costs only relate to goods or services that will be transferred under the initial contract or whether the costs also relate to goods or services that will be transferred under a specific anticipated contract.

If an entity's past experience indicates that a renewal is likely, the entity needs to determine whether the renewal commission is commensurate with the initial commission; if not, the amortisation period for the initial commission would be longer than the initial term. If the amortisation period extends beyond one year due to expected contract renewals, the practical expedient would not be available to the entity.

Question 10-13: If a contract contains more than one performance obligation, can an entity apply the practical expedient?

Whether the practical expedient for incremental costs to obtain a contract will apply when a contract contains more than one performance obligation will depend on the specific facts and circumstances. If a policy of recognising recoverable incremental costs to obtain a contract as an asset is chosen, entities could recognise such costs as an expense only if the asset resulting from capitalising these costs would have been amortised in one year or less. As discussed further in Question 10-23 in 10.3.3 below, we believe an entity can attribute capitalised contract costs to individual performance obligations in a contract, but it is not required to do so. That is, an entity can use multiple approaches to determine the amortisation period provided that the asset recognised is amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

Reasonable approaches could include:

- Amortising a single capitalised contract cost using one measure of performance considering all of the performance obligations in the contract.
 - Allocating the capitalised costs to all performance obligations in the contract on a relative basis and determining an appropriate amortisation period for each performance obligation.
- Or
- Allocating specific capitalised contracts costs to individual performance obligations in the contract (but not all) when the costs relate specifically to certain goods or services (but not all) in the contract.

Regardless of the approach used to determine the appropriate amortisation period for a capitalised contract cost related to a contract containing multiple performance obligations, all the amortisation periods related to the contract would have to be one year or less for an entity to apply the practical expedient. If any amortisation period related to the contract extends beyond one year, the entity cannot apply the practical expedient.

10.3.2 Costs to fulfil a contract

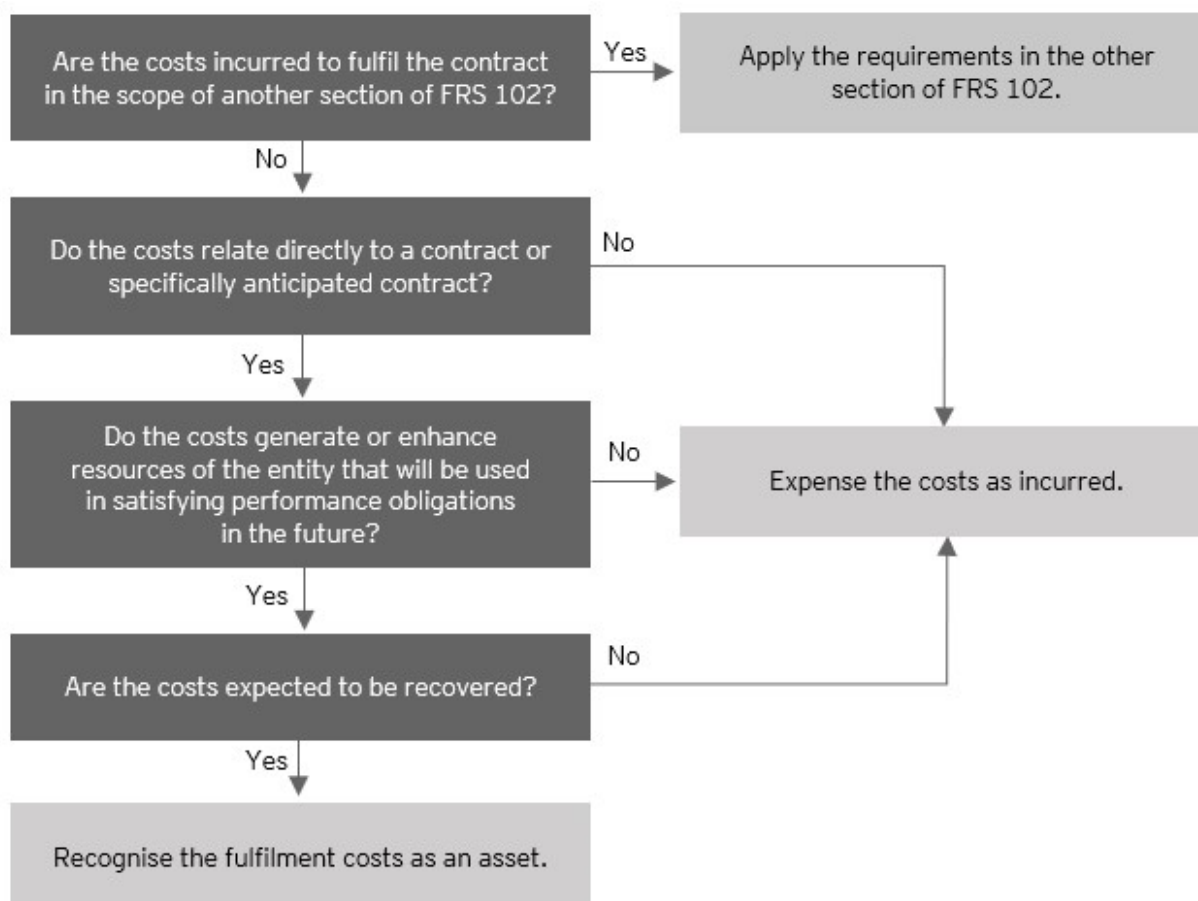
Section 23 divides contract fulfilment costs into two categories: (1) costs that give rise to an asset; and (2) costs that are expensed as incurred. When determining the appropriate accounting treatment for such costs, Section 23 makes it clear that any other applicable sections of FRS 102 (e.g., Section 13, Section 17 and Section 18) are considered first. That is, if costs incurred in fulfilling a contract are within the scope of another section of FRS 102, an entity accounts for those costs in accordance with those other sections of FRS 102. [FRS 102.23.116, FRS 102.23.117]. Accordingly, if those other sections of FRS 102 preclude capitalisation of a particular cost, then an asset cannot be recognised under Section 23. If the costs incurred to fulfil a contract are not within the scope of another section of FRS 102, an entity capitalises such costs only if they meet all of the following criteria: [FRS 102.23.117]

- The costs directly relate to a contract or to a specifically identifiable anticipated contract (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

If all the criteria are met, an entity is required to capitalise the costs as an asset. Such costs are recognised as an asset because they give rise to resources that the entity will use to satisfy future performance obligations in the contract. Conversely, costs that relate to performance obligations that are satisfied (or partially satisfied) are recognised as expenses when incurred, as those costs relate to past performance. [FRS 102.23.118].

The following flow chart illustrates these requirements:

Figure 10-3: Costs to fulfil a contract



Sections of FRS 102 that might be applicable to costs to fulfil a contract with a customer include, but are not limited to, the following:

- Inventory costs within the scope of Section 13.
- Costs related to the acquisition of an intangible asset within the scope of Section 18.
- Costs attributable to the acquisition or construction of PP&E within the scope of Section 17 or an investment property within the scope of Section 16.
- Costs related to biological assets or agricultural produce within the scope of Section 34 *Agriculture*.

Illustration 10-12 below illustrates some costs that are accounted for under other sections of FRS 102.

The IFRS IC received a request about the recognition of training costs incurred to fulfil a contract with a customer in relation to an entity that supplies outsourced services and incurs costs to train its employees so that they understand the customer's equipment and processes. This is expected to be relevant to entities reporting under FRS 102 due to the close alignment between Section 23 and IFRS 15 in this area.

In March 2020, the IFRS IC concluded that, before assessing the criteria in paragraph 95 of IFRS 15 (equivalent to the criteria in paragraph 23.117 of FRS 102), an entity first considers whether the training costs incurred to fulfil the contract are within the scope of another IFRS accounting standard. In relation to the request, since IAS 38 explicitly includes expenditure on training within its scope, the entity would apply the IAS 38 requirements and not IFRS 15. IAS 38 requires an entity to expense training costs as incurred and states that "an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset". [IAS 38.15, IAS 38.68, IAS 38.69]. The IFRS IC noted that the Basis for Conclusions on IFRS 15 states that "if the other Standards preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognised under IFRS 15". [IFRS 15.BC307]. Therefore, since IAS 38 requires those costs to be expensed as incurred, they cannot be capitalised under IFRS 15. The IFRS IC concluded that IFRS 15 and IAS 38 provide an adequate basis for an entity to determine its accounting for training costs incurred to fulfil a contract with a customer and decided not to add the matter to its agenda.²⁰⁰ Similarly, Section 18 also requires an entity to expense training costs as incurred, therefore, these costs cannot be capitalised under Section 23. [FRS 102.18.8C].

When determining whether costs to fulfil a contract with a customer meet the criteria for capitalisation in paragraph 23.117, an entity must consider its specific facts and circumstances.

With regard to the first criterion, Section 23 indicates that costs can be capitalised even if the contract with the customer is not yet finalised. However, rather than allowing costs to be related to any potential future contract, Section 23 requires that the costs relate directly to a specifically anticipated contract.

IFRS 15 provides the following examples of costs that meet the first criterion for capitalisation (i.e., costs that relate directly to the contract or a specifically anticipated contract) that can be useful in the application of the requirements in Section 23: [IFRS 15.97]

- (a) Direct labour (for example, salaries and wages of employees who provide the promised services directly to the customer)
 - (b) Direct materials (for example, supplies used in providing the promised services to a customer)
 - (c) Allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract)
 - (d) Costs that are explicitly chargeable to the customer under the contract
- And
- (e) Other costs that are incurred only because an entity enters into the contract (for example, payments to subcontractors)

Significant judgement might be required to determine whether costs meet the second criterion for capitalisation in paragraph 23.117(b) (i.e., the costs generate or enhance resources of the entity that will be used in satisfying, or in continuing to satisfy, performance obligations in the future). In the Basis for Conclusions on IFRS 15, the IASB explained that the revenue standard only results in the capitalisation of costs that meet the definition of an asset and precludes an entity from deferring costs merely to normalise profit margins throughout a contract (by allocating revenue and costs evenly over the contract term). [IFRS 15.BC308].

²⁰⁰ [IASB Staff Paper 2](#): Project: *Training Costs to Fulfil a Contract (IFRS 15)*, Paper topic: *Initial Consideration*, IFRS IC meeting, September 2019; and [IFRIC Update](#), March 2020. Available on the IFRS Foundation's website.

For costs to meet the third criterion (i.e., the 'expected to be recovered' criterion in paragraph 23.117(c)), they need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin. Determining whether the costs are expected to be recovered might be challenging and require significant judgement if some, or all, of the transaction price is contingent (e.g., success-based fees).

Similar to the discussion related to incremental costs to obtain a contract in 10.3.1 above, an entity needs to include all future cash inflows and outflows associated with fulfilling the contract to determine whether costs to fulfil a contract are recoverable. Furthermore, when determining the amount it expects to receive as part of the recoverability assessment, an entity would not apply the requirements for constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price to evaluate recoverability of the contract fulfilment costs. The unconstrained transaction price also needs to be adjusted to reflect the customer's credit risk. This recoverability assessment for the costs to fulfil a contract is similar to the impairment assessment discussed in 10.3.4 below.

How we see it

As discussed above, entities must first determine whether costs incurred to fulfil a contract with a customer are in the scope of other sections of FRS 102 before determining whether capitalisation is required under Section 23. As an example, an entity might determine that fulfilment costs related to a service contract are not in the scope of other sections of FRS 102 (e.g., Section 13), so it evaluates the requirements in Section 23 to determine whether the fulfilment costs need to be capitalised or expensed. The type of costs that might be capitalised under Section 23 for the service contract are similar to the types of costs that might be capitalised under Section 13 for a contract to sell goods.

As noted above, costs that are evaluated for capitalisation include direct costs and allocable overhead-type costs. However, an entity will also need to consider the types of costs that must be expensed as incurred, as discussed further below.

If the criteria for capitalisation in paragraph 23.117 are not met, the costs incurred in fulfilling a contract do not give rise to an asset and must be expensed as incurred. IFRS 15 provides some common examples of costs that must be expensed as incurred, as follows: [IFRS 15.98]

- (a) General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract – see discussion above)
 - (b) Costs of wasted materials, labour or other resources to fulfil the contract, that were not reflected in the price of the contract
 - (c) Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e., costs that relate to past performance)
- And
- (d) Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations)

Item (c) above specifies that, if a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfilment costs related to that performance obligation (or portion thereof) can no longer be capitalised. This is true even if the associated revenue has not yet been recognised (e.g., the contract consideration is variable and has been fully or partially constrained). Once an entity has begun satisfying a performance obligation that is satisfied over time, it only capitalises fulfilment costs that relate to future performance. Accordingly, it might be challenging for an entity to capitalise costs that are related to a performance obligation that an entity has already started to satisfy. Similarly, item (d) above specifies that, if an entity is unable to determine whether certain costs relate to past or future performance and the costs are not eligible for capitalisation under other sections of FRS 102, the costs are expensed as incurred.

The IFRS IC received a request about the recognition of costs incurred to fulfil a contract in relation to a performance obligation that is satisfied over time. In June 2019, the IFRS IC concluded that IFRS 15 provides an adequate basis for an entity to determine how to recognise the costs in the fact pattern provided and decided not to add the matter to its agenda.²⁰¹ The guidance in IFRS 15 discussed by the IFRIC is helpful in the application of Section 23 as the principles relating to the recognition of costs incurred to fulfil a contract are consistent with those in IFRS 15.

201 [IFRIC Update](#), June 2019, available on the IFRS Foundation's website.

Consider the following Illustration (which is based on an example discussed by the IFRS IC).²⁰²

Illustration 10-11: Costs to fulfil a contract related to past performance

An entity enters into a contract with a customer to construct a building. It identifies a single performance obligation, being the promise to transfer the building to the customer, which it expects will take three years to complete. The entity satisfies this performance obligation (and recognises revenue) over time in accordance with paragraph 23.81(c) because its performance does not create an asset with an alternative use and it has an enforceable right to payment (see 8.1.3 above).

At the end of the reporting period, the entity has begun constructing the building and has incurred costs related to laying the foundation of the building.

The IFRS IC noted that the foundation costs relate to construction work done on the partly-constructed building, which has been transferred to the customer. Therefore, the costs relate to the entity's past performance in partially satisfying its performance obligation and in accordance with paragraph 23.118, must be expensed as incurred. That is, the costs do not meet the criteria to be recognised as an asset under paragraph 23.117.

Illustration 10-12, which is based on Example 37 in IFRS 15, illustrates costs that are capitalised under other sections of FRS 102, costs that meet the capitalisation criteria and costs that do not: [IFRS 15, IE Example 37, IFRS 15.IE192-IE196]

Illustration 10-12: Costs that give rise to an asset - costs to fulfil a contract

An entity enters into a service contract to manage a customer's information technology data centre for five years. The contract is renewable for subsequent one-year periods. The average customer term is seven years. Before providing the services, the entity designs and builds a technology platform for the entity's internal use that interfaces with the customer's systems. That platform is not transferred to the customer, but will be used to deliver services to the customer.

The initial costs incurred to set up the technology platform are as follows:

	£
Design services	40,000
Hardware	120,000
Software	90,000
Migration and testing of data centre	100,000
Total costs	<u>350,000</u>

The initial setup costs relate primarily to activities to fulfil the contract but do not transfer goods or services to the customer. The entity accounts for the initial setup costs as follows:

- (a) Hardware costs are accounted for in accordance with Section 17.
- (b) Software costs are accounted for in accordance with Section 18.
- (c) Costs of the design, migration and testing of the data centre are assessed in accordance with paragraph 23.117 to determine whether an asset can be recognised for the costs to fulfil the contract. Any resulting asset would be amortised on a systematic basis over the seven-year period (i.e., the five-year contract term and two anticipated one-year renewal periods) that the entity expects to provide services related to the data centre.

In addition to the initial costs to set up the technology platform, the entity also assigns two employees who are primarily responsible for providing the service to the customer. Although the costs for these two employees are incurred as part of providing the service to the customer, the entity concludes that the costs do not generate or enhance resources of the entity (see FRS 102.23.117(b)). Therefore, the costs do not meet the criteria in paragraph 23.117 and cannot be recognised as an asset using Section 23. Accordingly, the entity recognises the payroll expense for these two employees when incurred.

²⁰² [IASB Staff Paper 2](#): Project: *Costs to Fulfil a Contract (IFRS 15)*, Paper topic: *Initial Consideration*, IFRS IC meeting, March 2019; and [IFRIC Update](#), June 2019. Available on the IFRS Foundation's website.

Frequently asked questions

Question 10-14: Can an entity defer costs of a transferred good or service that would otherwise generate an upfront loss because variable consideration is fully or partially constrained?

An entity cannot defer the costs of a transferred good or service when the application of the constraint on variable consideration results in an upfront loss, even if the entity ultimately expects to recognise a profit on that good or service, unless other specific requirements allow or require a deferral of those costs. The criteria in Section 23 must be met to capitalise costs to fulfil a contract, including the criterion that the costs must generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. An entity recognises such costs when control of a good or service transfers to the customer. As such, the cost of those sales would not generate or enhance resources of the entity used to satisfy future performance obligations.

Consider the following example:

Illustration 10-13: Recognise cost of sales when control is transferred

An entity sells goods with a cost of £500,000 for consideration of £600,000. The goods have a high risk of obsolescence, which might require the entity to provide price concessions in the future, resulting in variable consideration (see 6.2.1.A – 6.2.1.B above). The entity estimates and constrains the transaction price and concludes that it is highly probable that it will be entitled to £470,000, even though the entity reasonably expects the contract to ultimately be profitable. When control transfers, the entity recognises revenue of £470,000 and costs of £500,000. It would not capitalise the loss of £30,000 because the loss does not generate or enhance resources of the entity that will be used in satisfying performance obligations in the future.

Question 10-15: How does an entity account for fulfilment costs incurred prior to the contract establishment date that are outside the scope of another section of FRS 102 (e.g., Section 13 *Inventories*)?²⁰³

Entities sometimes begin activities on a specifically anticipated contract before the contract establishment date (e.g., before agreeing to the contract with the customer, before the contract satisfies the criteria to be accounted for under Section 23), that are not within the scope of another section of FRS 102 (e.g., Section 13). The costs in respect of such activities, that relate to a good or service that will transfer to the customer at or after the contract establishment date, might be capitalised as costs to fulfil a specifically anticipated contract. However, such costs would still need to meet the criteria in paragraph 23.117 to be capitalised (e.g., they are expected to be recovered under the anticipated contract). Certain costs, such as general and administrative costs that are not explicitly chargeable to the customer under the contract, would not satisfy these criteria and would need to be expensed as incurred.

Subsequent to capitalisation, costs that relate to goods or services that are transferred to the customer at the contract establishment date would be expensed immediately. Any remaining capitalised contract costs would be amortised over the period that the related goods or services are transferred to the customer.

For requirements on recognising revenue for a performance obligation satisfied over time when activities are completed before the contract establishment date, see Question 8-20 in 8.1.4.E above.

Question 10-16: How are the effects of learning curve costs addressed in Section 23?

Section 23 does not explicitly address the effects of learning curve costs. Entities reporting under FRS 102 could consider guidance provided in IFRS 15 due to the close alignment of the requirements about costs to fulfil a contract between Section 23 and IFRS 15.

In the Basis for Conclusions on IFRS 15, “a ‘learning curve’ is the effect of efficiencies realised over time when an entity’s costs of performing a task (or producing a unit) decline in relation to how many times the entity performs that task (or produces that unit)”. [IFRS 15.BC312].

Learning curve costs usually consist of materials, labour, overhead, rework or other costs that must be incurred to complete the contract (but do not include research and development costs). These types of efficiencies generally can be predicted at inception of an arrangement and are often considered in the pricing of a contract between an entity and a customer.

²⁰³ Based on TRG Agenda paper no. 33, *Partial Satisfaction of Performance Obligations Prior to Identifying the Contract*, dated 30 March 2015 and TRG Agenda paper no. 34, *March 2015 Meeting - Summary of Issues Discussed and Next Steps*, dated 13 July 2015.

The IASB noted that in situations where learning curve costs are incurred in relation to a contract with a customer accounted for as a single performance obligation that is satisfied over time to deliver a specified number of units, IFRS 15 requires an entity to select a method of progress that depicts the transfer over time of the good or service to the customer. [IFRS 15.BC313]. See also the discussions in 8.1.4 above.

The IASB further noted that an entity would probably select a method (such as a costs incurred measure of progress) for these types of contracts, which would result in the entity recognising more revenue and expense at the beginning of the contract relative to the end. The IASB clarified that this would be appropriate as an entity would charge a higher price to a customer only purchasing one unit (rather than multiple units) in order to recover its learning curve costs.

Conversely, when learning curve costs are incurred for a performance obligation satisfied at a point in time (rather than over time), an entity needs to assess whether those costs are within the scope of another standard. The IASB noted that in situations in which an entity incurs cost to fulfil a contract without also satisfying a performance obligation over time, the entity is probably creating an asset that is within the scope of another standard (e.g., IAS 2). [IFRS 15.BC315]. For example, if within the scope of IAS 2, the costs of producing the components would accumulate as inventory in accordance with the requirements in IAS 2. The entity would then recognise revenue when control of the inventory transfers to the customer. In that situation, no learning curve costs would be capitalised under IFRS 15 as the costs would be in the scope of another standard.

How we see it

If the learning curve costs are not within the scope of another section of FRS 102, we believe they generally will not be eligible for capitalisation under Section 23 (e.g., because the costs relate to past (and not future) performance).

Question 10-17: How does an entity account for pre-contract or setup costs?

Pre-contract costs are often incurred in anticipation of a contract and will result in no future benefit unless the contract is obtained. Examples include: (1) engineering, design or other activities performed on the basis of commitments, or other indications of interest, by a customer; (2) costs for production equipment and materials relating to specifically anticipated contracts (e.g., costs for the purchase of production equipment, materials or supplies); and (3) costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of subsequent orders for the same item.

Pre-contract costs that are incurred in anticipation of a specific contract must first be evaluated for capitalisation under other sections of FRS 102 (e.g., Section 13, Section 16, Section 18). For example, pre-contract costs incurred to acquire or produce goods in excess of contractual requirements for an existing contract in anticipation of subsequent orders for the same item would likely be evaluated under Section 13. Some other examples include costs incurred to move newly acquired equipment to its intended location, which could be required to be capitalised under Section 17 (see Question 10-18 below), and employee training costs that are expensed in accordance with Section 18 (see discussions in 10.3.2 above). Pre-contract costs incurred in anticipation of a specific contract that are not addressed under other sections of FRS 102 are capitalised under Section 23 only if they meet all of the criteria of a cost incurred to fulfil a contract. Pre-contract costs that are not in the scope of other sections of FRS 102 and do not meet the criteria under Section 23 are expensed as incurred.

Question 10-18: Can mobilisation costs be capitalised as costs to fulfil a contract with a customer under Section 23?

Entities incur mobilisation costs when moving personnel, equipment and supplies to a project site either before, at or after inception of a contract with a customer. They are incurred in order to ensure that the entity is in a position to fulfil its promise(s) in a contract (or specifically anticipated contract) with a customer, rather than transferring a good or service to a customer (i.e., they are not a promised good or service).

How we see it

The assessment of whether mobilisation costs can be capitalised depends on the specific facts and circumstances and might require significant judgement. Entities need to ensure that the costs are: (1) within the scope of Section 23; and (2) meet all the criteria in paragraph 23.117 of FRS 102 to be capitalised. We believe the considerations listed below are relevant to this assessment.

Are the costs within the scope of Section 23?

If the asset being moved is in the scope of another section of FRS 102 (e.g., equipment in the scope of Section 17, inventory in the scope of Section 13), an entity must determine whether the mobilisation costs are specifically addressed by the other section; if so, the cost is outside the scope of Section 23.

If the mobilisation costs are not specifically addressed in another section of FRS 102, or it is not clear whether these are within the scope of another section of FRS 102, an entity further analyses whether the mobilisation costs are:

- Specific to the asset being moved or applicable to more than one customer under unrelated contracts; in the latter case it is likely that they would not be within the scope of Section 23. For example, moving an asset between different premises of the entity to better utilise the asset in preparation for future contracts with many customers.
- Or
- Specific to the contract with the customer, in which case, it would be within the scope of Section 23. For example, moving an asset to a remote location at the customer's request, which does not provide a benefit to the entity beyond ensuring it is in a position to fulfil its obligation(s) to the customer under the contract.

Do the costs meet the criteria in FRS 102.23.117 to be capitalised?

As discussed above, Section 23 includes three criteria that must be met for costs to fulfil a contract within its scope can be capitalised:

- (a) Entities might need to use judgement to determine if costs relate directly to a contract (or a specifically anticipated contract, see 10.3.2 above), as required in paragraph 23.117(a). Indicators that a cost, by function rather than by nature, might be directly related include, but are not limited to, the following:
 - The costs are explicitly or implicitly chargeable to the customer under the contract.
 - The costs are incurred only because the entity entered into the contract.
 - The contract explicitly or implicitly refers to mobilisation activities (e.g., that the entity must move equipment to a specific location).
 - The location in which the entity must perform is explicitly or implicitly specified in the contract and the mobilisation costs are incurred in order for the entity to fulfil its promise(s) to the customer.
- (b) Significant judgement might also be required to determine whether costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future as required by paragraph 23.117(b). This determination would include (but not be limited to) considering whether:
 - The costs are incurred in order for the entity to be able to fulfil the contract

And

 - Location is implicitly or explicitly an attribute of the contract

If a performance obligation (or a portion of a performance obligation that is satisfied over time) has been satisfied, fulfilment costs related to that performance obligation (or portion thereof) can no longer be capitalised (see 10.3.2 above for further discussion).

- (c) For costs to meet the 'expected to be recovered' criterion as required by paragraph 23.117(c), they need to be either explicitly reimbursable under the contract or reflected through the pricing on the contract and recoverable through margin.

Determining whether mobilisation costs are directly related to a contract might be more challenging when they are incurred between two contracts. That is, when the costs are related to returning an entity's personnel, equipment and/or supplies to their original location or to another project site. In those situations, an entity will need to determine to which contract the costs relate. It will also need to determine whether the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future. This is important because costs related to past performance cannot be capitalised under Section 23.

Question 10-19: Can an entity defer losses incurred on a contract by capitalising related fulfilment costs when it is expected to generate future profits on the sale of optional goods or services (i.e., loss leader)?

Certain contracts are executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. In determining whether these anticipated contracts would be part of the accounting for the existing loss leader contract, entities need to refer to the definition of a contract in Section 23, which is based on enforceable rights and obligations in the existing contract (see 4.1 above). While it might be probable that the customer will enter into a future contract or the customer might even be economically compelled, or compelled by regulation to do so, it would not be appropriate to account for an anticipated contract when there is an absence of enforceable rights and obligations.

In addition, if the fulfilment costs incurred during satisfying the initial contract are within the scope of other sections of FRS 102 (e.g., Section 13), the entity must account for those costs under that relevant section of FRS 102. Even if the costs are not within the scope of another section of FRS 102, the costs would relate to a satisfied or partially satisfied performance obligation (i.e., the original contract priced at a loss) and, therefore, must be expensed as incurred. Section 23 does not permit an entity to defer fulfilment costs or losses incurred based on the expectation of profits in a future contract.

Question 10-20: How does an entity account for costs associated with installation or implementation services?

Entities that provide installation or implementation services to customers incur costs to fulfil the services. To determine the appropriate accounting for these costs, entities first need to determine whether the costs are within the scope of another section of FRS 102 (e.g., PP&E, intangibles).

[FRS 102.23.116].

If they are not within the scope of another section of FRS 102, entities need to determine whether the installation or implementation service is a separate performance obligation that is satisfied over time (see 5 and 8 above). If it is a performance obligation, then entities generally expense the costs associated with it as incurred because, as discussed in 10.3.2 above, it might be challenging to conclude that the costs relate only to the entity's satisfaction of performance obligations in the future, which is required for capitalisation by paragraph 23.117(b). [FRS 102.23.117, FRS 102.23.118].

If the installation or implementation service is not a separate performance obligation, an entity needs to evaluate whether it is required to capitalise the costs to fulfil the contract under Section 23 requirements mentioned above. That is, costs incurred to fulfil a contract are required to be capitalised only if they meet all the criteria for capitalisation in paragraph 23.117. [FRS 102.23.117].

The Illustrations below contrast an example of implementation services that are determined to be a separate performance obligation (and, therefore, are not capitalised as costs to fulfil a contract) with an example of implementation services that meet the criteria for capitalisation as costs to fulfil a contract under Section 23.

Illustration 10-14: Implementation services are not capitalised costs to fulfil a contract

Technology entity M enters into a three-year SaaS contract with a customer for £4,000,000 for a subscription to an inventory management application beginning 1 June 20X6. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 June 20X6. The implementation services include data migration, creation of objects for the customer's products that will be inventoried, and customisation of the application's layout with the customer's logo and colour scheme. Several third-party service providers also sell implementation services for Technology entity M's application. Assume that the implementation services do not represent a significant integration service (i.e., the implementation services do not significantly modify or customise the SaaS) and the SaaS is fully functional without the implementation service. Under the contract, the customer receives access to the fully functional SaaS on 1 June 20X6.

Technology entity M determines that the costs incurred related to the implementation services are not within the scope of another section of FRS 102 (e.g., PP&E, intangible assets).

Technology entity M then considers the implementation services and SaaS and determines that they are separate performance obligations that will be satisfied over time. This is because the implementation services and SaaS can be purchased separately. Technology entity M determines that it is able to fulfil its promise to transfer the SaaS separately from the implementation services, indicating that the two are not highly interdependent or interrelated. Therefore, Technology entity M determines that the costs incurred related to implementation services do not meet the criteria for capitalisation because they do not relate to the entity's satisfaction of performance obligations in the future (i.e., the costs are expensed as incurred in the process of performing the implementation services).

Illustration 10-15: Implementation services are capitalised costs to fulfil a contract

Technology entity N enters into a contract with a customer for £2,000,000 for a one-year SaaS subscription to an enterprise software application beginning when the customer obtains access to the SaaS. The contract includes implementation services that will be performed at the beginning of the contract, starting on 1 January 20X6. The implementation services, which will take approximately two months to complete, must be performed in order for the customer to access the SaaS because the services involve the creation of customer-specific interfaces. Technology entity N does not sell the SaaS without these implementation services and no other vendors are able to perform the implementation services because they require the creation of code that will reside on Technology entity N's servers.

Technology entity N determines that the costs incurred related to the implementation services are not within the scope of another section of FRS 102 (e.g., PP&E, intangible assets).

Technology entity N then determines that the implementation services are not capable of being distinct. This is because they cannot be purchased separately or provided by a third party and because the services do not provide benefit on their own or with other readily available resources (since the SaaS has not yet been provided and also cannot be sold separately). Therefore, the implementation services and SaaS subscription are a combined performance obligation.

Technology entity N also concludes that the combined performance obligation meets the requirements for recognition over time. It determines that revenue will be recognised over the contract term, beginning when the customer obtains access to the SaaS.

Therefore, Technology entity N considers whether the costs incurred related to the implementation services that will be provided at the outset of the contract (i.e., before the customer obtains access to the SaaS) meet the criteria to be capitalised as a cost to fulfil the contract, as follows:

- The costs relate specifically to the SaaS contract with this customer.
- The costs generate a resource (i.e., the interfaces) that will be used in future performance (i.e., providing the SaaS, to the customer).
- The costs are expected to be recovered based on the margin included in the contract.

As such, Technology entity N determines that the costs must be capitalised as a cost to fulfil as the implementation services are performed. The costs will then be amortised over the estimated period of benefit beginning when the customer gains access to the SaaS.

10.3.3 Amortisation of capitalised contract costs

Any capitalised contract costs are amortised, with the expense recognised on a systematic basis that is consistent with the entity's pattern of transfer to the customer of the goods or services to which the contract costs asset relates. [FRS 102.23.119, FRS 102.23.120].

When the timing of revenue recognition (e.g., at a point in time, over time) aligns with the transfer of the goods or services to the customer, the amortisation of the capitalised contract costs in a reporting period will correspond with the revenue recognition in that reporting period. However, the timing of revenue recognition might not always align with the transfer of the goods and services to the customer (e.g., when variable consideration is constrained at the time the related performance obligation is satisfied). When this occurs, the amortisation of the capitalised contract costs will not correspond with the revenue recognition in a reporting period.

For example, consider an entity that enters into a contract with a customer with two performance obligations: (a) a right-to-use licence; and (b) a related service for three years. Further assume that payment from the customer is based on the customer's usage of the intellectual property (i.e., a usage-based royalty). Revenue in respect of the licence of intellectual property would be recognised at a point in time (see 9.3.2 above) and revenue in respect of the related service would be recognised over time. The transaction price allocated to the performance obligation for the licence of intellectual property cannot be recognised at the point in time when control of the licence transfers to the customer due to the royalty recognition constraint (see 9.5 above). Accordingly, any capitalised contract costs that relate to the licence need to be fully amortised upon the transfer of control of that licence (i.e., at a point in time), regardless of when the related revenue will be recognised. Any capitalised contract costs that relate to the services need to be amortised over the period of time consistent with the transfer of control of the service.

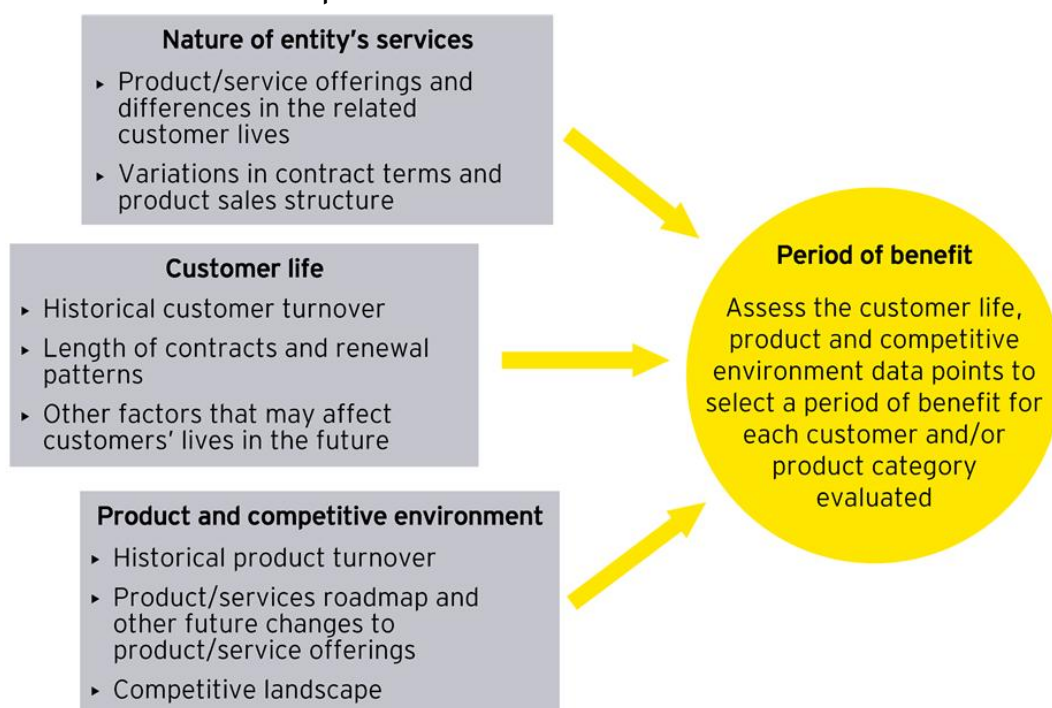
It is important to note that capitalised contract costs could relate to multiple goods or services (e.g., design costs to manufacture multiple distinct goods when design services are not a separate performance obligation) in a single contract. In such instances, the amortisation period could be the entire contract term. See Question 10-23 below for a discussion on how an entity might determine the appropriate amortisation period when capitalised contract costs relate to multiple performance obligations. The amortisation period could also extend beyond a single contract, if the capitalised contract costs relate to goods or services being transferred under multiple contracts or to a specifically anticipated contract (e.g., certain contract renewals). [FRS 102.23.117(a), FRS 102.23.120].

In these situations, the capitalised contract costs would be amortised over a period that is consistent with the transfer to the customer of the goods or services to which the asset relates. This can also be thought of as the expected period of benefit of the asset capitalised. The expected period of benefit might be the expected customer relationship period, but that is not always the case. To determine the appropriate amortisation period, an entity needs to evaluate the type of capitalised contract costs, what the costs relate to and other facts and circumstances of the specific arrangement. Furthermore, before including estimated renewals in the period of benefit, an entity needs to evaluate its history with renewals, to conclude that such an estimate is supportable.

How we see it

We believe the following factors might be relevant for the evaluation of the period of benefit.

Figure 10-4: Evaluation of the period of benefit



Because amortisation follows the entity's pattern of transfer of related goods or services to the customer, an entity will therefore need to update the amortisation period when there is a significant change in the expected timing of transfer to the customer of the goods or services to which the asset relates. The entity accounts for such a change as a change in accounting estimate and discloses related information in accordance with the requirements in Section 10 (see Chapter 9 at 3.4.1 and 3.6.2). This principle is also consistent with the principle applied under IFRS 15. [IFRS 15.100].

Consider the following Illustration:

Illustration 10-16: Amortisation period

Entity A enters into a three-year contract with a new customer for transaction processing services. To fulfil the contract, Entity A incurred set-up costs of £60,000, which it capitalised in accordance with paragraphs 23.116 - 23.118 (see 10.3.2 above) and will amortise over the term of the contract.

At the beginning of the third year, the customer renews the contract for an additional two years. Entity A will benefit from the initial set-up costs during the additional two-year period. Therefore, it changes the remaining amortisation period from one year to three years and adjusts the amortisation expense in the period of the change and future periods in accordance with the requirements in Section 10 for changes in accounting estimates. The disclosure requirements of Section 10 related to changes in accounting estimates are also applicable.

However, under Section 23, if Entity A had been in the position to anticipate the contract renewal at contract inception, Entity A would have amortised the set-up costs over the anticipated term of the contract including the expected renewal (i.e., five years).

Determining the amortisation period for capitalised incremental costs of obtaining a contract with a customer can be complicated, especially when contract renewals are expected and the commission rates are not constant throughout the entire life of the contract. IFRS 15 provides further discussion and guidance which entities reporting under FRS 102 could consider due to the close alignment between Section 23 and IFRS 15 in this area.

When evaluating whether the amortisation period for a sales commission extends beyond the original contract period, an entity would also evaluate whether an additional commission is paid for subsequent renewals. If so, it evaluates whether the renewal commission is considered 'commensurate' with the original commission. See Question 10-21 below for further discussion on whether a commission is commensurate. In the Basis for Conclusions on IFRS 15, the IASB explained that amortising the asset over a longer period than the initial contract would not be appropriate if an entity pays a commission on a contract renewal that is commensurate with the commission paid on the initial contract. In that case, the costs of obtaining the initial contract do not relate to the subsequent contract. [IFRS 15.BC309]. An entity would need to evaluate the appropriate amortisation period for any renewal commissions that are required to be capitalised under Section 23 in a similar manner. See Question 10-22 below for the discussion of how an entity determines the amortisation period of an asset recognised for the incremental costs of obtaining a contract with a customer.

How we see it

Under Section 23, entities are required to evaluate whether the period of benefit is longer than the term of the initial contract. As discussed above, it is likely that an entity would be required to amortise the capitalised sales commission cost over a period longer than the initial contract, if a renewal commission is not paid or a renewal commission is paid that is not commensurate with the original commission. It is also important to note that the amortisation period affects whether the entity can apply the practical expedient allowing the incremental cost of obtaining a contract to be expensed immediately. That expedient requires that the asset resulting from the capitalisation of these costs be amortised in one year or less. It is not dependent on the initial contract term.

In determining the appropriate amortisation period or the period of benefit for capitalised contract costs, an entity considers its facts and circumstances and might use judgement similar to that used when estimating the amortisation period for intangible assets (e.g., a customer relationship intangible acquired in a business combination). This could include considering factors such as customer retention and how quickly the entity's products and services change.

It is important for entities to document the judgements they make when determining the appropriate amortisation period and, if considered significant, disclose the same in their financial statements as required by Section 8 (see 11.4.3 below).

Frequently asked questions

Question 10-21: How does an entity determine whether a commission on a renewal contract is commensurate with the commission on the initial contract?²⁰⁴

Generally, the commissions would have to be reasonably proportional to the contract values (e.g., 5% of both the initial and renewal contract values) to be considered commensurate. Generally, it would not be reasonable for an entity to use a 'level of effort' analysis to determine whether a commission is commensurate. For example, a 6% commission on an initial contract and a 2% commission on a renewal would not be commensurate even if the declining commission rate corresponds to the level of effort required to obtain the contracts.

As discussed above in this section, if the renewal commission is considered to be commensurate with the commission on the initial contract, it would not be appropriate to amortise any asset for the initial commission over a longer period than the initial contract. In contrast, it is likely that it would be appropriate to amortise the asset over a longer period than the initial contract if the commissions are not considered to be commensurate (such as in the example above with a 6% initial commission and 2% renewal commission). See Question 10-22 below for discussion of how an entity determines this longer amortisation period.

Entities would also need to evaluate whether any expected subsequent renewal commissions are commensurate with prior renewal commissions to determine the appropriate amortisation period for any renewal commissions that are required to be capitalised under Section 23. Continuing the above example, assume the original three-year contract (for which a 6% commission is paid) and each subsequent renewal contract (for which a 2% renewal commission is paid) is for a one-year term. If the entity expects to renew the contract in years two through four and continue to pay a constant 2% commission upon each renewal, each renewal commission would be considered commensurate. As a result, it is likely that the appropriate amortisation period for each renewal required to be capitalised would be one year. See Question 10-25 below for discussion of when an entity would begin to amortise an asset recognised for the incremental cost of obtaining a renewal contract.

Question 10-22: How does an entity determine the amortisation period of an asset recognised for the incremental costs of obtaining a contract with a customer?²⁰⁵

Generally, when an entity determines an amortisation period that is consistent with the transfer to the customer of the goods or services to which the asset relates, it must determine whether the capitalised contract costs relate only to goods or services that will be transferred under the initial contract, or whether the costs also relate to goods or services that will be transferred under a specifically anticipated contract. For example, if an entity only pays a commission based on the initial contract and does not expect the customer to renew the contract (e.g., based on its past experience or other relevant information), amortising the asset over the initial term would be appropriate.

However, if the entity's past experience indicates that the customer is likely to renew the contract, the amortisation period would be longer than the initial term if the renewal commission is not 'commensurate' with the initial commission. See Question 10-21 above for a discussion of commensurate.

An entity needs to evaluate its facts and circumstances to determine an appropriate amortisation period if it determines that the period extends beyond the initial contract term, because the commission on the renewal contract is not commensurate with the commission on the initial contract. An entity might reasonably conclude that its average customer life is the best estimate of the amortisation period that is consistent with the transfer of the goods or services to which the asset relates (e.g., if the good or service does not change over time, such as a health club membership). However, this approach is not required and that entities must not use this as a default. Entities would use judgement that is similar to judgement used when estimating the amortisation period for intangible assets (e.g., a customer relationship intangible acquired in a business combination) and could consider factors such as customer loyalty and how quickly their products and services change.

204 Based on FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017.

205 Based on FASB TRG Agenda paper no. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*, dated 7 November 2016 and FASB TRG Agenda paper no. 60, *November 2016 Meeting - Summary of Issues Discussed and Next Steps*, dated 31 January 2017 and TRG discussions included in TRG Agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

Consider a technology entity that capitalises a commission paid on the sale of software, which the entity estimates it will maintain and support for only the next five years, and the estimated customer life is seven years. In evaluating the period of benefit, the entity might reasonably conclude that the capitalised commission has to be amortised over the five-year life of the software to which the commission relates. However, two acceptable methods for amortising capitalised contract costs that relate to both the original contract and the renewals in cases in which the renewal commission is not commensurate with the initial commission:

- The initial capitalised amount is amortised over the period of benefit that includes expected renewals, while amounts capitalised that relate to renewals are amortised over the renewal period.
- The portion of the initial capitalised amount that is commensurate is amortised over the original contract term and the additional amount that is not commensurate is amortised over the period of benefit that includes expected renewals. Capitalised amounts that relate to renewals are amortised over the renewal period.

Both methods are acceptable because they each meet the objective of amortising the costs on a systematic basis that is consistent with the pattern of transfer to the customer of the goods or services to which the asset relates. However, an entity needs to select one method and apply it consistently in similar circumstances. Other amortisation methods might also be acceptable if they are consistent with the pattern of transfer to the customer of the goods or services to which the asset relates.

The following Illustration shows the two methods described above:

Illustration 10-17: Methods for amortising capitalised contract costs

An entity has a commission plan that pays a 6% commission to a sales representative each time that sales representative obtains a new contract with a customer and a 2% commission each time that customer renews. The entity has elected an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset.

Based on the entity's assessment of the requirements in Section 23 for contract costs, it has concluded that the commissions paid as part of this commission plan are incremental costs to obtain a contract that are required to be capitalised. Furthermore, the entity has determined that the 2% commission paid for renewals is not commensurate with the 6% commission paid for initial contracts and, therefore, the period of benefit for capitalised commissions extends beyond the initial contract term.

The entity performs an assessment of average customer life, technology turnover and competitive factors and concludes that the period of benefit for capitalised commissions is five years.

The entity executes a three-year service contract with a customer for £600,000 and pays a 6% commission to the sales representative. At the end of the three-year term, the customer renews the contract for two more years for £400,000 and the entity pays a 2% commission to the sales representative.

The following are two acceptable methods for amortising the capitalised contract costs related to the £36,000 commission paid on the initial contract and the £8,000 commission paid on the renewal:

Method 1

The £36,000 commission related to the initial contract that was capitalised is amortised over the five-year period of benefit. When the contract is renewed, the £8,000 commission related to the renewal that was capitalised is amortised over the two-year renewal period. The commission would be amortised, as follows:

£	Year 1	Year 2	Year 3	Year 4	Year 5
Initial commission	7,200	7,200	7,200	7,200	7,200
Renewal commission	-	-	-	4,000	4,000
Total amortisation expense	7,200	7,200	7,200	11,200	11,200

Method 2

The £36,000 commission related to the initial contract that was capitalised is separated into two components: £12,000 that is commensurate with the commission paid on renewal (i.e., the amount of commission that the £600,000 initial contract earns at the commensurate rate of 2%); and £24,000 that is not commensurate. The entity amortises the £12,000 component over the three-year initial contract term and the £24,000 component over the five-year period of benefit. When the contract is renewed, the £8,000 commission related to the renewal that was capitalised is amortised over the two-year renewal period. The commission would be amortised, as follows:

£	Year 1	Year 2	Year 3	Year 4	Year 5
Initial commission (not commensurate)	4,800	4,800	4,800	4,800	4,800
Initial commission (commensurate)	4,000	4,000	4,000	-	-
Renewal commission	-	-	-	4,000	4,000
Total amortisation expense	8,800	8,800	8,800	8,800	8,800

Question 10-23: Can an entity attribute the capitalised contract costs to the individual performance obligations in the contract to determine the appropriate amortisation period?²⁰⁶

How we see it

We believe an entity can attribute the capitalised contract costs to individual performance obligations in the contract to determine the appropriate amortisation period, but it is not required to do so.

Paragraph 23.120 states that the asset recognised is amortised on a systematic basis “in accordance with the pattern of transfer to the customer of the goods or services to which the asset relates”. [FRS 102.23.120]. An entity would meet this objective by allocating the capitalised contract costs to performance obligations on a relative basis (i.e., in proportion to the transaction price allocated to each performance obligation) to determine the period of amortisation.

Illustration 10-18: Allocation of capitalised contract costs

A technology entity executes a contract for £600,000 for a perpetual software licence and one year of PCS. Based on the stand-alone selling prices, the entity allocates £500,000 (83%) of the total transaction price to the licence and £100,000 (17%) to the PCS. The entity has elected an accounting policy to recognise recoverable incremental costs of obtaining a contract as an asset. The entity pays a 4% commission to the sales representative and has determined that the commission is required to be capitalised because it is an incremental cost of obtaining the contract and is expected to be recovered.

The entity concludes that the £24,000 sales commission needs to be allocated between the licence and the PCS and amortised over the expected period of benefit associated with each of those performance obligations. The entity allocates £20,000 (83%) to the licence and £4,000 (17%) to the PCS, consistent with the relative value of the performance obligations to the transaction price.

Other methods for allocating capitalised contract costs might be appropriate. For example, we believe an entity would also meet the objective by allocating specific capitalised contract costs to individual performance obligations when the costs relate specifically to certain goods or services.

An entity needs to have objective evidence to support a conclusion that a specified amount of the costs relates to a specific performance obligation and consistently apply any methods used for allocating capitalised contract costs to performance obligations.

In addition, as discussed in Question 10-22 above, an entity that attributes capitalised contract costs to individual performance obligations needs to consider whether the amortisation period for some or all of the performance obligations extends beyond the original contract (see also discussion in this section above).

Another potentially acceptable amortisation pattern for capitalised contract costs relates to multiple performance obligations that are satisfied over different periods that would not require allocation of the asset to individual performance obligations in the contract. That is, an entity might amortise a single capitalised contract cost using one measure of performance taking into consideration all of the performance obligations in the contract. An entity that uses this method needs to select a measure that best reflects the ‘use’ of the asset as the goods and services are transferred to the customer. That is, the pattern of amortisation must meet the objective of paragraph 23.120 so that it is consistent with the pattern of transfer to the customer of the goods or services to which the asset relates.

Question 10-24: Over what period would an entity amortise a sales commission (that is only paid once a threshold is met) that is determined to be an incremental cost to obtain a contract?²⁰⁷

There are at least two alternatives that meet the objective of amortising the costs on a systematic basis that is consistent with the pattern of transfer to the customer of the goods or services to which the asset

²⁰⁶ Based on TRG Agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

²⁰⁷ Based on TRG Agenda paper no. 23, *Incremental costs of obtaining a contract*, dated 26 January 2015.

relates. However, either alternative must be applied consistently to similar circumstances. In the first alternative, an entity allocates the capitalised costs to all of the contracts that cumulatively result in the threshold being met and amortises the costs over the expected customer relationship period of each of those contracts. In the second alternative, an entity allocates the capitalised costs to the contract that results in the threshold being met and amortise the costs over the expected customer relationship period of that contract. Note that the second alternative might result in a counterintuitive answer if the commission paid upon obtaining the contract that resulted in the threshold being met was large in relation to the transaction price for only that contract. While the first alternative might be easier to apply and result in a more intuitive answer than the second alternative in some situations, either approach is considered acceptable. Note that there could be other approaches that also are acceptable.

Consider the following example:

Illustration 10-19: Amortisation of capitalised commission payments subject to a threshold

An entity has a commission programme that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The entity has elected an accounting policy to recognise recoverable incremental costs of obtaining a contract.

In this example, the first commission is paid when the first contract is signed. Subsequently, once a cumulative threshold number of contracts is reached, a commission is paid on that threshold contract as a fixed escalating amount, taking into account any commission already paid, as follows:

1 contract	£3,000 commission
10 contracts	£5,000 cumulative commission (including £3,000 already paid)
15 contracts	£10,000 cumulative commission (including £5,000 already paid)

Assume 11 new contracts are signed by a specific employee in that period.

As discussed in Question 10-7 in 10.3.1 above, generally, commission payments subject to a threshold are incremental costs of obtaining a contract with a customer and, therefore, if such costs are expected to be recovered, the costs must be capitalised when the entity incurs a liability to pay these commissions.

In the first acceptable alternative, an entity estimates the total amount of commission that is expected to be paid for the period and capitalises an equal amount as each contract is signed. In this example, because the entity estimates that the employee will sign 11 new contracts during the period, it expects the total amount of commission to be paid will be £5,000. The entity would capitalise £455 when each contract is signed (i.e., £5,000 cumulative commission divided by the 11 contracts). The capitalised amount would be amortised over the expected customer relationship period of each of those contracts. That is, the £455 capitalised for the first contract would be amortised over the expected customer relationship period of the first contract and the £455 capitalised for the second contract would be amortised over the expected customer relationship period of the second contract.

In the second acceptable alternative, an entity capitalises £3,000 in commission costs upon signing the first contract. This amount would be amortised over the expected customer relationship period of that contract (i.e., the first contract). The entity would not capitalise any additional costs upon signing the second contract through to the ninth contract because the next commission 'tier' has not been met. Once the tenth contract is signed, the entity capitalises an additional £2,000 in commission costs. This amount would be amortised over the expected customer relationship period for that contract (i.e., the tenth contract).

Question 10-25: When does an entity begin to amortise an asset recognised for the incremental cost of obtaining a renewal contract?

As discussed in Question 10-21 above, assets recognised for commensurate renewal commissions paid are amortised over the term of the contract renewal, with the expense recognised as the entity transfers the related goods or services to the customer.

How we see it

We believe that the amortisation of the renewal commission must not begin earlier than the beginning of the renewal period.

Consider the following Illustration:

Illustration 10-20: Amortisation of a capitalised contract costs

On 1 January 20X6, an entity enters into a three-year service contract with a customer that ends on 31 December 20X8. Upon the customer signing the contract, the entity pays a sales employee a £50,000 sales commission for obtaining the contract. On 30 September 20X8, the entity negotiates a three-year renewal term that will begin on 1 January 20X9 and pays the sales employee a renewal commission that is commensurate with the initial sales commission paid. Since the entity does not begin to transfer services under the contract renewal until 1 January 20X9, the entity would not begin amortising the asset related to the renewal commission until 1 January 20X9.

Question 10-26: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

As discussed in 10.3.1 to 10.3.3 above, Section 23 provides a policy choice to capitalise incremental costs of obtaining a contract and requires certain costs to fulfil a contract to be recognised as an asset, and that asset is required to be amortised on a systematic basis. Paragraph 23.138 requires separate disclosure of closing balances and the amount of amortisation and impairment losses recognised during the period (see 11.4.3 below). However, Section 23 is silent on the classification of that asset and the related amortisation.

While such capitalised contract cost assets are intangible in nature, Section 18 specifically excludes from its scope intangible assets arising from contracts with customers that are recognised in accordance with Section 23. [FRS 102.18.1]. In the absence of a section in FRS 102 that specifically deals with the classification and presentation of contract costs, management would need to apply the requirements in Section 10 to select an appropriate accounting policy (see Chapter 9 at 3.3).

How we see it

In developing such an accounting policy, we believe that costs to obtain a contract and costs to fulfil a contract need to be considered separately for the purpose of classification and presentation in the financial statements, as described in the bullets below.

Considering the nature of *costs to obtain a contract* and the lack of guidance in FRS 102 and adopted IFRS, we believe an entity can choose to classify and present these costs as either:

- A separate class of asset (which could be placed adjacent to inventories or 'stocks' as similar in nature to work in progress or 'inventory') in the statement of financial position and its amortisation within cost of goods sold, changes in contract costs or similar.
- Or
- A separate class of intangible assets in the statement of financial position and its amortisation in the same line item as amortisation of intangible assets within the scope of Section 18.

In contrast, the nature of costs to fulfil a contract is such that they directly impact the entity's performance under the contract. Therefore, costs to fulfil a contract are classified and presented as a separate class of asset in the statement of financial position (e.g., adjacent to inventories or 'stocks') and its amortisation within cost of goods sold, changes in contract costs or similar.

We do not believe it would be appropriate to analogise to the requirements for intangible assets in Section 18. Instead, such costs are consistent in nature to costs incurred in the process of production, as contemplated in Section 13. That is, in nature, they are consistent with work in progress, or 'inventory', of a service provider. Therefore, whether costs to fulfil a contract meet the criteria for capitalisation in paragraph 23.117 or are expensed as incurred, we believe that classification and presentation of such costs in the statement of profit or loss and other comprehensive income, and the classification and presentation of related cash flows in the statement of cash flows needs to be consistent.

Presenting the contract cost assets and corresponding amortisation as separate line items in the financial statements as described above is consistent with the requirements in Section 4 and Section 5 which apply both to statutory and adapted formats, i.e., additional line items, headings and subtotals are required to be added where relevant to an understanding of the entity's financial position or financial performance. [FRS 102.4.3, FRS 102.5.9].

Further, for entities using the statutory formats, presenting these items as separate line items in the financial statements can be justified by reference to the General Rules to the formats which allow any item to be shown in a company's balance sheet or profit and loss account in greater detail than required by the particular format used. The balance sheet or profit and loss account could include an item representing or covering the amount of any asset or liability, income or expenditure not otherwise covered by any of the items listed in the format used. [1 Sch 3].

For further discussion on presentation requirements in Section 4, Section 5 and the Regulations, please refer to Chapter 6.

In all cases, an entity needs to consider the aggregation requirements of Section 4 and the General Rules to the formats (if statutory formats are used) when determining whether the separate classes of assets or expense items are presented together with other assets or other expenses, respectively (see Chapter 6 at 8.4).

In addition, the entity needs to consider the requirements in Section 7, in particular paragraph 7.5(a), when determining the classification of cash flows arising from costs to obtain and fulfil a contract (i.e., either as a cash flow from operating activities or investing activities if costs to obtain a contract are classified as a class of intangible assets). [FRS 102.7.5(a)].

Capitalised contract costs are subject to impairment assessments (see 10.3.4 below). Impairment losses are recognised in profit or loss, but Section 23 is silent on where to classify and present such amounts within the primary financial statements.

How we see it

We believe it would be appropriate for the classification and presentation of any impairment losses to be consistent with the classification and presentation of the amortisation expense.

10.3.4 Impairment of capitalised contract costs

Capitalised contract costs must be tested for impairment. This is because the costs that give rise to an asset must be recoverable throughout the contract period (or period of benefit, if longer), to meet the criteria for capitalisation.

Under Section 23, an entity follows Section 27 for recognising and measuring the impairment of the capitalised contract costs. However, instead of following the requirements in paragraphs 27.11 to 27.20A to estimate the recoverable amount of such capitalised contract costs (i.e., using the higher of fair value less costs to sell and value in use), an entity estimates the recoverable amount of the contract costs asset as the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates, less the costs that relate directly to providing those goods or services and that have not been recognised as expenses. An impairment exists if the carrying amount of the asset exceeds the estimated recoverable amount. Impairment losses are recognised in profit or loss.

[FRS 102.23.121, FRS 102.23.122]. See Question 10-26 in 10.3.3 above for further discussion on classifying and presenting impairment losses within profit or loss.

IFRS 15 and TRG discussions provide further guidance on this area which entities reporting under FRS 102 could consider in its application of the requirements of Section 23.

TRG members generally agreed that an impairment test of capitalised contract costs must include future cash inflows and outflows associated with contract renewal or extension periods, if the period of benefit of the costs under assessment is expected to extend beyond the present contract.²⁰⁸ In other words, an entity must consider the total period over which it expects to receive economic benefits relating to the asset, for the purpose of both determining the amortisation period and estimating cash flows to be used in the impairment test. The question was raised because of an inconsistency within IFRS 15, which can also be observed in Section 23. IFRS 15 and Section 23 indicate that costs capitalised under the respective revenue standards could relate to goods or services to be transferred under 'a specific anticipated contract' (e.g., goods or services to be provided under contract renewals and/or extensions). [IFRS 15.95, FRS 102.23.117]. Both IFRS 15 and Section 23 also indicate that an impairment loss would be recognised when the carrying amount of the asset exceeds the remaining amount of consideration expected to be received (determined by using principles for determining the transaction price, see 6 above). [IFRS 15.101(a), IFRS 15.102, FRS 102.23.122(a), FRS 102.23.123]. However, the requirements for measuring the transaction price in IFRS 15 and Section 23 indicate that an entity does not anticipate that the contract will be "cancelled, renewed or modified" when determining the transaction price. [IFRS 15.49, FRS 102.23.42].

²⁰⁸ TRG Agenda paper no. 4, *Impairment testing of capitalised contract costs*, dated 18 July 2014 and TRG Agenda paper no. 5, *July 2014 Meeting-Summary of Issues Discussed and Next Steps*, dated 31 October 2014.

In some instances, excluding renewals or extensions would trigger an immediate impairment of a contract asset because the consideration an entity expects to receive would not include anticipated cash flows from contract extensions or renewal periods. However, the entity would have capitalised contract costs on the basis that they would be recovered over the contract extension or renewal periods. When an entity determines the amount it expects to receive (see 6 above), it would not apply the requirements for constraining estimates of variable consideration. That is, if an entity were required to reduce the estimated transaction price because of the constraint on variable consideration, it would use the unconstrained transaction price for the impairment test. This would include any amounts expected to be received but not yet recognised because of the royalties recognition constraint (see 9.5 above) or the 'right to invoice' practical expedient (see 8.1.4.B above). While the amount expected to be received is unconstrained, it would still need to be adjusted to reflect the customer's credit risk before it is used in the impairment test. [FRS 102.23.123].

Unlike Section 23, IFRS 15.103 provides prescriptive steps in assessing impairment of capitalised contract costs, which entities reporting under FRS 102 could consider when applying the impairment guidance. [IFRS 15.103]. Accordingly, following the guidance in paragraph 103 of IFRS 15, an entity would first consider impairment losses recognised in accordance with other sections in FRS 102 (e.g., impairment of specific assets such as inventories under Section 13) before recognising an impairment loss on capitalised contract costs incurred to obtain or fulfil a contract. After applying the impairment test to the capitalised contract costs (as discussed above), an entity includes the resulting carrying amounts in the carrying amount of a cash-generating unit for purposes of applying the requirements in Section 27.

Under FRS 102, Section 27 permits the reversal of some or all of previous impairment losses on assets (other than goodwill) or cash-generating units if the estimates used to determine the assets' recoverable amount have changed (see Chapter 29 at 7). [FRS 102.27.28-27.31]. Section 23 refers to the requirements of Section 27 when recognising and measuring the impairment of the capitalised contract costs (except for estimating the recoverable amount, as discussed above), therefore, Section 23 also permits reversal of impairment losses when impairment conditions no longer exist or have improved. However, consistent with requirements in Section 27, the increased carrying amount of the asset must not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously. [FRS 102.23.121, FRS 102.27.30(c), FRS 101.27.31(c)].

Frequently asked questions

Question 10-27: How often does an entity need to assess its capitalised contract costs for impairment under Section 23?

Section 23 refers to the requirements of Section 27 when recognising and measuring the impairment of the capitalised contract costs (except for estimating the recoverable amount, as discussed above). [FRS 102.23.121]. Accordingly, an entity needs to assess whether there is any indication that its capitalised contract costs might be impaired at the end of each reporting period.

This is consistent with the requirement in paragraph 27.7 to assess at each reporting date whether there are indicators that assets within the scope of Section 27 are impaired (see Chapter 29 at 4). For example, a pandemic or natural disaster might affect customers' ability and intent to pay, and/or entities might be more willing to accept partial payment or extend payment terms. Such collectability concerns might indicate that entities need to assess related capitalised costs to obtain or fulfil a contract for impairment.

11 Presentation and disclosure

Section 23 provides explicit presentation and disclosure requirements, which are more detailed than under legacy Section 23 and increase the volume of required disclosures that entities must include in their annual financial statements. However, Section 1 *Scope* of FRS 102 provides presentation and/or disclosure exemptions that are available to entities meeting the definition of a qualifying entity. The definition of a 'qualifying entity', the conditions required to be met to use any of the available presentation or disclosure exemptions and the list of these exemptions are discussed in detail in Chapter 3 at 3. The exemptions available for specific disclosure requirements in Section 23 are indicated in this part of the chapter, where appropriate.

While not part of the requirements in Section 23, entities also need to disclose material accounting policy information in accordance with Section 8. [FRS 102.8.5, FRS 102.8.6, FRS 102.8.7].

It is possible that entities will conclude that accounting policy information about areas of Section 23 that are complex or require significant judgements are material. If so, entities will need to make entity-specific and tailored disclosures (see Chapter 6 at 7.2). [FRS 102.8.5A-8.5C]. In addition, entities also need to disclose information about judgements and key sources of estimation uncertainty in respect of applying the requirements of Section 23 (see Chapter 6 at 7.3 and 7.4). [FRS 102.8.6, FRS 102.8.7]. See also discussions in 11.4.2 below.

How we see it

Section 23 requires more extensive and detailed disclosures in entities' financial statements, compared to legacy Section 23.

Entities might have to expend considerable effort when preparing the required disclosures for their annual financial statements. For example, some entities operating in multiple segments with many different product lines might find it challenging to gather the data needed to provide the disclosures. Therefore, it is important for entities to have the appropriate systems, internal controls, policies and procedures in place to collect and disclose the required information.

11.1 Presentation requirements for contract assets and contract liabilities

The revenue model is based on the notion that a contract asset or contract liability is generated when either party to a contract performs, depending on the relationship between the entity's performance and the customer's payment. Section 23 requires that an entity present these contract assets or contract liabilities in the statement of financial position, as extracted below: [FRS 102.23.124, FRS 102.23.125, FRS 102.23.126, FRS 102.23.127]

Extract from Section 23

- 23.124** When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between:
- (a) the entity's performance in transferring goods or services to the customer; and
 - (b) the customer's payment.
- 23.125** If an entity has received consideration (or consideration is due) from the customer before the entity transfers goods or services to the customer, the entity shall recognise a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer. When (or as) the entity transfers those goods or services to the customer, the entity shall derecognise the contract liability (or part of a contract liability) and recognise revenue, in accordance with paragraphs 23.78 to 23.112.
- 23.126** If an entity transfers goods or services to a customer before the customer pays consideration (or before payment is due), the entity shall recognise a contract asset, excluding any amounts presented as a trade receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (eg the entity transferring other goods or services promised in the contract). When the customer pays the consideration (or the consideration becomes due), the entity shall derecognise the contract asset. An entity shall assess a contract asset for impairment, and recognise any impairment loss, in accordance with Section 11.

23.127 A trade receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due. For example, an entity would recognise a trade receivable if it has a present right to payment even though that amount may be subject to refund in the future.

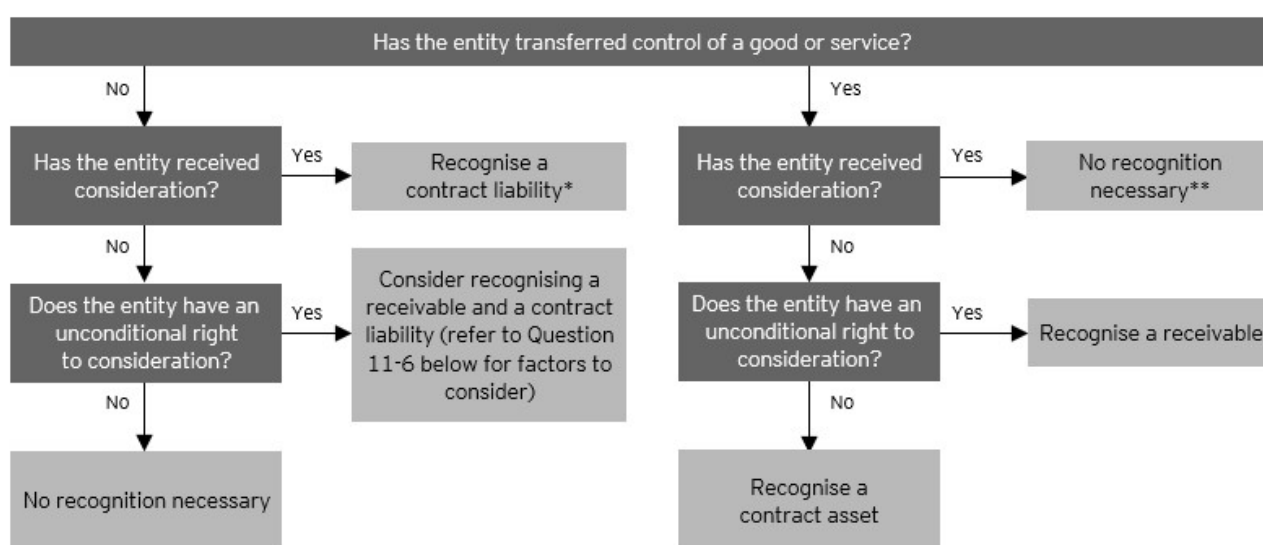
Section 23 does not explicitly require an entity to present contract assets or contract liabilities as separate line items in the statement of financial position. Therefore, entities need to consider the requirements in Section 4 (see Chapter 6) to determine whether to present them in separate line items.

Presenting these items as separate line items in the statement of financial position is consistent with the requirements in Section 4 which apply both to statutory and adapted formats, i.e., additional line items, headings and subtotals are required to be added where relevant to an understanding of the entity's financial position. [FRS 102.4.3].

See Question 11-1 and Question 11-3 in 11.1.5 below for further information on offsetting contract assets and contract liabilities and see 11.1.2 below for current versus non-current classification.

The following flowchart illustrates how an entity determines whether to recognise a receivable, a contract asset or a contract liability on the balance sheet:

Figure 11-1: Recognition of a receivable, a contract asset or a contract liability



* If the customer can cancel the contract and receive a refund of the advance payment, an entity would consider recognising a refund liability (separate from contract liabilities – see Question 11-4 below).

** This assumes the consideration received is equal to the amount to which the entity is entitled for the good or service already transferred. If the consideration received is less than this amount, an entity may need to recognise a contract asset or a receivable for the difference. If the consideration received is more than this amount, an entity may need to recognise a contract liability or a refund liability.

When an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer and, therefore, has a contract asset. When the customer performs first, for example, by prepaying its promised consideration, the entity has a contract liability.

[FRS 102.23.125, FRS 102.23.126].

An entity could also have recognised other assets related to contracts with a customer (e.g., the incremental costs of obtaining the contract and other costs incurred that meet the criteria for capitalisation). Section 23 requires that any such assets be presented separately from contract assets and contract liabilities in the statement of financial position or disclosed separately in the notes to the financial statements (assuming that they are material). [FRS 102.23.134(a)]. These amounts are also assessed for impairment separately (see 10.3.4 above).

11.1.1 Distinction between contract assets and receivables

Contract assets represent conditional or unconditional rights to consideration. The right is conditional, for example, when an entity must first satisfy another performance obligation in the contract before it is entitled to payment from the customer. If an entity has an unconditional right to receive consideration from the customer, the contract asset is accounted for as a receivable and presented separately from other contract assets. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due. For example, an entity recognises a trade receivable if it has a present right to payment even though that amount might be subject to refund in the future. [FRS 102.23.126, FRS 102.23.127].

In the Basis for Conclusions on IFRS 15, the IASB explains that in many cases, an unconditional right to consideration (i.e., a receivable) arises when an entity satisfies a performance obligation, which could be before it invoices the customer (e.g., an unbilled receivable) if only the passage of time is required before payment of that consideration is due. It is also possible for an entity to have an unconditional right to consideration before it satisfies a performance obligation. [IFRS 15.107, IFRS 15.BC325]. In some industries, it is common for an entity to invoice its customers in advance of performance (and satisfaction of the performance obligation). For example, an entity that enters into a non-cancellable contract requiring payment a month before the entity provides the goods or services would recognise a receivable and a contract liability on the date the entity has an unconditional right to the consideration (see Question 11-6 in 11.1.5 below for factors to consider when assessing whether an entity's right to consideration is considered unconditional). In this situation, revenue is not recognised until goods or services are transferred to the customer.

In December 2015, the IASB discussed application of IFRS 15 to contracts in which the entity has transferred control of a good to the customer at a point in time, but the consideration to which the entity is entitled is contingent upon a market price (e.g., a commodity price), which will be determined at a future date. The example assumed that there was no separable embedded derivative (i.e., the entire contract was within the scope of IFRS 15). In discussing this issue, the IASB clarified the nature of conditions that might prevent recognition of a receivable. Specifically, the IASB agreed that the variability arising solely from changes in the market price would not be a condition that prevents an entity to recognise a receivable. That is, since the entity has performed, "... nothing else (ie no future event) needs to happen before payment of the consideration is due. The existence of a price in the future requires no event to occur and depends solely on the passage of time. Changes in the price of Commodity do not affect the entity's right to consideration, even though the amount that the entity receives is known only on the payment date. In other words, there is no uncertainty with regards to the entity's entitlement to the consideration. The entity's right to consideration is therefore unconditional as understood by IFRS 15...". Therefore, when the entity performs by transferring control of the good to the customer, it recognises a receivable in accordance with IFRS 9 (and is no longer subject to the requirements in IFRS 15 for the variable consideration constraint).²⁰⁹

In the Basis for Conclusions on IFRS 15, the IASB noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. Although both are subject to credit risk, a contract asset is also subject to other risks (e.g., performance risk). [IFRS 15.BC323].

Under Section 23, entities are not required to use the terms 'contract asset', 'contract liability' or 'trade receivable' in the statement of financial position or in the notes, but must disclose sufficient information so that users of the financial statements can clearly distinguish between unconditional rights to consideration (receivables) and conditional rights to receive consideration (contract assets). [IFRS 102.23.128].

Illustration 11-1, which is based on Example 38 in IFRS 15, is an example of presentation of contract balances: [IFRS 15.IE Example 38, IFRS 15.IE198-IE200]

Illustration 11-1: Contract liability and receivable

Case A-Cancellable contract

On 1 January 20X6, an entity enters into a cancellable contract to transfer a product to a customer on 31 March 20X6. The contract requires the customer to pay consideration of £1,000 in advance on 31 January 20X6. The customer pays the consideration on 1 March 20X6. The entity transfers the product on 31 March 20X6. The following journal entries illustrate how the entity accounts for the contract:

- (a) The entity receives cash of £1,000 on 1 March 20X6 (cash is received in advance of performance):
- | | | |
|------|--------------------|--------|
| Cash | £1,000 | |
| | Contract liability | £1,000 |
- (b) The entity satisfies the performance obligation on 31 March 20X6:
- | | | |
|--------------------|---------|--------|
| Contract liability | £1,000 | |
| | Revenue | £1,000 |

²⁰⁹ IASB Staff Paper 7H: Project: Revenue from Contracts with Customers, Paper topic: Constraining estimates of variable consideration when the consideration varies based on a future market price, IASB Meeting, December 2015; and IASB Update, December 2015. Available on the IFRS Foundation's website.

Case B-Non-cancellable contract

The same facts as in Case A apply to Case B except that the contract is non-cancellable. The following journal entries illustrate how the entity accounts for the contract:

- (a) The amount of consideration is due on 31 January 20X6 (which is when the entity recognises a receivable because it has an unconditional right to consideration):

Receivable	£1,000	
Contract liability		£1,000

- (b) The entity receives the cash on 1 March 20X6:

Cash	£1,000	
Receivable		£1,000

- (c) The entity satisfies the performance obligation on 31 March 20X6:

Contract liability	£1,000	
Revenue		£1,000

If the entity issued the invoice before 31 January 20X6 (the due date of the consideration), the entity would not present the receivable and the contract liability on a gross basis in the statement of financial position because the entity does not yet have a right to consideration that is unconditional.

Illustration 11-2, which is based on Example 39 in IFRS 15 illustrates when an entity has satisfied a performance obligation, but does not have an unconditional right to payment and, therefore, recognises a contract asset: [IFRS 15.IE Example 39, IFRS 15.IE201-IE204]

Illustration 11-2: Contract asset recognised for the entity's performance

On 1 January 20X6, an entity enters into a contract to transfer Products A and B to a customer in exchange for £1,000. The contract requires Product A to be delivered first and states that payment for the delivery of Product A is conditional on the delivery of Product B. In other words, the consideration of £1,000 is due only after the entity has transferred both Products A and B to the customer. Consequently, the entity does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to the customer.

The entity identifies the promises to transfer Products A and B as performance obligations and allocates £400 to the performance obligation to transfer Product A and £600 to the performance obligation to transfer Product B on the basis of their relative stand-alone selling prices. The entity recognises revenue for each respective performance obligation when control of the product transfers to the customer.

The entity satisfies the performance obligation to transfer Product A:

Contract asset	£400	
Revenue		£400

The entity satisfies the performance obligation to transfer Product B and to recognise the unconditional right to consideration:

Receivable	£1,000	
Contract asset		£400
Revenue		£600

The following Illustration, which is based on Example 5 in the FRC's FRS 102 Factsheet 10,²¹⁰ shows accounting for contract balances when revenue is recognised over time:

Illustration 11-3: Contract balances

Entity E enters into a contract with a customer with a transaction price of £10,000, of which £5,000 is paid in advance and £5,000 is due within 30 days of the contract being completed. The contract contains a single performance obligation that is satisfied over time.

When the initial payment is received, the entity recognises the following transaction:

Dr	Cash	£5,000	
	Cr	Contract liability	£5,000

At the end of the reporting period, Entity E's measure of progress towards completion of the performance obligation is 60%. Entity E recognises the following transaction:

Dr	Contract liability	£5,000	
Dr	Contract asset	£1,000	
	Cr	Revenue	£6,000

As required by paragraph 23.126, Entity E assesses the contract asset for impairment in accordance with Section 11 (see 11.1.3 below); in this example there is no impairment.

Part-way through the subsequent period, the measure of progress towards completion of the performance obligation is 100%. Entity E recognises the following transaction:

Dr	Contract asset	£4,000	
	Cr	Revenue	£4,000

The contract requires the customer to pay Entity E in full when the performance obligation is complete, so Entity E has a right to the remaining £5,000 consideration that is unconditional (refer to paragraph 23.127). Entity E recognises the following transaction:

Dr	Trade receivable	£5,000	
	Cr	Contract asset	£5,000

Also consider the following Illustration, which shows an unbilled receivable (rather than a contract asset):

Illustration 11-4: Unbilled receivable

On 14 September 20X6, Entity L enters into a contract to sell 100 widgets to Customer F at £10 per widget. All of the widgets are delivered to Customer F on 29 September 20X6. Entity L invoices Customer F on 12 October 20X6.

Entity L determines that revenue is recognised when control of the widgets transfers to Customer F on 29 September 20X6. Entity L records a corresponding receivable because only the passage of time is required before payment of that consideration is due. That is, Entity L has an unconditional right to consideration as at 29 September 20X6, even though Entity L has not yet issued an invoice. That is, even though the amount is 'unbilled', it is still considered a receivable, rather than a contract asset.

As noted in Question 6-6 in 6.2.1 above, when an entity is entitled to receive consideration denominated in a foreign currency, it needs to apply Section 30 to appropriately translate a foreign denominated transaction on initial recognition. After initial recognition, receivables are retranslated using the spot exchange rate at each subsequent reporting date and on derecognition, with the exchange gains and losses being recognised in profit or loss. This is because receivables are monetary items as defined in FRS 102. [FRS 102 Appendix I]. Further analysis is needed for a contract asset to determine whether it is a monetary item that requires retranslation, or a non-monetary item that does not. Some (or all) of a contract asset will meet the definition of a monetary item to the extent the (conditional) right to consideration is to foreign denominated cash.²¹¹ See Chapter 32 at 3.4.6 to 3.4.9 for further discussion.

²¹⁰ [FRS 102 Factsheet 10 Revenue](#) from *Contracts with Customers*, FRC, issued on 27 November 2024, Section 3 Other requirements, Contract balances, page 19.

²¹¹ Based on [IASB Staff Paper 2](#): Project: *IAS 21 The Effects of Changes in Foreign Exchange Rates*, Paper topic: *Draft Interpretation- Foreign Currency Transactions and Advance Consideration*, IFRS IC meeting, March 2015, paragraph 38. Available on the IFRS Foundation's website.

11.1.2 Contract assets classification

Since Section 23 does not address whether an entity needs to present and classify contract assets or contract liabilities as current or non-current (or, if applicable, as fixed assets) in the statement of financial position, entities need to consider the requirements in Section 4 and the Regulations (see Chapter 6 at 4).

The current versus non-current (or, if applicable, fixed assets) assessments are also relevant for other assets and liabilities arising from contracts with customers within the scope of Section 23 (e.g., capitalised contract costs to obtain and fulfil a contract – see 10.3 above).

▪ *Use of adapted formats:*

If an entity is using the adapted formats, the distinction between current and non-current items depends on the length of the entity's operating cycle. The concept of 'operating cycle' is not further explained in FRS 102 but under adopted IFRS, IAS 1 *Presentation of Financial Statements* (or IFRS 18 *Presentation and Disclosure in Financial Statements*²¹²) states that the operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. However, when the entity's normal operating cycle is not clearly identifiable, it is assumed to be 12 months. [IAS 1.68, IAS 1.70, IFRS 18.B95, IFRS 18.B96]. IAS 1 (or IFRS 18) does not provide guidance on how to determine whether an entity's operating cycle is 'clearly identifiable'. For some entities, the time involved to produce goods or provide services might vary significantly from contracts with one customer to another. In such cases, it might be difficult to determine what is the normal operating cycle. Therefore, entities need to consider all facts and circumstances and use judgement to determine whether it is appropriate to consider that the operating cycle is clearly identifiable, or whether to use the twelve-month default. [IAS 1.68, IAS 1.70, IFRS 18.B95, IFRS 18.B96]. See Chapter 6 at 4.1.1A and 4.1.2.A for further discussion.

Consequently, an entity assesses, based on the contract terms, facts and circumstances, whether a contract asset or contract liability is classified as current or non-current. It considers:

- For a contract asset: when payment is due (e.g., based on payment schedule agreed with client)
- For a contract liability: the timing of satisfaction of the performance obligation as a factor when applying the requirements of Section 4

This assessment might lead to a separation of the contract asset or contract liability into a current and a non-current portion.

▪ *Use of statutory formats:*

The statutory formats distinguish between current and fixed assets and the definitions of these categories differ to that for current and non-current assets, under the adapted formats. This is discussed in detail in Chapter 6 at 4.2.2.

Contract assets and contract liabilities do not feature in the balance sheet formats. As further discussed in Chapter 6 at 4.3.13A, it would be appropriate to include the contract asset as a line item within 'debtors' and would follow the disclosure requirements for any material amounts due after more than one year, as required by Section 4. Contract liabilities are similar in nature to deferred income. The statutory formats permit a choice of locations for the deferred income line item: either in creditors falling due within one year / creditors falling due after more than one year or in the separate line item for accruals and deferred income.

For further discussion, please see Chapter 6 at 4.

11.1.3 Impairment of contract assets

After initial recognition, contract assets, like receivables, are subject to impairment assessments in accordance with Section 11 (the impairment requirements are discussed in Chapter 13 at 6.5).

[FRS 102.23.126].

Unless an entity chooses to apply the recognition and measurement provisions of IFRS 9 (as a policy choice – see Chapter 11 at 4) to account for all of its financial instruments, the entity is required to assess contract assets for impairment in accordance with Section 11 which uses the same principles and criteria as the incurred loss model under IAS 39 *Financial Instruments: Recognition and Measurement* with one major difference. Under Section 11, assets which have been individually assessed for impairment and found not to be impaired, are not subsequently required to be included in a collective assessment of impairment. If there is objective evidence of impairment, the entity recognises an impairment loss in profit or loss immediately.

[FRS 102.11.21].

²¹² IFRS 18 supersedes IAS 1 for reporting periods beginning on or after 1 January 2027 (with earlier application permitted). See Chapter 6 for further information.

The expected credit loss model in IFRS 9 focuses on the difference between the contractual cash flows and expected cash flows, [IFRS 9.B5.5.29], while the incurred loss model under Section 11 focuses on the difference between the carrying amount of the contract asset and the present value of estimated cash flows. [FRS 102.11.25(a)]. However, the right to receive non-cash consideration does not give rise to cash inflows. As such, judgement might be needed when the consideration to which the entity is entitled is non-cash. Since the entity does not yet hold the non-cash consideration, the impairment requirements in Section 27, for example, do not directly apply.

How we see it

When applying the impairment requirements of Section 11 (or if elected, IFRS 9) to the contract asset, an entity considers the likelihood of not receiving the non-cash consideration (i.e., non-performance risk). However, this would not consider any potential impairment in the underlying asset to which the entity is entitled. As such, an entity might need to consider the value of the underlying non-cash consideration to which it is entitled to use as a proxy for the cash inflows when applying the impairment requirements of Section 11 (or if elected, IFRS 9).

Further information regarding impairment under IFRS 9 is available in the EY publication, International GAAP®.

As discussed in 6.5.4 above, impairment losses on receivables are presented in line with the general requirements of Section 5 (see Chapter 6 at 5) and the disclosure requirements in Section 11 or Section 12 (see Chapter 15). In addition, as discussed in 11.2 below, Section 23 requires that such amounts are disclosed separately from impairment losses from other contracts. [FRS 102.23.133(b)]. These requirements also apply to impairment losses on contract assets.

11.1.4 Derecognition of contract assets and contract liabilities

Section 23 explicitly requires an entity to derecognise contract assets when the customer pays the consideration or the consideration becomes due (i.e., when the entity's right to consideration becomes unconditional, and it is able to recognise a receivable in accordance with Section 11). [FRS 102.23.126]. When (or as) the entity transfers the promised goods or services to the customer, the entity is required to derecognise the contract liability (or part of a contract liability) and recognise revenue in accordance with paragraphs 23.78 to 23.112 (see 8 above). [FRS 102.23.125].

11.1.5 Initial measurement of receivables

If the initial measurement of a receivable is at fair value, there might be a number of reasons why differences from the transaction price could arise (e.g., changes in the fair value of non-cash consideration not yet received, changes in market interest rates or inflation, etc.). This is the case when the difference is attributable to customer credit risk, rather than an implied price concession. Implied price concessions are deducted from the contract price to derive the transaction price, which is the amount recognised as revenue. Distinguishing between implied price concessions and expense due to customer credit risk requires judgement (see 6.2.1.A – 6.2.1.B above). Impairment losses resulting from contracts with customers are presented separately from other impairment losses (see 11.4.1 below for further discussion). [FRS 102.23.133(b)].

Further analysis of the reason for such a difference might be needed if an entity has an unconditional right to payment (i.e., a receivable) even though that amount is subject to refund in the future. This could occur because, for example, a customer might be entitled to a retrospective volume rebate. Assume, for example, that an entity has invoiced a customer £100 for the sale of goods, but expects to refund £25 because the customer will meet the conditions for an agreed volume rebate. The entity recognises £75 because it has constrained the consideration (in accordance with the variable consideration requirements, see 6.2 above). However, it has an unconditional right to receive payment for the full invoice price of £100. Therefore, the entity recognises a receivable of £100 and the refund obligation of £25 (on a gross basis), unless the offsetting requirements in paragraph 11.38A, or paragraph 12.25B, are met (see Chapter 13 at 8.1 on the requirements in Section 11 and Section 12 for offsetting financial assets and financial liabilities). This example is consistent with Example 40 in IFRS 15. [IFRS 15.IE Example 40, IFRS 15.IE205-IE208]. Careful analysis of the facts will be important including expectations about when any conditions for refund will be met and when the entity has an unconditional right to payment.

Section 23 does not provide specific guidance on how to present any difference between the initial measurement of the receivable and the corresponding amount of revenue recognised. However, an entity could consider the requirements and guidance in IFRS 15. Under IFRS 15, if upon initial measurement there

is a difference between the measurement of the receivable (in accordance with IFRS 9) and the corresponding amount of revenue, that difference is presented immediately in profit or loss (e.g., as an impairment loss). [IFRS 15.108]. Further discussion on recognition and initial measurement under IFRS 9 is available in the EY publication, International GAAP®.

Frequently asked questions

Question 11-1: How would an entity determine the presentation of contract assets and liabilities for contracts that contain multiple performance obligations?²¹³

Contract assets and liabilities would be determined at the contract level and not at the performance obligation level. That is, an entity does not separately recognise an asset or liability for each performance obligation within a contract, but aggregates them into a single contract asset or liability.

Under Section 23, the amount and timing of revenue recognition is determined based on progress toward complete satisfaction of *each* performance obligation. Therefore, this question addresses whether an entity could have a contract asset and a contract liability for a single contract. An example is when the entity has satisfied (or partially satisfied) one performance obligation in a contract for which consideration is not yet due but has received a prepayment for another unsatisfied performance obligation in the contract. Entities reporting under FRS 102 could consider further guidance in IFRS 15. That is, the discussion in the Basis for Conclusions on IFRS 15 is clear that contract asset or contract liability positions are determined for each contract on a net basis. This is because the rights and obligations in a contract with a customer are interdependent - the right to receive consideration from a customer depends on the entity's performance and, similarly, the entity performs only as long as the customer continues to pay. Those interdependencies are best reflected by accounting and presenting contract assets or liabilities on a net basis. [IFRS 15.BC317].

Consider the following Illustration:

Illustration 11-5: Presentation of contract assets and liabilities

Entity A has a contract with Customer B to transfer a licence on 1 January 20X6 for the right to use Entity A's intellectual property in exchange for a £200,000 milestone payment that is contingent upon Customer B achieving a specific outcome. The contract also includes a one-year service to be provided by Entity A for fixed consideration of £100,000 that is paid upfront by Customer B at contract inception.

Assume Entity A concludes there are two performance obligations: one for the right to use licence of intellectual property that will be satisfied when the licence is delivered and one for the service that will be recognised over time using a time-elapsed measure of progress. On 1 January 20X6, the licence is delivered and the service commences.

Entity A determines that the milestone payment is variable consideration. Because of the binary nature of the outcome (i.e., the entity will either receive the milestone payment or not), Entity A determines that the most likely amount method (discussed in 6.2.2 above) is the better predictor of the amount to which it expects to be entitled. Entity A believes it is 90% probable that it will receive the £200,000 milestone payment. Therefore, using the most likely amount method, Entity A estimates that it will receive the full £200,000. Entity A then allocates the total transaction price of £300,000 (variable consideration of £200,000 plus the fixed consideration of £100,000) to the licence and the service based on their relative stand-alone selling prices (assume this arrangement does not meet the variable consideration allocation exception). Further assume that £200,000 is allocated to the licence and £100,000 is allocated to the service, i.e., the components were priced at their stand-alone selling price.

On 1 January 20X6, when Entity A satisfies the performance obligation related to the licence, it recognises revenue and a contract asset of £200,000. A contract asset is recorded (rather than a receivable) because Entity A's right to the consideration is contingent upon something other than the passage of time, i.e., Customer B achieving a specific outcome (see 11.1.1 above). The performance obligation associated with the service results in the recognition of a contract liability of £100,000 as at 1 January 20X6 because Entity A paid upfront for the service (see 11.1 above).

On 31 March 20X6, related to the contract with Customer B, Entity A has a contract asset of £200,000 (because the condition to receive consideration for the licence still has not been met) and a contract liability of £75,000 (because £25,000 of revenue has been recognised for one quarter of service). For presentation purposes as at 31 March 20X6, Entity A nets the contract asset of £200,000 and the contract liability of £75,000 and presents a net contract asset of £125,000.

²¹³ Based on TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

After determining the net contract asset or contract liability position for a contract, entities consider the requirements in Section 4 on presentation (including classification as current or non-current) in the statement of financial position (as discussed in 11.1.2 above).

Question 11-2: How would an entity determine the presentation of two or more contracts that are required to be combined under Section 23?²¹⁴

Generally, the contract asset or liability would be combined (i.e., presented net) for different contracts with the same customer (or a related party of the customer) if an entity is otherwise required to combine those contracts under Section 23 (see 4.3 above for discussion of the criteria for combining contracts). When two or more contracts are required to be combined under Section 23, the rights and obligations in the individual contracts are interdependent. Therefore, as discussed in Question 11-1 above, this interdependency is best reflected by combining the individual contracts as if they were a single contract. However, this analysis might be operationally difficult for some entities because their systems might capture data at the performance obligation level in order to comply with the recognition and measurement aspects of the standard.

Question 11-3: When would an entity offset contract assets and liabilities against other statement of financial position items (e.g., accounts receivable)?²¹⁵

Because Section 23 does not provide requirements for offsetting, entities need to apply the requirements of other sections of FRS 102 to determine whether offsetting is appropriate (e.g., Section 2, Section 11, Section 12, Section 21). For example, if an entity has recorded a contract asset (or a receivable) and a contract liability (or refund liability) from separate contracts with the same customer (that are not required to be combined under Section 23), the entity needs to look to requirements outside Section 23 to determine whether offsetting is appropriate.

Question 11-4: Is a refund liability a contract liability (and, thus, subject to the presentation and disclosure requirements of a contract liability)?

How we see it

An entity needs to determine whether a refund liability is characterised as a contract liability based on the specific facts and circumstances of the arrangement. We believe the following are relevant considerations in making that determination.

We believe that a refund liability typically does not meet the definition of a contract liability. When an entity concludes that a refund liability is not a contract liability, it presents the refund liability separately from any contract liability (or asset) and the refund liability is not subject to the disclosure requirements in paragraph 23.134 discussed in 11.4.1.B below.

When a customer pays consideration (or consideration is unconditionally due) and the entity has an obligation to transfer *goods or services* to the customer, the entity recognises a contract liability. When the entity expects to refund some or all of the *consideration* received (or receivable) from the customer, it recognises a refund liability. A refund liability generally does not represent an obligation to transfer goods or services in the future. Similar to receivables (which are considered a subset of contract assets), refund liabilities could be considered a subset of contract liabilities.

We believe refund liabilities are also similar to receivables in that they are extracted from the net contract position and presented separately (if material). This conclusion is consistent with the specific requirement in Section 23 to present the corresponding asset for expected returns separately (see 6.4 above).

If an entity concludes, based on its specific facts and circumstances, that a refund liability represents an obligation to transfer goods or services in the future, the refund liability is a contract liability subject to the disclosure requirements in paragraph 23.134. In addition, in that situation, the entity presents a single net contract liability or asset (i.e., including the refund liability) determined at the contract level, as discussed in Question 11-1 above.

²¹⁴ Based on TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

²¹⁵ Based on TRG Agenda paper no. 7, *Presentation of a contract as a contract asset or a contract liability*, dated 31 October 2014 and TRG Agenda paper no. 11, *October 2014 Meeting - Summary of Issues Discussed and Next Steps*, dated 26 January 2015.

Question 11-5: How would an entity account for a contract asset that exists when a contract is modified if the modification is treated as the termination of an existing contract and the creation of a new contract? ²¹⁶

A contract asset that exists when a contract is modified would be carried forward into the new contract if the modification is treated as the termination of an existing contract and the creation of a new contract (see 4.4.1 above).

This question addresses this type of modification because the termination of the old contract could indicate that any remaining balances associated with the old contract must be written off.

It is appropriate to carry forward the related contract asset in such modifications because the asset relates to a right to consideration for goods or services that have already been transferred and are distinct from those to be transferred in the future. As such, the revenue recognised to date is not reversed and the contract asset continues to be realised as amounts become due from the customer and are presented as a receivable. The contract asset that remains on the entity's statement of financial position at the date of modification continues to be subject to evaluation for impairment.

Consider the following example:

Illustration 11-6: Accounting for an existing contract asset when the contract is modified

Vendor A enters into a contract to provide a good and one year of service. The transaction price is £4,200. The good and service are separate performance obligations, and the service is considered a series of distinct goods or services (see 5.2.2 above). The stand-alone selling price for the good is £3,000 and the stand-alone selling price for the services is £100 per month (£1,200 for one year). Therefore, Vendor A allocates £3,000 to the good and £1,200 to the services. Customer B will pay 12 equal instalments of £350. Vendor A will invoice Customer B at the end of each month.

At the beginning of the first month, the good is transferred to Customer B and the revenue allocated to that performance obligation (£3,000) is recognised. Vendor A also recognises a contract asset for £3,000 because payment of that £3,000 is conditional upon Vendor A's performance of future services.

At the end of the first month, Vendor A recognises revenue of £100 for progress toward complete satisfaction of the performance obligation related to the services (assuming the entity is using a time-based measure of progress). Vendor A also recognises accounts receivable of £350 because that amount is not conditional. The contract asset, which had a balance of £3,000 at the beginning of the month, would have a balance of £2,750 at the end of the first month.

Vendor A continues to make similar entries for the first nine months of the contract. After nine months, £3,900 of revenue has been recognised for the contract (£900 of revenue for the services and £3,000 for the good). Vendor A has a receivable for £350 (assuming Customer B already paid the first eight instalments). In addition, Vendor A has a contract asset for £750 ($CU3,000 - (9 \times (£350 - £100))$).

At the end of nine months, the contract is modified to include one additional year of service. The fee for the last three months of the initial one-year contract is unchanged, but the agreed fee for the additional one year of services is £50 per month, which is significantly below the stand-alone selling price of the services.

In addition, because the remaining services are a series of distinct services, Vendor A determines that the remaining services are distinct from the goods or services transferred prior to the modification. Therefore, the modification would be accounted for under paragraph 23.16(a) (i.e., as a termination of the existing contract and the creation of a new contract, as discussed in 4.4.2.A above).

At the modification date, Vendor A retains the existing contract asset of £750 that relates to revenue previously recognised, but which has not been paid by the customer (and is not presented as a receivable). Vendor A also determines the total consideration to be allocated to the remaining performance obligations. The consideration promised by Customer B that was included in the transaction price, but not yet recognised as revenue under the original contract, is £300 (equal to £4,200 transaction price - £3,900 already recognised as revenue). The additional consideration promised as part of the contract modification is £600 (equal to 12 additional months $\times$ £50 per month). Therefore, the total amount of consideration allocated to the remaining distinct services is £900 (£300 + £600). Vendor A would allocate the £900 to the remaining performance obligations and recognise revenue over the remaining modified contract duration. Subsequent to the contract modification, the contract asset would be evaluated and accounted for in the same manner as any other contract asset.

How we see it

We believe a similar conclusion would be appropriate when accounting for an asset created under Section 23, such as a capitalised commission, which exists immediately before a contract modification that is treated as if it were a termination of the existing contract and creation of a new contract. See Question 10-11 in 10.3.1 above for further discussion.

Question 11-6: If an entity has not transferred a good or service, when does it have an unconditional right to payment?

Section 23 states in paragraph 23.127 that a receivable is an entity's right to consideration that is unconditional.

How we see it

In general, we believe it might be difficult to assert that the entity has an unconditional right to payment when it has not transferred a good or service.

However, an entity might enter into non-cancellable contracts that provide unconditional rights to payment from the customer for services that the entity has not yet completed providing or services it will provide in the near future (e.g., amounts invoiced in advance related to a service or maintenance arrangement).

When determining whether an entity is required to recognise accounts receivable and a corresponding contract liability, the contractual terms and specific facts and circumstances supporting the existence of an unconditional right to payment need to be evaluated, including the factors outlined below.

- (a) Does the entity have a contractual (or legal) right to invoice and receive payment from the customer for services being provided currently (and not yet completed) or being provided in the near future (e.g., amounts invoiced in advance related to a service or maintenance arrangement)?
- (b) Is the advance invoice consistent with the entity's normal invoicing terms?
- (c) Will the entity commence performance within a relatively short time frame of the invoice date?
- (d) Is there more than one year between the advance invoice and performance?

11.2 Presentation requirements for revenue from contracts with customers

Section 23 requires entities to separately present or disclose the amount of revenue related to contracts with customers, as follows: [FRS 102.23.133]

- Paragraph 23.133(a) requires an entity to disclose (or present in the statement of comprehensive income or income statement, if presented) the amount of revenue recognised from contracts with customers under Section 23 separately from other sources of revenue. For example, a large equipment manufacturer that both sells and leases its equipment is required to present (or disclose) amounts from these transactions separately.
- For qualifying entities, an exemption is available from presenting or disclosing revenue recognised from contracts with customer, provided certain conditions are met (see Chapter 3 at 3 and 3.2).
- Paragraph 23.133(b) also requires an entity to disclose, in aggregate, the impairment losses recognised (by applying Section 11) on any receivables or contract assets arising from contracts with customers separately from other impairment losses arising from other contracts, if they are not presented in the statement of comprehensive income (or income statement, if presented) separately.

Unless required, or permitted, by another section of FRS 102, Section 2 does not permit offsetting of income and expenses within profit or loss or the statement of comprehensive income. [FRS 102.2.96].

Section 23 requires an entity to measure revenue from contracts with customers at the amount of consideration to which the entity expects to be entitled in exchange for transferring promised goods or services. [FRS 102.23.41]. Accordingly, after applying the requirements for determining the transaction price in Section 23 (see 6 above), revenue recognised by an entity might include offsets, for example, for any trade discounts given and volume rebates paid by the entity to its customers.

216 Based on FASB TRG Agenda paper no. 51, *Contract Asset Treatment in Contract Modifications*, dated 18 April 2016.

Section 5 also requires 'turnover' to be presented on the face of the income statement (or statement of comprehensive income, if presented). [FRS 102.5.7D]. However, not all income reported in the statement of comprehensive income is turnover, nor is the concept of turnover synonymous with revenue. As discussed in Chapter 6 at 5.5.1, this implies that an additional analysis of revenue between turnover and other components of revenue (if any) is required in the income statement (or single statement of comprehensive income).

See further discussions in Chapter 6 at 5.5.1, 5.6.1 and 5.7.1.

Frequently asked questions

Question 11-7: Can income outside the scope of Section 23 be presented as revenue in the income statement?

How we see it

Entities need to consider the definition of revenue to determine whether income outside the scope of Section 23 can be presented as revenue in the income statement. We believe an entity needs to consider the discussion below as part of its determination.

FRS 102 defines revenue as "Income arising in the course of an entity's ordinary activities", but Section 23 excludes some revenue contracts from its scope (e.g., leases). [FRS 102 Appendix I, FRS 102.23.1]. Revenue might be referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent. These revenue items would be in scope of different sections of FRS 102. Section 23 only involves a subset of revenue – specifically, revenue that arises from a contract when the counterparty to that contract is a customer (as defined, see 3.1.3 above) and the contract is not specifically excluded from its scope (see 3.1.1 above).

Also, in defining items of revenue, income arising from 'ordinary activities' pertains to income generated from the primary business activities of an entity, rather than income generated from its incidental activities (see Chapter 6 at 5.1.2 and 3.1.3 above).

Accordingly, if the transaction involves the sale of an asset, the nature of the asset and the purpose for which it was held by the entity could be informative. For example, inventory accounted for under Section 13 is, by definition, held for use in production or sale in the ordinary course of business. [FRS 102 Appendix I]. Therefore, the sale of that inventory is typically part of an entity's primary business activities. Conversely, PP&E accounted for under Section 17 is, by definition, held for use by the entity for more than one period. [FRS 102 Appendix I]. Likewise, Section 18 excludes from its scope intangible assets held for sale in the ordinary course of business. [FRS 102.18.1]. Therefore, disposal of an item of PP&E or an intangible asset is not typically part of an entity's primary business activities and the difference between the net disposal proceeds and the carrying amount of the asset is not recognised as revenue under Section 23, but as a gain or loss on disposal. See also discussions in 3.1.6.C and 3.1.6.D above.

If an entity receives consideration in the course of its ordinary activities that is outside the scope of Section 23 (e.g., leases), it might present that income as revenue in the income statement. This view is consistent with the Basis for Conclusions on IFRS 15, which says that an entity can present interest income as revenue only when interest income represents income from an entity's ordinary activities (also discussed in 6.5.4 above). [IFRS 15.BC247]. However, any revenue recognised that is outside the scope of Section 23 will need to be presented either separately from revenue from contracts with customers within the income statement or disclosed separately within the notes. This is because, as mentioned above, entities are required to present in the statement of comprehensive income, or disclose within the notes, the amount of revenue recognised from contracts with customers separately from other sources of revenue. [FRS 102.23.133(a), FRS 102 Appendix I].

Section 23 does not explicitly require an entity to use the term 'revenue from contracts with customers'. Therefore, entities might use a different terminology in their financial statements to describe revenue arising from transactions that are within the scope of Section 23. However, entities need to ensure the terms used are not misleading and allow users to distinguish revenue from contracts with customers from other sources of revenue. [FRS 102.23.133(a)].

11.3 Other presentation considerations

Section 23 also includes presentation requirements for products expected to be returned and for those that contain a financing component. See 6.4 and 6.5.4 above for presentation considerations related to rights of return and financing components, respectively. Also see Question 10-26 in 10.3.3 above for classification and presentation considerations related to capitalised contract costs to obtain and fulfil a contract.

Frequently asked questions

Question 11-8: How are shipping and handling costs incurred in relation to a revenue contract presented in the income statement?

How an entity presents shipping and handling costs in the income statement will depend upon how it presents expenses in accordance with the requirements of Section 5 and the Regulations. The statutory formats in Schedule 1 to the Regulations require an analysis of expenses by function, e.g., cost of sales, costs of distribution or administrative activities, (format 1 profit and loss account) or by nature, e.g., purchases of materials or transportation costs, (format 2 profit and loss account), and where the adapted formats available in those schedules are used, Section 5 requires an analysis of expenses to be presented either in the income statement or in the notes to the financial statements, which is equivalent to what would have been presented if the statutory formats had been adopted. [FRS 102.5.5B]. The presentation requirements for the income statement under FRS 102 are further discussed in Chapter 6 at 5.

An entity might be involved with a variety of shipping and handling activities. Prior to a revenue contract, for example, an entity might transport inventory it has purchased to its warehouse or move it between warehouses. In such cases, the related costs will be within the scope of Section 13 (discussed in Chapter 16). An entity might also incur shipping and handling costs not related to a promised good or service to the customer (e.g., distribution costs) that are outside the scope of Section 13 and Section 23. An entity might need to apply judgement to distinguish such costs from those within the scope of Section 13 or Section 23, and to determine where to present such costs.

Under Section 23, an entity needs to determine whether shipping and handling is a separate promised service to the customer or if they are activities to fulfil the promise to transfer the good (see 5.1 above). Shipping and handling activities that are performed before the customer obtains control of the related good are activities to fulfil its promise to transfer control of the good. If shipping and handling activities are performed after a customer obtains control of the related good, shipping and handling is a promised service to that customer and an entity needs to determine whether it acts as a principal or an agent in providing those services.

If an entity determines that the shipping and handling activities are related to a promised good or service to the customer (either the promise to transfer control of the good or the promise to provide shipping and handling services) and the entity is the principal (rather than the agent), the costs are incurred to fulfil its promise to provide those services.

How we see it

If the entity determines that the shipping and handling activities are related either to the promise to transfer control of the good or the promise to provide shipping and handling services and the entity is the principal, we believe it is appropriate to present the related costs as cost of sales, changes in contract costs, or similar, because the costs would be incurred to fulfil a revenue obligation (i.e., fulfilment costs).

Entities need to consider whether disclosure of the amount of shipping and handling costs and the line items in the income statement that include them is required. [FRS 102.3.2, FRS 102.5.9, FRS 102.5.9A].

If the entity determines that shipping and handling is a separate promised service to the customer and it is acting as an agent in providing those services, the related revenue to be recognised for shipping and handling services would be net of the related costs. [FRS 102.23.41, FRS 102.23.36-23.40].

Question 11-9: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

See response to Question 10-26 in 10.3.3 above.

Question 11-10: How would entities determine the presentation of amounts billed to customers (e.g., shipping and handling, expenses or cost reimbursements and taxes) under FRS 102 (i.e., as revenue or as a reduction of costs)?

See response to Question 5-16 in 5.4.4 above.

11.4 Specific disclosure requirements

The following Illustration depicts the disclosure requirements in Section 23, which are discussed further below by category:

Figure 11-2: Specific disclosure requirements in Section 23

Category	Sub-category/type	Required disclosure*
Contracts with customers	Contracts with customers (see 11.4.1 below) <i>Quantitative</i>	If not presented separately in the statement of comprehensive income: ▪ The amount of revenue recognised from contracts with customers (i.e., Section 23) separately from other sources of revenue** ▪ Any impairment losses from contract with customers separately from other impairment losses
	Disaggregation of revenue (see 11.4.1.A below) <i>Quantitative and qualitative</i>	▪ Disaggregation of revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors** ▪ Sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment, if the entity applies IFRS 8 <i>Operating Segments</i>**
	Contract balances (see 11.4.1.C below) <i>Quantitative</i>	▪ Opening and closing balances of receivables, contract assets and contract liabilities, if not otherwise separately presented or disclosed ▪ Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period
	Performance obligations (see 11.4.1.D below) <i>Quantitative and qualitative</i>	▪ Descriptive information about an entity's performance obligations related to the following: ▪ When typically satisfied** ▪ Significant payment terms** ▪ Nature of goods and services** ▪ Obligations for returns, refunds, and other similar obligations And ▪ Types of warranties and related obligations ▪ Revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods ▪ The methods used to recognise revenue over time and how the methods are applied** ▪ Explanation of the significance of performance obligations that are unsatisfied (or partially satisfied) as of the end of the reporting period and explanation of when the related revenue is expected to be recognised (subject to certain optional exemptions)**
Costs to obtain or fulfil a contract (see 11.4.3 below)	<i>Quantitative</i>	▪ Closing balances of capitalised contract costs by main category or asset ▪ Amount of amortisation and any impairment losses recognised in the period

Category	Sub-category/type	Required disclosure*
Practical expedients (see 11.4.4 below)	Qualitative	▪ Use of the following options: ▪ Option to make no adjustments for the time value of money** ▪ Option to recognise costs incurred to obtain a contract as an asset** ▪ Option to expense incremental costs of obtaining a contract when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less**

* These disclosures must not be viewed as a checklist of minimum requirements.

** These disclosure requirements are optional for entities meeting the definition of a qualifying entity (see Chapter 3 at 3). However, the use of any of these disclosure exemptions is conditional on specified criteria being met (see Chapter 3 at 3.2).

11.4.1 Contracts with customers

The majority of the disclosure requirements in Section 23 relate to an entity's contracts with customers. These disclosures include disaggregation of revenue, information about contract asset and liability balances and information about an entity's performance obligations.

11.4.1.A Disaggregation of revenue

Entities are required to disclose disaggregated revenue information to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors. [FRS 102.23.131].

Subject to the discussion in 11.4.1.B below, note that for qualifying entities, disclosing disaggregated revenue is optional, provided that certain conditions are met (see Chapter 3 at 3 and 3.2).

Section 23 suggests categories for entities to consider when disaggregating revenue. An entity could also consider the application guidance in IFRS 15 which indicates that the most appropriate categories for a particular entity depend on its facts and circumstances, but an entity needs to consider how it disaggregates revenue in other communications (e.g., strategic reports, press releases, information regularly reviewed by the chief operating decision maker) when determining which categories are most relevant and useful. [IFRS 15.B88].

Section 23 includes the following guidance on the required disaggregation of revenue disclosures: [FRS 102.23.131]

Extract from Section 23

- 23.131** An entity shall disaggregate revenue recognised from contracts with customers into categories that depict how its revenue and cash flows are affected by economic factors. Categories that might be appropriate include:
- (a) type of good or service (eg major product lines);
 - (b) geographical market (eg country or region);
 - (c) market or type of customer (eg government and non-government customers);
 - (d) timing of transfer of goods or services (eg revenue from goods or services transferred to customers at a point in time and revenue from goods or services transferred over time); and
 - (e) revenue earned as an agent or as a principal.

In addition to above, IFRS 15 provides other examples that might be appropriate categories when disaggregating revenue:

- Type of contract (for example, fixed-price and time-and-materials contracts)
 - Contract duration (for example, short-term and long-term contracts)
- And
- Sales channels (for example, goods sold directly to consumers and goods sold through intermediaries)

Section 23 does not prescribe a specific characteristic of revenue to be used as the basis for disaggregation, therefore, entities need to make this determination based on entity-specific and/or industry-specific factors that are the most meaningful for their businesses. This might require an entity to use more than one type of category to disaggregate its revenue.

We believe that, when determining categories for disaggregation of revenue, entities need to analyse specific risk factors for each of their revenue streams to determine the appropriate level of revenue disaggregation that will be beneficial to users of the financial statements. If certain risk factors could lead to changes in the nature, amount, timing and uncertainty of revenue recognition and cash flows, those factors will need to be considered as part of the evaluation. Different risk factors associated with each revenue streams might indicate when disaggregation is required.

FRS 102 requires certain types of entities to directly apply particular IFRS Accounting Standards (as adopted in the relevant jurisdiction), including IFRS 8 (see Chapter 3 at 2.4). An entity does not have to duplicate disclosures required by another standard (or another section of FRS 102). For example, if an entity applies IFRS 8 and provides disaggregated revenue disclosures as part of its segment disclosures, the entity does not need to separately provide disaggregated revenue disclosures if the segment-related disclosures are sufficient to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows from contracts with customers are affected by economic factors and are presented on a basis consistent with FRS 102.

However, segment disclosures might not be sufficiently disaggregated to achieve the disclosure requirements of Section 23, as described above. If an entity applies IFRS 8, it is required under Section 23 to explain the relationship between the disaggregated revenue information and revenue information that is disclosed for each reportable segment. [FRS 102.23.132]. Users of the financial statements believe this information is critical to their ability to understand not only the composition of revenue, but also how revenue relates to other information provided in the segment disclosures. Entities can provide this information in a tabular or a narrative form.

How we see it

Regulators might review publicly provided information (e.g., investor presentations, press releases) in order to evaluate whether entities have met the objectives of this disclosure requirement. As discussed above, an entity needs to consider how information about its revenue has been presented for other purposes, including information disclosed outside the financial statements, information regularly reviewed by the chief operating decision maker (e.g., chief executive officer or chief operating officer) and other similar information used by the entity or users of the financial statements to evaluate the entity's financial performance or to make resource allocation decisions.

In addition, as discussed above, to help determine the appropriate level of revenue disaggregation that is beneficial to users of the financial statements, entities would analyse specific risk factors for each revenue stream. Different risk factors for revenue streams might indicate when disaggregation is required.

It is important to note that Section 23 and IFRS 8 have different objectives. The objective of the segment reporting requirements in IFRS 8 is to enable users of the financial statements to evaluate the nature and financial effects of the business activities in which an entity engages and the economic environment in which it operates. [IFRS 8.20]. These disclosure requirements are largely based on how the chief operating decision maker allocates resources to the operating segments of the entity and assesses their performance. [IFRS 8.5(b)]. They also permit aggregation in certain situations. In contrast, Section 23 disclosure requirements focus on how the revenues and cash flows from contracts with customers are affected by economic factors and do not have similar aggregation criteria. As noted above, if an entity concludes that it is necessary to provide disaggregated revenue disclosures along with the segment disclosures required under IFRS 8, it is required under Section 23 to explain the relationship between the disclosures.

Note that for qualifying entities, disclosing additional information that enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment is optional, provided that certain conditions are met (see Chapter 3 at 3 and 3.2).

The illustration below, which is based on Example 41 in IFRS 15, is an example of the disclosures for disaggregation of revenue: [IFRS 15.IE Example 41, IFRS 15.IE210-IE211]

Illustration 11-7: Disaggregation of revenue-quantitative disclosure

An entity reports the following segments: consumer products, transportation and energy, in accordance with IFRS 8. When the entity prepares its investor presentations, it disaggregates revenue into primary geographical markets, major product lines and timing of revenue recognition (i.e., goods transferred at a point in time or services transferred over time).

The entity determines that the categories used in the investor presentations can be used to meet the objective of the disaggregation disclosure requirement in paragraph 23.131, which is to disaggregate revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The following table illustrates the disaggregation disclosure by primary geographical market, major product line and timing of revenue recognition, including a reconciliation of how the disaggregated revenue ties in with the consumer products, transportation and energy segments, in accordance with paragraph 23.132.

Segments	Consumer products	Transport	Energy	Total
	£	£	£	£
<u>Primary geographical markets</u>				
United Kingdom	990	2,250	5,250	8,490
Ireland	300	750	1,000	2,050
Spain	700	260	-	960
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
<u>Major goods/service lines</u>				
Office supplies	600	-	-	600
Appliances	990	-	-	990
Clothing	400	-	-	400
Motorcycles	-	500	-	500
Automobiles	-	2,760	-	2,760
Solar panels	-	-	1,000	1,000
Power plant	-	-	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>
<u>Timing of revenue recognition</u>				
Goods transferred at a point in time	1,990	3,260	1,000	6,250
Services transferred over time	-	-	5,250	5,250
	<u>1,990</u>	<u>3,260</u>	<u>6,250</u>	<u>11,500</u>

Since entities are encouraged to tailor their disclosure of disaggregated revenue, they are unlikely to follow a single approach.

Consistent with the approach demonstrated in Illustration 11-7 above, some entities could provide disaggregated revenue information within their IFRS 8 segment reporting disclosure. Such disclosure might already provide adequate information that allows users to understand the composition of revenue. However, in other cases, this information might be based on non-GAAP information (i.e., the revenue that is reported to the chief operating decision maker might be calculated on a basis that is not in accordance with

Section 23). In such a situation, an entity might need to disclose additional information to meet the objective in paragraph 23.131.

11.4.1.B Particulars of turnover

Although FRS 102 is not inconsistent with company law, compliance with FRS 102 alone will often be insufficient to ensure compliance with all the disclosure requirements set out in the Act and the Regulations. Therefore, preparers must have regard to the requirements of company law in addition to accounting standards. [FRS 102.A3.10].

For example, as discussed in 11.4.1.A above, paragraph 23.131 requires an entity to disclose the revenue it has recognised from contracts with customers disaggregated into categories. In some cases, the disclosures provided in applying this paragraph might not be sufficient to comply with the requirement in paragraph 68 of Schedule 1 to the Regulations, which requires particulars of turnover to be disclosed. In addition, although paragraph 1.12(cB) provides an exemption for qualifying entities from paragraph 23.131, the requirements of the Regulations is still required to be complied with. [FRS 102.A3.38A].

Accordingly, entities must comply with the requirements on particulars of turnover:

- Where a company has carried on two or more classes of business during the financial year, and these, in the opinion of the directors, differ substantially from each other, the notes to the financial statements must give: [1 Sch 68(1)]
 - A description of each class of business.
 - And
 - The amount of turnover that is attributable to each class of business.
- If the company has supplied markets during the financial year that, in the opinion of the directors, differ substantially from each other, the amount of the turnover attributable to each such market must also be stated. Note that “market” means a market delimited by geographical bounds. [1 Sch 68(2)].

In analysing the source (in terms of business or in terms of market) of turnover, the directors of the company must have regard to the manner in which the company’s activities are organised. [1 Sch 68(3)]. Also, note that classes of business which, in the opinion of the directors, do not differ substantially from each other must be treated as one class, and markets which, in the opinion of the directors, do not differ substantially from each other must be treated as one market, and any amounts properly attributable to one class of business or (as the case may be) to one market which are not material could be included in the amount stated in respect of another. [1 Sch 68(3)].

However, where in the opinion of the directors the disclosure of any information described above would be seriously prejudicial to the interests of the company, that information need not be disclosed, but the fact that any such information has not been disclosed must be stated. [1 Sch 68(5)].

See also the discussion in Chapter 6 at 7.6.

11.4.1.C Contract balances

Section 23 includes the following disclosure requirements for an entity’s contract balances: [FRS 102.23.134]

Extract from Section 23

23.134 An entity shall disclose:

- (a) the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed;
- (b) revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; and
- (c) revenue recognised in the reporting period from performance obligations satisfied or partially satisfied in previous periods (eg changes in estimates of variable consideration).

As described above, Section 23 requires an entity to disclose quantitative information about contract balances. [FRS 102.23.134(a)]. If an entity chooses to present contract balances on the face of the statement of financial position, the entity needs to consider the requirements in Section 4 and the Regulations (see Chapter 6 at 4). See also discussions in 11.1.2 above.

Section 23 also requires entities to disclose revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period. [FRS 102.23.134(b)].

In addition, Section 23 requires entities to disclose the amount of revenue recognised in the period that relates to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (e.g., due to a change in transaction price or in estimates related to the constraint on revenue recognised). [FRS 102.23.134(c)]. For example, this disclosure requirement applies to sales-based and usage-based royalties received from a customer in exchange for a licence of intellectual property that are recognised as revenue in a reporting period, but relate to performance obligations satisfied (or partially satisfied) in previous periods (e.g., sales-based royalties recognised in the current period that are related to a right-to-use licence previously transferred to a customer). This provides relevant information about the timing of revenue recognised that was not a result of performance in the current period.

While it is not an explicit requirement under Section 23, additional disclosure could be provided when necessary to enable users better understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance. [FRS 102.3.2]. The users of the financial statements might want to understand the relationship between the revenue recognised and changes in the overall balances of an entity's total contract assets and liabilities during a particular reporting period. Additional information could include the information required under IFRS 15. [IFRS 15.117, 118]. Refer to the EY publication, International GAAP®, for the detailed discussions of such additional information required by IFRS 15.

The Illustration below is an example of how an entity might fulfil these requirements:

Illustration 11-8: Contract asset and liability disclosures

Company A discloses receivables from contracts with customers separately in the statement of financial position. To comply with the other disclosure requirements for contract assets and liabilities, Company A includes the following information in the notes to the financial statements:

	20X8	20X7	20X6
Contract asset	£1,500	£2,250	£1,800
Contract liability	£(200)	£(850)	£(500)
Revenue recognised in the period from:			
Amounts included in contract liability at the beginning of the period	£650	£200	£100
Performance obligations satisfied in previous periods	£200	£125	£200

We receive payments from customers based on a billing schedule, as established in our contracts. Contract assets relate to our conditional right to consideration for our completed performance under the contract. Accounts receivable are recognised when the right to consideration becomes unconditional. Contract liabilities relate to payments received in advance of performance under the contract. Contract liabilities are recognised as revenue as (or when) we perform under the contract. In addition, the contract asset decreased in 20X8 due to a contract asset impairment of £400 relating to the early cancellation of a contract with a customer.

How we see it

Paragraph 23.134(a) requires entities to separately disclose contract balances from contracts with customers. Therefore, it is necessary for entities that have material receivables from non-Section 23 contracts to separate these balances for disclosure purposes. For example, an entity might have accounts receivable relating to leasing contracts that would need to be disclosed separately from accounts receivable related to contracts with customers.

Entities need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

11.4.1.D Performance obligations

Section 23 requires an entity to provide more descriptive information about its performance obligations to help users of financial statements analyse the nature, amount, timing and uncertainty about revenue and cash flows arising from contracts with customers. This requirement is in addition to the requirement in Section 8 to disclose material accounting policies. [FRS 102.8.5].

An entity is also required to disclose information about remaining performance obligations and the amount of the transaction price allocated to such obligations, including an explanation of when it expects to recognise the amount(s) in its financial statements. Entities need to make sure they have appropriate systems, policies and procedures and internal controls in place to collect and disclose the required information.

Both quantitative and qualitative information are required as follows: [FRS 102.23.135, FRS 102.23.136, FRS 102.23.137]

Extract from Section 23

- 23.135** An entity shall disclose information about its performance obligations in contracts with customers, including a description of:
- (a) when the entity typically satisfies its performance obligations (eg upon shipment, upon delivery, as services are rendered or upon completion of service);
 - (b) the significant payment terms (eg when payment is typically due, whether the contract includes a financing transaction, and whether the consideration amount is variable);
 - (c) the nature of the goods or services that the entity has promised to transfer, highlighting any promises to arrange for another party to transfer goods or services (ie if the entity is acting as an agent);
 - (d) obligations for returns, refunds and other similar obligations; and
 - (e) types of warranties and related obligations.
- 23.136** For performance obligations that an entity satisfies over time, the entity shall disclose the methods it used to recognise revenue - for example, a description of the output methods or input methods used and how those methods are applied.
- 23.137** An entity shall provide a quantitative or qualitative explanation of the significance of unsatisfied performance obligations and when they are expected to be satisfied. However, an entity need not disclose such information for a performance obligation if either of the following conditions is met:
- (a) the performance obligation is part of a contract that has an original expected duration of one year or less; or
 - (b) the entity recognises revenue from the satisfaction of the performance obligation in accordance with paragraph 23.103.

Note that for qualifying entities, disclosing the information required by paragraphs 23.135(a), 23.135(b), 23.135(c), 23.136 or 23.137 is optional, provided that certain conditions are met (see Chapter 3 at 3 and 3.2).

Section 23 requires an entity to provide a quantitative or qualitative explanation of the significance of unsatisfied performance obligations and when they are expected to be satisfied. [FRS 102.23.137]. This disclosure can be provided on either a quantitative basis (e.g., amounts to be recognised in given time bands, such as between one and two years and between two and three years) or by disclosing a mix of quantitative and qualitative information. In addition, this disclosure would only include amounts related to performance obligations in the current contract. For example, expected contract renewals that have not been executed and do not represent material rights are not performance obligations in the current contract. As such, an entity does not disclose amounts related to such renewals. However, if an entity concludes that expected contract renewals represents a material right to acquire goods or services in the future (and, therefore, was a separate performance obligation - see 5.6 above), the entity includes in its disclosure the consideration attributable to the material right for the options that have not yet been exercised (i.e., the unsatisfied performance obligation(s)).

Consider the following Illustration:

Illustration 11-9: Transaction price allocated to remaining performance obligations in an MSA with a minimum purchase requirement

An entity sells equipment and consumables under a two-year MSA. Both the equipment and the consumables are determined to be distinct performance obligations that are recognised at a point in time. The stand-alone selling price of the equipment and each consumable is £10,000 and £100, respectively. The equipment costs £8,000 and each consumable costs £60. The entity sells the equipment for £6,000 (a 40% discount from the stand-alone selling price) with a customer option to purchase each consumable for £100 (equal to its stand-alone selling price). The customer will incur a penalty if it does not purchase at least 200 consumables over the next two years. The entity concludes that the penalty is substantive and it creates a minimum purchase commitment. The option to purchase the consumables does not represent a material right because it is priced at the stand-alone selling price for the consumable.

As at the entity's reporting date, the customer has purchased 80 consumables during the first six months of the two-year contract. While the entity expects to sell quantities in excess of the remaining 120 units that are subject to the minimum purchase commitment, it only includes the transaction price for the remaining 120 committed consumables in the disclosure of the transaction price allocated to remaining performance obligations. This is because the MSA only commits the parties to the purchase and sale of these minimum units. The entity does not include the transaction price for any expected units in excess of the required minimum because the additional optional purchases are not within the enforceable rights and obligations of the current contract with the customer.

When providing a quantitative disclosure of the transaction price allocated to the remaining performance obligations, an entity might not include consideration that has been excluded from the transaction price (e.g., amounts subject to termination without penalty). Consequently, entities could disclose such information qualitatively in explaining the significance of unsatisfied (or partially satisfied) performance obligations.

Optional exemptions

Section 23 provides a practical expedient under which an entity need not disclose the amount of the remaining performance obligations for contracts with an original expected duration of one year or less or those that meet the requirements of the right to invoice practical expedient in paragraph 23.103. [FRS 102.23.137]. As explained in 8.1.4.B above, the right to invoice practical expedient permits an entity that is recognising revenue over time to recognise revenue as invoiced if the entity's right to payment is an amount that corresponds directly with the value to the customer of the entity's performance to date. For example, an entity is not required to make the disclosure for a three-year service contract under which it has a right to invoice the customer a fixed amount for each hour of service provided.

The illustration below, which is based on Example 42 in IFRS 15, are examples of the required disclosures about remaining performance obligations: [IFRS 15.IE Example 42, IFRS 15.IE212-IE219]

Illustration 11-10: Disclosure of the transaction price allocated to the remaining performance obligations

On 30 June 20X6, an entity enters into three contracts (Contracts A, B and C) with separate customers to provide services. Each contract has a two-year non-cancellable term. The entity considers the requirements in paragraph 23.137 in determining the information in each contract to be included in the disclosure of the transaction price allocated to the remaining performance obligations at 31 December 20X6.

Contract A

Cleaning services are to be provided over the next two years typically at least once per month. For services provided, the customer pays an hourly rate of £25.

Because the entity bills a fixed amount for each hour of service provided, the entity has a right to invoice the customer in the amount that corresponds directly with the value of the entity's performance completed to date in accordance with paragraph 23.103 (see 8.1.4.B above). Consequently, no disclosure is necessary if the entity elects to apply the practical expedient in paragraph 23.137(b).

Contract B

Cleaning services and lawn maintenance services are to be provided as and when needed with a maximum of four visits per month over the next two years. The customer pays a fixed price of £400 per month for both services. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.

The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The information for Contract B included in the overall disclosure is, as follows:

	20X7	20X8	Total
	£	£	£
Revenue expected to be recognised on this contract as of 31 December 20X6	4,800 ^(a)	2,400 ^(b)	7,200

(a) £4,800 = £400 × 12 months.

(b) £2,400 = £400 × 6 months.

Contract C

Cleaning services are to be provided as and when needed over the next two years. The customer pays fixed consideration of £100 per month plus a one-time variable consideration payment ranging from £0-£1,000 corresponding to a one-time regulatory review and certification of the customer's facility (i.e., a performance bonus). The entity estimates that it will be entitled to £750 of the variable consideration (see 6.2.2 above for the discussion on estimating variable consideration). On the basis of the entity's assessment of the factors discussed in 6.2.3 above, the entity includes its estimate of £750 of variable consideration in the transaction price because it is highly probable that the entity will be entitled to the cumulative amount of revenue in future periods once the uncertainty related to the variable consideration is resolved. The entity measures its progress towards complete satisfaction of the performance obligation using a time-based measure.

The entity discloses the amount of the transaction price that has not yet been recognised as revenue in a table with quantitative time bands that illustrates when the entity expects to recognise the amount as revenue. The entity also includes a qualitative discussion about any significant variable consideration that is not included in the disclosure. The information for Contract C included in the overall disclosure is as follows:

	20X7	20X8	Total
	CU	CU	CU
Revenue expected to be recognised on this contract as of 31 December 20X6	1,575 ^(a)	788 ^(b)	2,363

(a) Transaction price = £3,150 (£100 × 24 months + £750 variable consideration) recognised evenly over 24 months at £1,575 per year.

(b) £1,575 ÷ 2 = £788 (i.e., for 6 months of the year).

In addition, as discussed above, the entity could disclose qualitatively that part of the performance bonus has been excluded from the disclosure because it was not included in the transaction price, if it is considered a significant information. That part of the performance bonus was excluded from the transaction price in accordance with the requirements for constraining estimates of variable consideration.

The illustration below, which is based on Example 43 in IFRS 15, is an example of how an entity could make the disclosure required by paragraph 23.137 relating to the amount and timing of when unsatisfied performance obligations are expected to be satisfied, using qualitative information (instead of quantitatively, using time bands), as follows: [IFRS 15.IE Example 43, IFRS 15.IE220-IE221]

Illustration 11-11: Disclosure of the transaction price allocated to the remaining performance obligations-qualitative disclosure

On 1 January 20X6, an entity enters into a contract with a customer to construct a commercial building for fixed consideration of £10 million. The construction of the building is a single performance obligation that the entity satisfies over time. As of 31 December 20X6, the entity has recognised £3.2 million of revenue. The entity estimates that construction will be completed in 20X7, but it is possible that the project will be completed in the first half of 20X8.

At 31 December 20X6, the entity discloses the amount of the transaction price that has not yet been recognised as revenue in its disclosure of the transaction price allocated to the remaining performance obligations. The entity also discloses an explanation of when the entity expects to recognise that amount as revenue. The explanation can be disclosed either on a quantitative basis using time bands that are most appropriate for the duration of the remaining performance obligation or by providing a qualitative explanation. Because the entity is uncertain about the timing of revenue recognition, the entity discloses this information qualitatively as follows:

'As of 31 December 20X6, the aggregate amount of the transaction price allocated to the remaining performance obligation is £6.8 million and the entity will recognise this revenue as the building is completed, which is expected to occur over the next 12-18 months.'

Frequently asked questions

Question 11-11: If an entity does not meet the criteria to use the 'right to invoice' practical expedient, can it still use the disclosure practical expedient regarding the amount of transaction price allocated to remaining performance obligations? ²¹⁷

Section 23 is clear that an entity can only use the practical expedient to avoid disclosing the amount of the transaction price allocated to remaining performance obligations for contracts: (a) with an original expected duration of less than one year; or (b) that qualify for the 'right to invoice' practical expedient. [FRS 102.23.137]. If a contract does not meet either of these criteria, an entity must disclose the information about remaining performance obligations as required by paragraph 23.137. Also, as discussed above, an entity might qualitatively describe any consideration that is not included in the transaction price (e.g., any estimated amount of variable consideration that is constrained) if it is considered significant information in explaining the significance of unsatisfied (or partially satisfied) performance obligations.

11.4.2 Significant judgements

Unlike the requirements in paragraphs 123-126 of IFRS 15, Section 23 does not specifically require disclosure of significant accounting estimates and judgements (and changes in those judgements) made in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied.

However, note that Section 8 has general requirements requiring disclosure of information regarding significant accounting estimates and judgements made by an entity. This would also apply to the significant accounting estimates and judgements applied in respect of Section 23. [FRS 102.BC.B23.11]. Section 8 requires entities to disclose information about judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements (see Chapter 6 at 7.3). [FRS 102.8.6]. Entities are also required to disclose information about key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (see Chapter 6 at 7.4). [FRS 102.8.7].

When providing the required disclosures in Section 8 about the significant accounting estimates and judgements applied in respect of Section 23, an entity could consider the guidance and related disclosure requirements in paragraphs 123-126 of IFRS 15.

Detailed discussion related to significant judgements in the application of IFRS 15 is available in the EY publication, International GAAP®.

²¹⁷ Based on TRG Agenda paper no. 40, *Practical Expedient for Measuring Progress toward Complete Satisfaction of a Performance Obligation*, dated 13 July 2015.

11.4.3 Assets recognised from the costs to obtain or fulfil a contract

As discussed in 10.3 above, Section 23 specifies the accounting for costs an entity incurs to obtain and fulfil a contract to provide goods or services to customers. Section 23 requires entities to disclose closing balances of assets recognised for costs to obtain or fulfil contracts with customers, as well as any amortisation or impairment losses recognised during the reporting period. These disclosure requirements are as follows: [FRS 102.23.138]

Extract from Section 23

23.138 An entity shall disclose:

- (a) the closing balances of assets recognised from the costs incurred to obtain or fulfil a contract with a customer (in accordance with paragraph 23.113 or 23.117), by main category of asset (eg costs to obtain contracts with customers, pre-contract costs and set-up costs); and
- (b) the amount of amortisation and any impairment losses recognised in the reporting period.

The above quantitative disclosure requirements are consistent with IFRS 15. However, IFRS 15 further requires an entity to disclose information about the method it uses to determine the amortisation for each reporting period related to the assets recognised for costs to obtain or fulfil contracts with customers. [IFRS 15.127]. An entity reporting under FRS 102 could consider providing the similar information.

Under IFRS 15, entities are also required to disclose the judgements made in determining the amount of costs that were incurred to obtain or fulfil contracts with customers that meet the criteria for capitalisation, as well as the method the entity uses to amortise the assets recognised. [IFRS 15.127]. As discussed in 11.4.2 above, an entity reporting under FRS 102 is required to provide information about significant judgements it used in applying the entity's accounting policies. For example, for costs to obtain a contract, an entity that capitalises commission costs upon the signing of each contract needs to describe the judgements used, if considered significant, to determine the commission costs that qualified as costs incurred to obtain a contract with a customer, as well as the determination of the amortisation period. [FRS 102.8.6].

Frequently asked questions

Question 11-12: How are capitalised contract costs and their amortisation classified and presented in the statement of financial position and statement of profit or loss and other comprehensive income, respectively?

See response to Question 10-26 in 10.3.3 above.

11.4.4 Practical expedients

Section 23 allows entities to use several practical expedients. FRS 102.23.139 requires entities to disclose their use of three practical expedients: (a) the practical expedient in FRS 102.23.60 associated with the option to make no adjustments for the time value of money (see 6.5 above); (b) the practical expedient in paragraph 23.113 for the option to adopt a policy of recognising incremental costs incurred to obtain a contract with a customer as an asset (see 10.3.1 above), and (c) the practical expedient in paragraph 23.114 to recognise an immediate expense when incurred for incremental costs of obtaining a contract with a customer in which the amortisation period for the asset that the entity would otherwise have recognised is one year or less (see 10.3.1 above). [FRS 102.23.139].

Section 23 provides other practical expedients. Entities must consider the need to disclose any other practical expedients it uses, particularly if it provides additional information that enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

12 Periodic review 2024

In March 2024, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS - Periodic Review 2024* ('Periodic Review 2024 amendments'), following the second periodic review of FRS 102. [FRS 102.1.36]. Subsequently the FRC issued new September 2024 editions of UK and Ireland financial reporting standards (FRS 100 - 105) that encompass all amendments to that date. The Periodic Review 2024 results in substantial amendments to FRS 102 and consequential amendments to other FRSS. The most significant changes apply to leases (see Chapter 23) and revenue recognition to align with changes to IFRSs. Incremental improvements and clarifications have also been made to a number of other sections.

See also discussion in 1 above.

12.1 Effective date

Except for the new supplier finance arrangements disclosure requirements (effective 1 January 2025), the Periodic Review 2024 amendments are effective for accounting periods beginning on or after 1 January 2026, with early application permitted provided all amendments are applied at the same time and that fact is disclosed (see Chapter 3 at 1.2). [FRS 102.1.37, FRS 102.1.38].

The amendments are applied retrospectively in accordance with FRS 102.10.12 (see Chapter 9 at 3.3.2), except when a specific transitional provision allows or requires otherwise (see Chapter 3 at 1.3). [FRS 102.1.39]. The transitional provisions related to revenue from contracts with customers are discussed in 12.2 below.

12.2 Transition methods

Section 1 requires retrospective application when an entity first applies the Periodic Review 2024 amendments. However, in applying revised Section 23, it allows either a 'modified retrospective' adoption or a 'full retrospective' adoption in which the revised Section 23 is applied to all of the periods presented (see 12.2.3 and 12.2.4 below, respectively). [FRS 102.1.61].

The following are the dates relevant to transition:

- *The date of initial application* - the beginning of the reporting period in which an entity first applies revised Section 23. [FRS 102.1.40(a)]. This date of initial application does not change, regardless of the transition method that is applied. Examples of dates of initial application for different year-ends include:

Year ending	Date of initial application
31 December 2026	1 January 2026
30 June 2027	1 July 2026

- *The beginning of the earliest period presented* - the start of the earliest reporting period presented within an entity's financial statements for the reporting period in which the entity first applies revised Section 23. This is relevant for entities using the full retrospective adoption method. For example:

Year ending	Beginning of the earliest period presented	
	(one comparative period)	(two comparative periods)
31 December 2026	1 January 2025	1 January 2024
30 June 2027	1 July 2025	1 July 2024

As discussed in 1 above, the revised Section 23 includes accounting simplifications compared to IFRS 15 to provide proportionate and practical solutions that are cost effective to apply. These simplifications include greater use of hindsight when using practical expedients in estimating variable consideration and evaluating contract modifications when an entity applies the revised Section 23 for the first time or when an entity adopts FRS 102 for the first time (see Chapter 37). [FRS 102.BC.B23.9].

An entity is permitted to use the practical expedient in paragraph 1.65(b) to estimate variable consideration when an entity applies the revised Section 23. That is, for completed contracts that have variable consideration, an entity could use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. The FRC permits the use of that practical expedient by entities adopting either the modified retrospective method or the full retrospective method when transitioning to revised Section 23 (see 12.2.3 and 12.2.4 below). [FRS 102.1.62(c), FRS 102.1.65(b)]. By contrast, this expedient was applicable only to entities which adopted the full retrospective method under IFRS 15.

Section 4 of the FRC's FRS 102 Factsheet 9 *Initial application of the Periodic Review 2024 amendments*,²¹⁸ which illustrates how revenue transactions might be dealt with on initial application of the Periodic Review 2024 amendments, clarifies that "To account for contracts with variable consideration which are *completed by the reporting date*, the entity may use the transaction price at the date the contract was completed, rather than estimating amounts of variable consideration in comparative periods" (emphasis added). Accordingly, depending on the practical expedients an entity chooses to apply under the full retrospective method (e.g., FRS 102.1.65(a) allows an entity not to restate certain completed contracts - see 12.3.4 below), for all completed contracts with variable consideration, an entity applying the practical expedient in paragraph 1.65(b) above could use the transaction price at the date the contract was completed. As clarified in Section 4 of the FRS 102 Factsheet 9, this practical expedient covers even those contracts with variable consideration that are completed by the reporting date (e.g. 31 December 2026 for an entity with a 31 December year-end that adopted the revised Section 23 on 1 January 2026 - the date when the entity first applied the Periodic Review 2024 amendments). Although under the modified retrospective method an entity is required to apply the revised Section 23 retrospectively only to contracts that are not completed contracts at the date of initial application, [FRS 102.1.62(b)], the entity could also apply this practical expedient in the same manner as described above if any of these contracts contain variable consideration and such contracts are completed by the reporting date, i.e., contracts completed even during the year when the entity first applied the Periodic Review 2024 amendments. [FRS 102.1.62(c)]. Therefore, entities using this practical expedient benefit from greater use of hindsight when estimating variable consideration, regardless of the transition method applied.

An entity is also permitted to use the practical expedient in paragraph 1.65(c) in evaluating contract modifications when an entity applies the Periodic Review 2024 amendments. That is, for contracts that were modified before the date of initial application, an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 23.15 to 23.16 (see 4.4 above). Instead, an entity is permitted to reflect the aggregate effect of all the modifications when identifying the satisfied and unsatisfied performance obligations, determining the transaction price and allocating the transaction price to the satisfied and unsatisfied performance obligations. Entities can choose whether to apply the practical expedient to all contract modifications that occur before either (1) the beginning of the earliest period presented; or (2) the date of initial application. The FRC allows the use of this practical expedient by entities adopting either the modified retrospective method or the full retrospective method when transitioning to revised Section 23 (see 12.2.3 and 12.2.4 below). [FRS 102.1.62(c), FRS 102.1.65(c)]. In contrast, for entities which adopted full retrospective method under IFRS 15, this practical expedient was applied only to all contract modifications that occur before the beginning of the earliest period presented. Accordingly, entities electing the full retrospective method when transitioning to revised Section 23 and using this practical expedient benefit from greater use of hindsight when evaluating contract modifications.

12.2.1 Definition of a completed contract

For the purposes of applying the transition provisions related to revenue from contracts with customers, Section 1 defines a completed contract as a contract for which the entity has transferred all of the goods or services identified in accordance with previous requirements for accounting for revenue from contracts with customers, which the revised Section 23 replaced, i.e., - the legacy Section 23 (see 1 above). [FRS 102.1.67].

²¹⁸ [FRS 102 Factsheet 9 Initial application of the Periodic Review 2024 amendments](#), FRC, issued on 27 November 2024, Section 4 Transitional provisions relating to Section 23 *Revenue from Contracts with Customers*, pages 10 and 11.

Depending on the manner an entity elects to transition to the revised Section 23, it need not apply the revised Section 23 to contracts that qualify as completed contracts before the date of initial application or the beginning of the earliest period presented (depending on the practical expedient) (see 12.2.3 and 12.2.4 below), even if they have not yet received the consideration and that consideration is still subject to variability. Applying a completed contract practical expedient might also affect an entity's revenue recognition in subsequent reporting periods. That is, if an entity applied a practical expedient for completed contracts, it continues to apply its legacy revenue policy to its completed contracts, instead of the revised Section 23. In some cases, even though an entity has fully transferred its identified goods or services, there might still be revenue to recognise in reporting periods after adoption of the revised Section 23.

FRS 102 does not provide guidance on the meaning of 'transferred all of the goods or services'. However, with reference to IFRS 15, the IASB noted in the Basis for Conclusions on IFRS 15 that 'transferred all of the goods or services' is not meant to imply that an entity would apply the 'transfer of control' notion in IFRS 15 to goods or services that have been identified in accordance with legacy IFRS. Rather it is performance in accordance with legacy IFRS requirements (i.e., IAS 11, IAS 18 and related Interpretations). [IFRS 15.BC441]. Legacy Section 23 was based on legacy IFRS. Consequently, in many situations the term 'transferred' would mean 'delivered' within the context of contracts for the sale of goods and 'performed' within the context of contracts for rendering services and construction contracts. In some situations, the entity would use judgement when determining whether it has transferred goods or services to the customer. [IFRS 15.BC445D].

Consider the following examples:

- Contract is completed – a retailer sold products to a customer on 31 December 2025, with immediate delivery. The customer had a poor credit history. Therefore, the retailer required the customer to pay half of the consideration upfront and half within 60 days. In accordance with legacy Section 23, the retailer recognised half of the consideration at the time of the sale. However, the retailer concluded it was not probable that it would be able to collect the remainder and deferred recognition of this amount. Because the goods were delivered prior to the date of initial application of the revised Section 23 (e.g., 1 January 2026) and collectability concerns were only the reason for delaying recognition of revenue under legacy Section 23, the contract is considered completed under the transition provisions in Section 1 (see 12.2.2.E below for further discussion on collectability); or
- Contract is not completed – an entity entered into a contract to provide a service and loyalty points to a customer on 31 January 2025. In accordance with legacy Section 23, the entity deferred a portion of the total contract consideration for the loyalty points and deferred revenue recognition until the points were exercised on 15 January 2026. The entity completed the required service within six months and recognised revenue related to the service over that period in accordance with legacy Section 23. As at the date of initial application of revised Section 23 (e.g., 1 January 2026), the entity had not yet performed in relation to the loyalty points. As a result, the contract was not considered completed under the transition provisions in Section 1 (see 12.2.2.G below for further discussion on loyalty points).

As discussed above, determining which contracts are completed at transition might require significant judgement, particularly if legacy Section 23 did not provide detailed requirements or guidance that indicated when goods had been delivered or services performed (e.g., licences of intellectual property).

Entities must not consider elements of a contract that did not result in recognition of revenue under legacy Section 23 (e.g., warranty provisions) when assessing whether a contract is a completed contract (see 12.2.2.A below).

12.2.2 Implementation questions on definition of a completed contract

12.2.2.A Elements in a contract to be considered

When determining whether a contract meets the definition of a completed contract, an entity must consider all of the elements (or components) in a contract that give rise to revenue in the scope of legacy Section 23. It does not consider the elements of a contract that do not result in recognition of revenue (e.g. warranty provisions accounted for in accordance with Section 21) when assessing whether a contract is a completed contract.

For example, under legacy Section 23, an entity might have accounted for a financing component (i.e., separating the interest income or expense from the revenue). Doing so effectively splits the contract into a revenue component and a financing component.

How we see it

In our view, the financing component generally would not be considered in determining whether the goods or services have transferred to the customer (i.e., it would generally not affect the assessment of whether the contract meets the definition of a completed contract). In addition, income elements that are not within the scope of the revised Section 23 need not be considered even if they were covered by revenue requirements in legacy Section 23.

For example, legacy Section 23 applied to dividends and provided guidance on the recognition of interest and fees integral to the issuance of a financial instrument. None of these elements would be considered when determining whether a contract meets the definition of a completed contract for transition to the revised Section 23. This is because:

- Dividends are not within the scope of the revised Section 23 (see Chapter 13 at 6.3.2) [FRS 102.11.14A, FRS 102.12.9A]
 - The guidance that was previously included in the illustrative examples in the Appendix to legacy Section 23 for fees integral to the issuance of a financial instrument is no longer included in the revised Section 23. Accounting for such fees is included within Section 11 (see Chapter 13 at 6.2) [FRS 102.11.18]
- Or
- Interest income continues to be accounted for in accordance with the effective interest method as set out in Section 11 (see Chapter 13 at 6.2). [FRS 102 Appendix I, FRS 102.11.16].

12.2.2.B Identification of a contract under legacy Section 23

When determining whether a contract is completed, an entity considers the requirements of legacy Section 23 and not the revised Section 23.

How we see it

In order to determine whether a contract is completed, an entity needs to determine the boundaries of a contract, including the term of the contract, whether it was combined with other contracts, whether it was modified, etc. That is, an entity must identify what is the contract in order to assess if it meets the definition of a completed contract.

The revised Section 23 provides detailed requirements to assist entities in identifying a contract, including determining the contract duration. These requirements are more detailed than legacy Section 23 and could lead to different outcomes from legacy Section 23 (e.g., an entity might conclude a contract is of a shorter duration than the stated contractual term in certain circumstances under the revised Section 23, see 4.2 above for further discussion).

While legacy Section 23 did not provide detailed requirements for identifying the contract, accounting policies and an entity's past practice might be informative in identifying the contract, including determining: (a) what the entity considered the contract to be (e.g., master supply agreement or individual purchase orders); and (b) the contract duration (i.e., the stated contractual term or a shorter period). Consider the following examples:

Illustration 12-1: Definition of completed contract: contract duration

Scenario 1

On 30 June 2024, Entity A entered into a contract with a customer to provide services for 24 months. The customer was required to pay a fixed monthly fee of £150, which remained constant during the contract term of 24 months, regardless of the time needed to provide the services or the actual usage from the customer each day. The customer could cancel the contract at any time without penalty by giving Entity A one month's notice. Entity A had not received any cancellation notice up to 1 January 2025 and, based on past experience, Entity A did not expect customers to cancel within the first year. For this contract, Entity A concluded that the contract duration under legacy Section 23 was the stated contractual term of 24 months.

Entity A's accounting policy for these types of contracts under legacy Section 23 stated that revenue from providing monthly services to customers was recognised over the service period, on a monthly basis. While not explicitly stated in its accounting policy, Entity A had typically treated the stated contractual term as the duration of the contract (unless the customer cancelled or the contract was modified) and considered this to be the period over which the contractual rights and obligations were enforceable.

Assume that Entity A adopts the Periodic Review 2024 amendments on 1 January 2026 using the full retrospective method to transition to revised Section 23. Entity A also uses the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that are completed contracts at the beginning of the earliest period presented (i.e., 1 January 2025; Entity A presents one comparative period only). [FRS 102.1.65(a)(ii)].

Under revised Section 23, Entity A is likely to conclude that the contract is a month-to-month contract. However, when determining whether the contract is completed, Entity A only considers the requirements of legacy Section 23. Entity A might have noted that its accounting policy under legacy Section 23 did not focus on the identification of contract duration and, therefore, perhaps the contract is neither a 24-month contract nor a month-to-month contract. Entity A had accounted for this type of service contract based on monthly invoicing and, arguably, that accounting treatment is similar to the accounting treatment of a month-to-month contract. However, while not explicitly stated, Entity A has generally viewed the stated contractual term as the period over which the rights and obligations are enforceable.

Furthermore, Entity A cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which would limit Entity A's obligation to provide services for the next 30 days from the notification date. Since no cancellation notice had been submitted by the customer at least one month before 1 January 2025, approximately 18 months of services still need to be provided as at the beginning of the earliest period presented (i.e., 1 January 2025). Therefore, Entity A concludes that the contract does not meet the definition of a completed contract and would need to be transitioned to revised Section 23.

Scenario 2

Assume the same facts as Scenario 1, with the exception that the customer submitted an early termination notice on 30 November 2024.

Similar to Scenario 1, the contract duration under legacy Section 23 would have been the stated contractual term of 24 months. However, in this scenario, the customer has submitted the termination notice on 30 November 2024. Therefore, Entity A concludes that the term of the contract ceases on 31 December 2024.

Entity A cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which limits Entity A's obligation to provide service for the next 30 days from the notification date. Since Entity A had provided all services prior to 31 December 2024, Entity A concludes that the contract is a completed contract. Entity A continues to apply its legacy accounting policy (developed in accordance with legacy Section 23) to any remaining consideration still to be recognised.

Scenario 3

Assume the same facts with Scenario 1, with the exception that the customer was required to pay a non-refundable upfront fee of £50 at commencement of the contract (in addition to the monthly fixed fee). The customer can cancel the contract at any time without penalty, with a month's notice period. The customer cancelled the contract on 30 November 2024.

In its financial statements, Entity A's accounting policy for these types of contracts under legacy Section 23 stated that revenues from non-refundable upfront fees were deferred over the average customer retention period. The customer retention period was estimated to be two years. Therefore, the deferred revenue was recognised as revenue on a straight-line basis over the next 24 months.

Similar to Scenario 2, the contract duration under legacy Section 23 would have been the stated contractual term of 24 months. However, the customer had submitted the termination notice on 30 November 2024 and, therefore, Entity A concludes that the term of the contract ceases on 31 December 2024.

Entity A's legacy accounting policy for the non-refundable upfront fee refers to recognition of the deferred income over average customer retention period, not the contractual term. The definition of a completed contract is not dependent on all revenue being recognised, but rather on all goods and services being transferred to the customer. Furthermore, the period over which revenue is recognised does not affect the contract duration. As such, recognition of this upfront fee is not relevant in determining whether the contract is a completed contract. All previously contracted services had been provided to the customer up to the date of cancellation. Therefore, the contract is a completed contract.

Entity A continues applying its legacy accounting policy (developed in accordance with legacy Section 23) to any remaining consideration still to be recognised. However, given that the customer has terminated the contract early, Entity A needs to reassess, in line with the requirements of legacy Section 23, the period over which this remaining revenue arising from the non-refundable upfront fee would be recognised.

12.2.2.C Determination whether all goods or services have been transferred

When determining whether an entity has 'transferred all goods or services', the entity does not consider the requirements of revised Section 23 for 'transfer of control'. Instead, an entity considers transfer of goods or services in accordance with legacy Section 23. [FRS 102.1.67].

As discussed in 12.2.1 above, FRS 102 does not provide guidance on the meaning of 'transferred all of the goods or services'. However, with reference to IFRS 15, the IASB noted in the Basis for Conclusions on IFRS 15 that 'transferred all of the goods or services' is not meant to imply that an entity would apply the 'transfer of control' notion in IFRS 15 to goods or services that have been identified in accordance with legacy IFRS. Rather, an entity is required to determine whether it has transferred all the goods or services in accordance with the requirements in legacy IFRS requirements (i.e., IAS 11, IAS 18 and related Interpretations) (see 12.2.2.D below). [IFRS 15.BC441].

Legacy Section 23 was based on legacy IFRS. Consequently, in many situations the term "transferred" would mean "delivered" within the context of contracts for the sale of goods and "performed" within the context of contracts for rendering services and construction contracts. In some situations, the entity would use judgement when determining whether it has transferred goods or services to the customer.

[IFRS 15.BC445D].

12.2.2.D Some or all revenue has not been recognised under legacy Section 23

If some or all revenue has not been recognised under legacy Section 23, this could possibly prevent the contract from being completed.

How we see it

The definition of a completed contract is not dependent on an entity having recognised all related revenue. However, the requirements in legacy Section 23 with respect to the timing of recognition might provide an indication of whether the goods or services have been transferred.

Legacy Section 23 provided the following five criteria, all of which needed to be satisfied in order to recognise revenue from the sale of goods: [FRS 102(2022).23.10]

- The entity had transferred to the buyer the significant risks and rewards of ownership of the goods.
 - The entity retained neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
 - The amount of revenue could be measured reliably.
 - It was probable that the economic benefits associated with the transaction would flow to the entity.
- And
- The costs incurred or to be incurred in respect of the transaction could be measured reliably.

Legacy Section 23 viewed the passing of risks and rewards as the most crucial of the five criteria, giving the following four examples of situations in which an entity might have retained the significant risks and rewards of ownership: [FRS 102(2022).23.12]

- When the entity retained an obligation for unsatisfactory performance not covered by normal warranty provisions.
- When the receipt of the revenue from a particular sale was contingent on the derivation of revenue by the buyer from its sale of the goods.
- When the goods were shipped subject to installation and the installation was a significant part of the contract which had not yet been completed by the entity.
- When the buyer had the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity was uncertain about the probability of return.

Understanding the reasons for the accounting treatment under legacy Section 23 might, therefore, assist entities in determining whether the goods or services have been transferred and the completed contract definition has been met. However, judgement might be needed in respect of some goods or services. Assume, for example, that an entity sells products, but cannot recognise revenue immediately. The delayed recognition of revenue might be because of factors related to the timing of transfer, such as a bill-and-hold arrangement, or because the goods or services have been transferred, but not all of the criteria for recognition have been met.

12.2.2.E Delayed recognition of revenue due to collectability concerns

If collectability concerns were the only reason for delaying recognition of revenue under legacy Section 23 (i.e., because it was not probable that the economic benefits associated with the transaction would flow to the entity), [FRS 102(2022).23.10(d)], it would not prevent a contract from meeting the definition of a completed contract. However, it is important to ensure that this is the only reason for the delay in recognition.

Consider the following examples:

Illustration 12-2: Definition of completed contract: collectability

Scenario 1

In November 2024, Entity A entered into a contract with a customer to deliver 1,000 products with immediate delivery. Because of the customer's poor credit history, Entity A agreed that the customer could pay for 60% of the products on the date of delivery and the remaining 40% within 60 days of the delivery date. Under its previous accounting policy (in accordance with paragraph 23.10 of legacy Section 23), [FRS 102(2022).23.10], Entity A only recognised revenue for 60% of the consideration and deferred recognition of the remaining 40% until it was probable that this amount would be collected (provided the other criteria in paragraph 23.10 of legacy Section 23 were met). Collectability of the remaining 40% of the consideration became probable at the end of January 2025.

Assume that Entity A adopted the Periodic Review 2024 amendments on 1 January 2026 and used the full retrospective method to transition to revised Section 23. Entity A also uses the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that meet the definition of a completed contract, as defined in paragraph 1.67, at the beginning of the earliest period presented (see 12.2.4 below and 12.2.1 above).

At the beginning of the earliest period presented (i.e., 1 January 2025; Entity A presents one comparative period only), Entity A had transferred all goods identified in the contract by delivering 1,000 products to the customer and had recognised 60% of the revenue. Although Entity A could only partially recognise the revenue from the sale of the 1,000 products (because it was not probable whether it would collect 40% of the consideration), this does not affect the determination of whether the identified goods were transferred to the customer. Therefore, Entity A considers the contract as a completed contract. In line with the discussion in 12.2.4.B below, Entity A continues to account for the contract in accordance with its legacy accounting policy (developed in accordance with legacy Section 23).

Scenario 2

In January 2024, Entity A entered into a contract with a customer to construct a highly specialised system on the customer's premises that was expected to be completed within 11 months. The consideration of £100,000 took into account the particularities of the customer's specific premises. The repayment schedule corresponded to the performance completed to date and Entity A applied the percentage of completion method in accordance with paragraph 23.17 of legacy Section 23, recognising revenue in the accounting period in which the relevant services were rendered. [FRS 102(2022).23.17].

Upon completion of the highly specialised system, Entity A had collected the consideration of £100,000 and recognised an equal amount as revenue. However, in October 2024, while executing the construction activities, Entity A incurred unexpected additional costs to adjust the initial design of the highly specialised system due to certain changes in the customer's premises that had not been communicated at contract inception. Entity A filed a claim for these unexpected costs, requesting an increase in the consideration of £1,000. The construction was completed in November 2024. In February 2025, Entity A agreed with its customer to settle the claim at an amount of £500 to be paid within three months.

Assume that Entity A adopted the Periodic Review 2024 amendments on 1 January 2026 and used the full retrospective method to transition to revised Section 23. Entity A also used the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that meet the definition of a completed contract, as defined in paragraph 1.67, at the beginning of the earliest period presented (see 12.2.4 below and 12.2.1 above).

At the beginning of the earliest period presented (i.e., 1 January 2025), Entity A had transferred all goods and services identified in the contract by completing the construction and delivering the highly specialised system to the customer. The fact that Entity A had submitted a claim for additional consideration for the identified goods and services that had already been transferred to the customer is not relevant when determining whether the identified goods or services have been transferred. Therefore, Entity A considers the contract as a completed contract. In line with the discussion in 12.2.4.B below, Entity A continues to account for the contract in accordance with its legacy accounting policy (developed in accordance with legacy Section 23).

12.2.2.F Transfer of a licence under legacy Section 23

Legacy Section 23 provided limited guidance to assist entities in determining when a licence of intellectual property is transferred (i.e., when the significant risks and rewards of ownership of the licence transfer to the customer in accordance with paragraph 23.10(a) of legacy Section 23). *[FRS 102(2022).23.10(a)]*. Therefore, entities will need to use significant judgement to determine whether a contract involving the licence of intellectual property meets the definition of a completed contract.

Under legacy Section 23, royalties were recognised on an accrual basis in accordance with the substance of the relevant agreement. *[FRS 102(2022).23.29(b)]*. Legacy Section 23 further stated that fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are recognised in accordance with the substance of the agreement. As a practical matter, this might be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use specified technology for a specified period of time. *[FRS 102(2022).23A.34]*. In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred'. *[FRS 102(2022).23A.36]*.

Since the guidance provided in legacy Section 23, as described above, focused on the recognition of revenue, it might be difficult to determine when the entity has transferred the significant risks and rewards of ownership to the customer. If an entity has recognised revenue over time under legacy Section 23, it needs to carefully assess the reason for this treatment.

It might be helpful to assess whether or not there are remaining or ongoing obligations related to the licence, as discussed in paragraphs 23A.35 of legacy Section 23:

- If the licence of intellectual property is an in-substance sale and there were no remaining obligations to perform, it is likely that the significant risks and rewards of ownership will have transferred to the customer at the time of sale.
- As discussed in paragraph 23A.35 of legacy Section 23: "An assignment of rights for a fixed fee or non-refundable guarantee under a non-cancellable contract that permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations after delivery. Another example is the granting of rights to exhibit a motion picture film in markets in which the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale". *[FRS 102(2022).23A.35]*.
- In all other instances, an entity needs to use judgement to determine when the licensee can exploit the rights under the license freely and the licensor has no remaining obligations to perform. This might be helpful in understanding whether the ongoing obligations mean that the significant risks and rewards of ownership did not pass at a single point in time, but over a period of time. Furthermore, this assessment could help in determining whether it is over the entire licence period or a shorter period and might include considering factors such as:
 - The reason that the contract is cancellable (if applicable).
 - The nature of any restrictions over use of the intellectual property. For example, whether it is a characteristic of the licence itself (e.g., the countries covered by the licence) or restricts the licensor's ability to use the rights received (e.g., the licensor cannot use the intellectual property before a specified date).

Or

 - The nature of any remaining obligations and the period in/over which those obligations apply.

Consider the following examples:

Illustration 12-3: Definition of completed contract: licences

Scenario 1

On 1 January 2024, Entity A entered into a three-year contract that granted rights to exhibit a film at cinemas and allowed for multiple showings within a specific period for a non-refundable upfront fee of £9,000. The delivery of the film was the only activity that Entity A was obliged to perform in the contract and there was no further involvement or other obligations for Entity A. The film was delivered to the customer on 1 January 2024 and Entity A concluded that the significant risks and rewards of ownership transferred to the customer on that date.

Entity A's legacy Section 23 accounting policy for this type of contracts stated that revenue was recognised in full upon commencement of the licence period, because that was the first point at which the customer had the risks and rewards of ownership and all the criteria for revenue recognition were met at that date.

Assume that Entity A adopted the Periodic Review 2024 amendments on 1 January 2026 and used the full retrospective method to transition to revised Section 23. Entity A also used the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that meet the definition of a completed contract as defined in FRS 102.1.67 at the beginning of the earliest period presented (see 12.2.4 below and 12.2.1 above).

According to Entity A's previous accounting policy, revenue was recognised in full upon commencement of the licence period (i.e., on 1 January 2024) and Entity A had no further involvement beyond that point. Therefore, at the beginning of the earliest period presented (i.e., 1 January 2025), the contract is completed. In line with the discussion in 12.2.4.B below, Entity A continues to account for the contract in accordance with its legacy accounting policy (developed in accordance with legacy Section 23).

Scenario 2

Assume the same facts as Scenario 1, with the exception that the fee was contingent upon the occurrence of a future event, specifically the purchase price was based on a percentage of the box office receipts during the contract term (i.e., three years).

Entity A concluded that the significant risks and rewards of ownership transferred to the customer on 1 January 2024, when the film was delivered.

The existence of a sales-based royalty earned over a three-year period does not affect the timing of transfer to the customer because Entity A had no further obligations to perform. The licence fee is contingent on box office receipts. In such cases, paragraph 23A.36 of legacy Section 23 stated 'revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.'

[FRS 102(2022).23A.36].

However, this does not give rise to an additional obligation for Entity A. Therefore, it does not affect the timing of transfer to the customer.

Therefore, at the beginning of the earliest period presented (i.e., 1 January 2025), the contract is completed. Entity A continues to account for the contract in accordance with its legacy accounting policy (developed in accordance with legacy Section 23).

Scenario 3

Assume the same facts with Scenario 1, with the exception that, along with the delivery of the film, Entity A supported the promotion of the films through promotional and marketing campaigns for a period of 18 months after the film was delivered to the customer.

Entity A's legacy Section 23 accounting policy for this type of contracts stated that 'promotional and marketing campaigns are not separately identifiable components in a contract in which it grants rights to exhibit and broadcast films. Revenue is recognised as the promotional and marketing campaigns are performed on a straight-line basis over the period of the licence.'

Entity A concluded that, while the film was delivered on 1 January 2024, the significant risks and rewards of ownership of the deliverable (i.e., the film and services, together) did not transfer to the customer until the services were provided (i.e., 30 June 2025).

The contract included multiple components because Entity A had to provide promotional support services in addition to the delivery of the licence. However, Entity A had considered paragraph 23.8 of legacy Section 23 and determined that these services were not separately identifiable components to which revenue needed to be allocated. [FRS 102(2022).23.8]. Instead, revenue was recognised for both the licence and the promotional support services during the licence period, as Entity A provided the services.

The contract is not considered completed because Entity A has to transfer additional services after transferring the right to exhibit the film. The fact that Entity A had not separately allocated the consideration to each component in the contract does not relieve it from its obligations to undertake the promotional activities over the following 18 months.

Therefore, at the beginning of the earliest period presented (i.e., 1 January 2025), Entity A still had to perform and provide the remaining promotional support services to the customer up to 30 June 2025. Accordingly, the contract does not meet the definition of a completed contract. The contract needs to be transitioned to revised Section 23.

12.2.2.G Transfer of loyalty points under legacy Section 23

Under legacy Section 23, an entity would not have 'transferred' loyalty points granted to a customer until the points were redeemed or expired.

Entities will need to carefully assess their loyalty programmes as points typically arose from several contracts with the same customer(s). Since legacy Section 23 required that such programmes be treated as a revenue element in a contract rather than a cost accrual, a contract would not be considered complete until the loyalty points arising from that contract have been redeemed or have expired.

Entities that operate loyalty programmes might face practical challenges in determining which contracts gave rise to unexpired and unused loyalty points and, therefore, which contracts are not yet completed (and must be transitioned to revised Section 23). Some entities might have data within their systems that assist them in identifying those contracts for each customer. However, if an entity has not specifically tracked such information by customer, the terms and conditions of the loyalty programme might assist entities in understanding whether/when points expire in order to identify the likely timing of the original transaction that gave rise to the point(s). Furthermore, it might help to understand whether the entity used a first-in-first-out approach to the utilisation of loyalty points or some other approach.

Consider the following examples:

Illustration 12-4: Definition of completed contract: loyalty programmes

Entity A sells goods to retail customers. The customers can enter into a loyalty programme such that when they purchase goods, they receive 1 loyalty point for every £100 spent on goods purchased from Entity A. Customers can redeem their accumulated loyalty points for discounts on future purchases from Entity A. When redeemed, 1 point entitles the customer to a £1 discount, which is assumed to be the fair value of each loyalty point. Points awarded expire in two years from the award day.

Entity A recognises revenue from sales of goods when customers buy them at the point of sale. According to legacy Section 23, Entity A allocated the fair value of the consideration received or receivable in respect of the initial sale between the award points and the initial good sold.

On 1 November 2024, Entity A sold £10,000 worth of goods and granted 100 loyalty points to a customer. Using a relative fair value approach, Entity A allocated £9,901 to the sale of goods and £99 to the loyalty points. The revenue from the sale of goods was recognised immediately. However, revenue recognition for the loyalty points was deferred until the points were exercised or expired. On 1 January 2025, the customer had not used the points.

Assume that Entity A adopted the Periodic Review 2024 amendments on 1 January 2026 and uses the full retrospective approach to transition to revised Section 23. Entity A also uses the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that meet the definition of a completed contract as defined in paragraph 1.67 at the beginning of the earliest period presented (i.e., 1 January 2025; Entity A presents one comparative period only) (see 12.2.4 below and 12.2.1 above).

As at the beginning of the earliest period presented, Entity A concludes that the loyalty points have not yet been exercised or expired.

At the beginning of the earliest period presented (i.e., 1 January 2025), Entity A had delivered the goods to the customer that triggered the award of the unredeemed loyalty points. However, at that date, Entity A had not yet performed in relation to the loyalty points that represented a separately identifiable component of the initial sale transactions in which they were granted. Therefore, the contract does not meet the definition of a completed contract. The contract needs to be transitioned to revised Section 23.

12.2.3 Modified retrospective adoption

An entity that elects the modified retrospective method applies the revised Section 23 retrospectively to only the current period presented in the financial statements (i.e., the initial period of application). To do so, the entity recognises the cumulative effect of initially applying the revised Section 23 to all contracts that are not completed contracts at the date of initial application, as an adjustment to the opening balance of retained earnings (or other appropriate components of equity) at the date of initial application.

[FRS 102.1.61(a), FRS 102.1.62(b)].

When an entity applies the modified retrospective method, there is no effect on the statement of financial position as at the beginning of the preceding period. Furthermore, an entity presents comparative periods in accordance with legacy Section 23 because under this method, an entity must not restate comparative information – there is no restated comparative information in its financial statements or in the notes to the financial statements (e.g., disaggregated revenue disclosures in the comparative period) under this method. [FRS 102.1.61(b)].

Under the modified retrospective approach, the revised Section 23 is applied retrospectively only to contracts that are not completed at the date of initial application, e.g., 1 January 2026 for an entity with a 31 December year-end (see 12.2 and 12.2.1 above). [FRS 102.1.62(b)]. An entity must evaluate only those that are not completed before the date of initial application as if the entity had applied the revised Section 23 to them since inception. So, if an entity elects to apply the modified retrospective method, it continues to apply legacy Section 23 to completed contracts at the date of initial application, i.e., completed contracts at the date of initial application are not restated. This is discussed further at 12.2.4.B below. Accordingly, an entity that applies the modified retrospective method applies different accounting to similar contracts after the date of adoption. Consider the example discussed at 12.2 above, a sale by a retailer on 31 December 2025, the contract in that example is considered a completed contract as at the date of initial application (i.e., 1 January 2026 in that example). The retailer would not restate revenue for this contract and would continue to account for the remaining revenue to be recognised under legacy Section 23 after adoption of the revised Section 23. However, any similar sales on or after the date of initial application (i.e., 1 January 2026 in that example) would be subject to the requirements of the revised Section 23. If the retailer prefers to account for similar transactions under the same accounting model, it could choose to adopt the full retrospective method (see 12.2.4 below).

An entity that chooses the modified retrospective method can use only two of the five practical expedients available to entities that apply the full retrospective method. These are described in paragraph 1.65(b) and paragraph 1.65(c) and relate to estimating variable considerations and contract modifications, respectively (see 12.2.4 and 12.2.5 below). [FRS 102.1.62(c)]. The FRC notes that these practical expedients allow greater use of hindsight when estimating variable consideration and evaluating contract modifications than was permitted for ongoing IFRS reporters and first-time adopters of IFRS implementing IFRS 15's requirements for the first time. [FRS 102.BC.B23.9, FRS 102.BC.B23.12]. See further discussions in 12.2 above.

If an entity electing the modified retrospective method uses either the practical expedient on estimating variable considerations or on accounting for contract modifications, the entity must apply the expedient consistently to all contracts and the entity is required to disclose that fact (i.e., the type of practical expedient the entity applied). [FRS 102.1.62(c), FRS 102.1.66].

The following Illustration 12-5 demonstrates the potential effects of the modified retrospective method:

Illustration 12-5: Cumulative effect of adoption under the modified retrospective method

A software vendor with a 31 December year-end adopts the Periodic Review 2024 amendments on 1 January 2026. The vendor adopts the revised Section 23 using the modified retrospective method and applies the revised Section 23 only to contracts that are not completed on 1 January 2026.

The vendor frequently enters into contracts to provide a software licence, professional services and post-delivery service support. It previously accounted for its contracts in accordance with legacy Section 23, particularly paragraph 23A.33 of legacy Section 23. [FRS 102(2022).23A.33]. As a result, it recognised fees from the development of its software by reference to the stage of completion of the development, which included the completion of post-delivery service support services. In effect, the software vendor treated the development of software and post-delivery service support as a single deliverable.

Revised Section 23 provides more detailed requirements for determining whether promised goods or services are performance obligations (discussed further at 5.2 above) than legacy Section 23 provided regarding the number of deliverables to identify.

As a result, the vendor's analysis of contracts in progress as at 1 January 2026 might result in the identification of different performance obligations from those it previously used for revenue recognition. As part of this assessment, the entity needs to allocate the estimated transaction price, based on the relative stand-alone selling price method (see 7.2 above), to the newly identified performance obligations.

The vendor compares the revenue recognised for each contract, from contract inception through to 31 December 2025, to the amount that would have been recognised if the entity had applied the revised Section 23 since contract inception. The difference between those two amounts would be accounted for as a cumulative catch-up adjustment and recognised as at 1 January 2026 in opening retained earnings. From 1 January 2026 onwards, revenue recognised would be based on the revised Section 23.

When there is a change in accounting policy, an entity must provide the disclosures required in paragraph 10.13. However, the FRC provided some additional relief from these disclosures. An entity that elects to apply the revised Section 23 retrospectively using the modified retrospective method is not required to disclose information required by paragraphs 10.13(b) to 10.13(d) (see Chapter 9 at 3.61). However, an entity that elects to apply the modified retrospective method is required to make certain disclosures in the year of initial application. [FRS 102.1.63]. Specifically, the entity must disclose:

- The nature of the change in accounting policy. [FRS 102.10.13(a)].
- And
- For the current period, to the extent practicable, the amount of the adjustment to revenue and to profit or loss for the effect of applying the revised Section 23 and an explanation of the reasons for any significant changes (i.e., changes between the reported results under the revised Section 23 and under legacy Section 23), or an explanation if it is impracticable to determine these amounts. [FRS 102.1.63].

Note also that FRS 102 does not require a third statement of financial position as at the beginning of the preceding period to be presented whenever an accounting policy is applied retrospectively or a retrospective restatement or reclassification is made in the financial statements (see Chapter 9 at 2.3).

Depending on an entity's prior accounting policies, applying the modified retrospective method might be more difficult than an entity would anticipate. Situations that might make application under this method more complex include the following:

- The performance obligations identified under the revised Section 23 are different from the elements/deliverables identified under legacy requirements.
- The relative stand-alone selling price allocation required by the revised Section 23 results in different amounts of the consideration being allocated to performance obligations than had been allocated in the past.

Or

- The contract contains variable consideration and the amount of variable consideration that can be included in the allocable consideration differs from the amount under legacy requirements.

In addition, the modified retrospective method effectively requires an entity to keep two sets of accounting records in the year of adoption in order to comply with the requirement to disclose the amount of adjustment to revenue and to profit or loss which requires corresponding amounts as if they were prepared under legacy Section 23.

12.2.4 Full retrospective adoption

Entities electing the full retrospective adoption must apply the provisions of revised Section 23 to each period presented in the financial statements in accordance with paragraph 10.12, subject to the practical expedients created to provide relief. [FRS 102.1.61(b), FRS 102.1.65]. The requirements of Section 10 are discussed in Chapter 9.

Under the full retrospective method, entities apply the revised Section 23 as if it had been applied since the inception of all its contracts with customers that are presented in the financial statements. That is, an entity electing the full retrospective method transitions all its contracts with customers to revised Section 23 (subject to the practical expedients described below), not just those that are not considered completed contracts as at the beginning of the earliest period presented. This means that for contracts that were considered completed (as defined) before the beginning of the earliest period, an entity still needs to evaluate the contract under the revised Section 23 in order to determine whether there was an effect on revenue recognised in any of the years presented in the period of initial application (unless an entity elects to use one of the practical expedients described below).

To ease the potential burden of applying it on a fully retrospective basis, the FRC has provided relief. An entity is permitted to use one or more of the following practical expedients when applying the revised Section 23 retrospectively: [FRS 102.1.65]

- (a) For completed contracts, an entity need not restate contracts that:
 - (i) Begin and end within the same annual reporting period.

Or

 - (ii) Are completed contracts at the beginning of the earliest period presented.

- (b) For completed contracts that have variable consideration, an entity is allowed to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.

The FRC's FRS 102 Factsheet 9²¹⁹ clarifies that this practical expedient is available for contracts with variable consideration which are completed by the reporting date (i.e., the end of the reporting period when the entity first applies the Periodic Review 2024 amendments – see 12.2 above).

- (c) For contracts that were modified before the date of initial application, an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 23.15 to 23.16 (see 4.4 above). Instead, an entity is permitted to reflect the aggregate effect of all the modifications that occurred before the beginning of the earliest period presented or the date of initial application when: *[FRS 102.23.15, FRS 102.23.16]*

- (i) Identifying the satisfied and unsatisfied performance obligations.
- (ii) Determining the transaction price.

And

- (iii) Allocating the transaction price to the satisfied and unsatisfied performance obligations.

See further discussion of this practical expedient in 12.2.5 below.

- (d) For prior periods presented, an entity need not disclose the quantitative or qualitative explanation of the significance of unsatisfied performance obligations and when they are expected to be satisfied as required by paragraph 23.137 (see 11.4.1.D above). *[FRS 102.23.137]*.

The FRC notes that the practical expedients described in (b) and (c) above allow greater use of hindsight when estimating variable consideration and when evaluating contract modifications than was permitted for ongoing IFRS reporters and first-time adopters of IFRS implementing IFRS 15's requirements for the first time. *[FRS 102.BC.B23.9]*. See further discussions in 12.2 above. When there is a change in accounting policy, an entity must provide the disclosures required in paragraph 10.13. However, the FRC provided some additional relief from these disclosures. An entity that elects to apply the revised Section 23 retrospectively on a full retrospective basis is only required to make the disclosure requirements set out in paragraph 10.13(b) for the period immediately preceding initial application, rather than providing the disclosure requirements for the current period and each of the prior period presented. Accordingly, an entity must provide the following: *[FRS 102.10.13, FRS 102.1.64]*

- (a) The nature of the change in accounting policy.
 - (b) For the most recent prior period presented (i.e., the immediately preceding period), to the extent practicable, the amount of the adjustment for each financial statement line item affected.
 - (c) The amount of the adjustment relating to periods before those presented, to the extent practicable.
- And

- (d) An explanation if it is impracticable to determine the amounts to be disclosed in (b) or (c) above.

An entity must make the above disclosures in the period in which the revised Section 23 is applied for the first time under full retrospective method. Financial statements in subsequent periods need not repeat the required disclosures (see Chapter 9 at 3.6.1). *[FRS 102.10.13]*.

Note also that FRS 102 does not require a third statement of financial position as at the beginning of the preceding period to be presented whenever an accounting policy is applied retrospectively or a retrospective restatement or reclassification is made in the financial statements (see Chapter 9 at 2.3).

12.2.4.A Does an entity have to apply elected practical expedients to all periods and to all contracts?

Entities could elect to apply one, some, or all of these practical expedients. However, if an entity elects to use any of these practical expedients, it must apply that practical expedient consistently to all contracts and periods presented. *[FRS 102.1.66]*. It would not be appropriate to apply the selected practical expedient to some, but not all, of the periods presented under the revised Section 23.

Entities that choose to use any of the practical expedients are required to disclose that fact (i.e., the types of practical expedients the entity has applied). *[FRS 102.1.66]*.

²¹⁹ [FRS 102 Factsheet 9 Initial application of the Periodic Review 2024 amendments](#), FRC, issued on 27 November 2024, Section 4 Transitional provisions relating to Section 23 *Revenue from Contracts with Customers*, pages 10 and 11.

12.2.4.B Consequences of applying transition practical expedients: accounting for completed contracts excluded from transition

Depending on the way in which an entity adopts the revised Section 23 and practical expedients an entity applies, it might be able to exclude contracts that meet the definition of a completed contract from the population of contracts to be transitioned to the revised Section 23 (i.e., it would not need to restate those contracts). This is illustrated in Illustration 12-1 at 12.2.2.B, Illustration 12-2 at 12.2.2.E, Illustration 12-3 at 12.2.2.F and Illustration 12-4 at 12.2.2.G above.

The transition provisions in Section 1 provide that if an entity is required, or chooses, not to apply the revised Section 23 to completed contracts in accordance with paragraph 1.62(b) or 1.65(a), these completed contracts are not restated. Accordingly, only contracts that are not completed contracts are included in the transition to revised Section 23. The entity would, therefore, continue to account for the completed contracts in accordance with its accounting policies based on legacy Section 23.

For example, an entity might elect to apply the revised Section 23 retrospectively using the full retrospective method and use the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that are completed contracts at the beginning of the earliest period presented (i.e., 1 January 2025 for an entity with a December year-end that presents one comparative period only). Therefore, the entity also would not record an asset for incremental costs to obtain contracts under the revised Section 23 (see 10.3.1 above) that meet the definition of a completed contract as at the beginning of the earliest period presented. Furthermore, any assets or liabilities related to completed contracts that are on the balance sheet prior to the date of the earliest period presented would continue to be accounted for under legacy Section 23 after the adoption of the revised Section 23.

Note that the same accounting for completed contracts excluded from transition is applied by entities adopting the revised Section 23 under the modified retrospective method (see 12.2.3 above).

12.2.5 Practical expedient on evaluating contract modifications

As discussed in 12.2.3 and 12.2.4 above, an entity is permitted to use the practical expedient on evaluating contract modifications when applying the revised Section 23 retrospectively. For contracts that were modified before the date of initial application, an entity need not retrospectively restate the contract for those contract modifications in accordance with FRS 102.23.15 to 23.16 (see 4.4 above). Instead, an entity is permitted to reflect the aggregate effect of all modifications that occurred before the beginning of the earliest period presented or the date of initial application when: [FRS 102.1.65(c)]

- (i) Identifying the satisfied and unsatisfied performance obligations.
- (ii) Determining the transaction price.

And

- (iii) Allocating the transaction price to the satisfied and unsatisfied performance obligations.

When adopting either the modified retrospective method (see 12.2.3 above) or the full retrospective method (see 12.2.4 above) when transitioning to revised Section 23, an entity that uses the expedient described in above has to identify all contract modifications from the inception of the contract until either: (1) the beginning of the earliest period presented; or (2) the date of initial application. It then determines how each modification affected the identification of performance obligations as at the modification date. However, the entity would not need to determine or allocate the transaction price as at the date of each modification. Instead, at the beginning of the earliest period presented or the date of initial application of the revised Section 23, the entity would determine the total transaction price for all satisfied and unsatisfied performance obligations identified in the contract (as modified up to the relevant date) from contract inception. The entity would then perform a single allocation of the transaction price to those performance obligations, based on their relative stand-alone selling prices. See Illustration 12-6 below.

How we see it

While the practical expedients provide some relief under both transition methods, the adoption of revised Section 23 could be challenging and an entity still needs to use judgement and make estimates. For example, an entity needs to use judgement in estimating stand-alone selling prices when there has been a wide range of selling prices and when allocating the transaction price to satisfied and unsatisfied performance obligations, if there have been several performance obligations or contract modifications over an extended period. Furthermore, depending on how the entity elects to adopt the practical expedient, it is required to apply the revised Section 23's contract modification requirements (see 4.4 above) to either: (a) modifications made after the beginning of the earliest period presented under the revised Section 23 (e.g. modifications made after 1 January 2025 for an entity with a December year-end that presents one comparative period only and with 1 January 2026 as the date the entity first applied the Periodic Review 2024 amendments); or (b) modifications made after the date of initial application (e.g. modifications made after 1 January 2026 for an entity with a December year-end that presents one comparative period only).

Illustration 12-6 below demonstrates the practical expedient for contract modifications.

Illustration 12-6: Transition practical expedient for contract modifications

Entity A entered into a contract with a customer to sell equipment for £1 million and provide services for five years for £20,000 annually.

The equipment was delivered on 1 January 2021 and the service contract commenced at that time. The equipment and the service contract are separate performance obligations.

On 1 July 2023, the contract was modified to extend the provision of service by two years.

On 1 July 2024, the contract was further modified to extend the provision of service by three years.

On 1 July 2025, the contract was modified to provide an additional piece of equipment for £1 million. The additional equipment will be delivered during 2026 and is a separate performance obligation.

Assume that Entity A adopted the Periodic Review 2024 amendments on 1 January 2026 and uses the full retrospective approach to transition to revised Section 23. Entity A also elects to apply the practical expedient on contract modifications in accordance with paragraph 1.65(c). [FRS 102.1.65(c)].

Entity A has two options:

- Entity A could elect to reflect the aggregate effect of modifications that occurred before the date of initial application, i.e., 1 January 2026. The total transaction price for the modified contract is £2,200,000 [£1 million (equipment) + £1 million (equipment) + (10 years × £20,000 (service))], which is allocated to the two products and the service contracts based on the relative stand-alone selling price of each performance obligation.
- Entity A could elect to reflect the aggregate effect of modifications that occurred before the beginning of the earliest period presented, i.e., 1 January 2025 (Entity A presents one comparative period only). In this instance, the total transaction price for the modified contract occurred before 1 January 2025 is £1,200,000 [£1 million (equipment) + (10 years × £20,000 (service))], which is allocated to the first product and the service contract based on the relative stand-alone selling price of each performance obligation.

Entity A is still required to apply the revised Section 23's contract modification requirements to modifications made after the beginning of the earliest period presented. Accordingly, the modification on 1 July 2025 for an additional piece of equipment is accounted for from that date, applying paragraphs 23.13 to 23.16 (see 4.4 above).

In both cases above, see 7 above for a discussion on allocating the transaction price to performance obligations. The transaction price allocated to the second piece of equipment and the remaining unperformed services would be recognised when or as they are transferred to the customer.

12.2.6 Other transition considerations

Regardless of the transition method they choose, many entities have to apply the revised Section 23 to contracts entered into in prior periods. The population of contracts will be larger under the full retrospective method. However, under the modified retrospective method, entities apply the revised Section 23 to all contracts that are not completed as at the date of initial application, regardless of when those contracts commenced.

The FRC has provided some relief from a full retrospective method, in the form of several practical expedients, and provided the option of a modified retrospective method, which provides two practical expedients.

However, there are still a number of application issues that might make applying the revised Section 23 difficult and/or time-consuming, for example:

- In the case of full retrospective adoption, entities must perform an allocation of the transaction price because of changes to the identified deliverables, the transaction price or both. If an entity previously performed a relative fair value allocation, this step might be straightforward. Regardless, an entity is required to determine the stand-alone selling price of each performance obligation as at inception of the contract. Depending on the age of the contract, this information might not be readily available and the prices could differ significantly from current stand-alone selling prices. While the practical expedients in paragraph 1.65 are clear about when it is acceptable to use hindsight in respect of variable consideration to determine the transaction price (see 6.2 above for a discussion on variable consideration), the practical expedients are silent on whether the use of hindsight is acceptable for other aspects of the model (e.g., for the purpose of allocating the transaction price) or whether it is acceptable to use current pricing information if that were the only information available.
- Estimating variable consideration for all contracts for prior periods is likely to require significant judgement. The practical expedient in paragraph 1.65(b) relating to estimating variable consideration is clear that hindsight cannot be used for contracts that are not completed. As a result, entities must make this estimate based only on information that was available at contract inception for contracts that are not completed. Contemporaneous documentation clarifying what information was available to management, and when it was available, is likely to be needed to support these estimates. In addition to estimating variable consideration using the expected value or a most likely amount method, entities must make conclusions about whether such variable consideration is subject to the constraint (see 6.2.3 above for further discussion).
- The modified retrospective method requires entities not to restate the amounts reported in prior periods. However, at the date of initial application, entities electing this method still have to calculate, for all contracts that are not completed, the revenues they would have recognised as if they had applied the revised Section 23 since contract inception. This is needed to determine the cumulative effect of adopting the revised Section 23. It is likely to be most challenging for contracts in which the identified elements/deliverables or allocable consideration change when the new requirements are applied.

Finally, entities need to consider a number of other issues as they prepare to adopt the revised Section 23. For example, entities with significant deferred revenue balances under legacy Section 23 could experience 'lost revenue', if those amounts were deferred at the adoption date of the revised Section 23 and, ultimately, are reflected in the restated prior periods or as part of the cumulative adjustment upon adoption, but are never reported as revenue in a current period within the financial statements. Also, an entity needs to analyse each of its contracts to determine the appropriate timing and pattern of recognition, considering the specific criteria and requirements of the revised Section 23. In some instances, this could result in a change in the timing and/or pattern of revenue recognition compared to its legacy revenue accounting policy. For example, a transaction in which an entity might have a change in recognition timing is that of a contract manufacturer that produces goods designed to a customer's unique specifications and can reasonably conclude that the goods do not have an alternative use. If the manufacturer also has an enforceable right to payment for performance completed to date, it would meet the revised Section 23's third criterion to recognise revenue over time (see 7.1 above for further discussion), even though it might have recognised revenue at a point in time under its legacy revenue accounting policy (e.g. based on the number of units produced or units delivered).

13 Summary of GAAP differences

Key differences between FRS 102 and IFRS 15 in accounting for revenue are set out below.

FRS 102		IFRS 15
Scope		
Interests and dividends	Unless an entity chooses to apply IAS 39 <i>Financial Instruments: Recognition and Measurement</i> or IFRS 9 <i>Financial Instruments</i> (as a policy choice), accounting for interest and dividends are included in the scope of Section 11 <i>Basic Financial Instruments</i> and Section 12 <i>Other Financial Instruments Issues</i> .	Recognition and measurement requirements for interest and dividends are in scope of IFRS 9 <i>Financial Instruments</i> .
Public benefit entities	Explicitly excludes from its scope incoming resources from non-exchange transactions for public benefit entities (i.e., Section 34 <i>Specialised Activities</i> applies instead – see Chapter 36).	No explicit exclusion for public benefit entities.
Interactions with other sections (or accounting standards)	If a component of the arrangement is covered by another section of FRS 102 (for example, Section 20, Section 11 or Section 12) and that other section specifies how to separate and/or initially measure that component, an entity needs to first apply that section of FRS 102. Otherwise, the entity shall apply Section 23 to separate or initially measure those parts of the contract (see 3.1.5 above). The scope of such requirements is applicable only to Section 23's interactions with other sections of FRS 102; it is not applicable to contracts that might be partially within the scope of Section 23 and partially with other FRSS (e.g., FRS 103). An entity would need to apply the requirements in Section 10 to develop an accounting policy to determine how to separate the parts of the contract between Section 23 and the other FRSS.	If a component of the arrangement is covered by another adopted IFRS that is listed in IFRS 15.5, i.e.,: ▪ IFRS 16 <i>Leases</i> ▪ IFRS 17 <i>Insurance Contracts</i> ▪ IFRS 9 <i>Financial Instruments</i>, ▪ IFRS 10 <i>Consolidated Financial Statements</i>, ▪ IFRS 11 <i>Joint Arrangements</i>, ▪ IAS 27 <i>Separate Financial Statements</i> And ▪ IAS 28 <i>Investments in Associates and Joint Ventures</i> and that other adopted IFRS specifies how to separate and/or initially measure that component, an entity needs to first apply that standard. Otherwise, the entity applies IFRS 15 to separate or initially measure those parts of the contract. The scope of such requirements is narrow and not applicable to all contracts that might be partially within the scope of IFRS 15 (i.e., the requirements are applicable only to IFRS 15's interactions with adopted IFRS listed above). An entity applies the requirements in IAS 8 to develop an accounting policy to determine how to separate the parts of the contract between IFRS 15 and the other adopted IFRS.

FRS 102		IFRS 15
<i>Consideration received or receivable from a customer</i>		
Variable consideration	An entity estimates the variable consideration and includes it in the transaction price but “only to the extent that it is highly probable that that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved.” See further discussion in 6.2.3 above.	An entity estimates the amount of variable consideration and includes it in the transaction price but “only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.” The above assessment requires an entity to consider both the likelihood and the magnitude of the revenue reversal.
Sale with a right of return, refund liability and return/refund asset	A ‘refund asset’ recognised for products expected to be returned is classified as inventory (see 6.4 above).	IFRS 15 requires presenting the ‘return asset’ separately from the refund liability. IFRS 15 has no explicit classification requirement for the ‘return asset’ recognised in a sale with a right of return. However, we believe that the return asset would generally be presented separately from inventory.
Time value of money	If payment is deferred beyond normal business terms or is financed (by the entity) at a rate of interest that is not market rate, the arrangement constitutes a financing transaction (see 6.5.2 above).	An entity considers all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including: ▪ The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services - And ▪ The combined effect of the expected length of time between the transfer of the goods or services and the receipt of consideration and the prevailing market interest rates The assessment of significance is made at the individual contract level - this requires application of judgement.
	A practical expedient similar to IFRS 15 is available if payment is deferred and the arrangement constitutes a financing transaction, an entity need not account for the effects of the time value of money if, at contract inception, the period between the transfer of good or service promised to a customer and when the customer pays for that good or service is expected to be 12 months or less. Absent the use of the practical expedient, no other factors or situations are set out, which could preclude accounting for the financing component. See further discussion in 6.5.2 above.	As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. In addition to above, IFRS 15.62 includes several situations which do not provide the customer or the entity with a significant benefit of financing, and therefore, no adjustment for financing component is required.

FRS 102		IFRS 15
	If payment is received in advance, an entity is not required (i.e., policy choice) to adjust the promised amount of consideration for the effects of the time value of money and recognise the resulting interest expense (see 6.5.2.A above).	No overall exemption from accounting for the effects of a significant financing component arising from advance payments.
Non-cash consideration	No specific exclusion when determining the transaction price in relation to the subsequent changes of fair value attributable to the form of non-cash consideration. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 6.6 above.	The fair value of the non-cash consideration might vary because of the form of the consideration (e.g., a change in the price of a share to which an entity is entitled to receive from a customer). If the fair value of the non-cash consideration promised by a customer varies for reasons other than only the form of the consideration (e.g., the fair value could vary because of the entity's performance), an entity applies the requirements in constraining estimates of variable consideration.
	No specific guidance on a customer's contribution of goods or services to facilitate an entity's fulfilment of the contract. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 6.6 above.	An entity assesses whether it obtains control of goods or services that a customer contributes (for example, materials, equipment or labour) to facilitate an entity's fulfilment of the contract in order to account for these contributed goods or services as non-cash consideration received from the customer.
Consideration payable to a customer	No specific guidance when consideration payable to the customer exceeds the fair value of the distinct good or service received from the customer or when fair value of good or service received from the customer cannot be reasonably estimated. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 6.7.2 above.	If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, an entity accounts for such an excess as a reduction of the transaction price. If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it accounts for all of the consideration payable to the customer as a reduction of the transaction price.
<i>Allocation of consideration received or receivable</i>		
Basis of estimating stand-alone selling prices	Similar to IFRS 15, except no explicit requirement to maximise the use of observable inputs when estimating a stand-alone selling price. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 7.1 above.	If a stand-alone selling price is not directly observable, an entity estimates the stand-alone selling price. In doing so, an entity maximises the use of observable inputs when considering all information that is reasonably available to the entity.

FRS 102		IFRS 15
Application of residual approach	Application of the residual approach allows an entity to estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable or estimated stand-alone selling prices of other goods or services promised in the contract (see 7.1.2 above).	Application of the residual approach allows an entity to estimate the stand-alone selling price of a promised good or service as the difference between the total transaction price and the observable (i.e., not estimated) stand-alone selling prices of other promised goods or services in the contract.
	No explicit guidance on application of residual approach if two or more of promised goods or services have highly variable or uncertain stand-alone selling prices. However, an entity could consider the principle used in the related guidance in IFRS 15. See further discussion in 7.1.2 above.	IFRS 15 allows the use of the residual approach if two or more of the promised goods or services have highly variable or uncertain stand-alone selling prices. In such cases, a combination of methods could be used to estimate the stand-alone selling prices of each of the promised goods or services with highly variable or uncertain stand-alone selling prices (e.g., an entity could apply the residual approach to estimate the aggregate of the stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices and then use another method to estimate the stand-alone selling prices of each of those promised goods or services relative to that estimated aggregate stand-alone selling price determined by the residual approach).
Allocation of a discount or variable consideration	Allocation exception relating to discounts and variable consideration are combined into a single requirement. This requirement is less prescriptive than IFRS 15 and refers to the allocation objective, that is, to depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 7 and 7.3 above.	IFRS 15 provides two exceptions to the default method of allocating transaction price based on relative stand-alone selling price method. The two exceptions relate to the allocation of discount and variable consideration. The criteria that must be satisfied to apply the allocation exception to variable consideration are different from the criteria set out in the context of discounts. Where the respective criteria are met, any discount and variable consideration must be entirely allocated to one or more, but not all, performance obligations in the contract.

FRS 102		IFRS 15
	No hierarchy for allocation is established. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 7 and 7.3 above.	IFRS 15 establishes a hierarchy for allocation. An entity identifies and allocates variable consideration first. The general guidance related to allocation of transaction price to performance obligations on a relative stand-alone selling price basis and the specific requirements related to allocation of a discount are then applied to allocate the remaining amount of the transaction price that does not meet the criteria related to allocation of variable consideration. However, when an entity meets the specified criteria and applies a discount to one or more performance obligations, the discount is allocated first before using the residual approach to estimate the stand-alone selling price of a good or service.
Revenue recognition		
Bill-and-hold arrangements	No specific guidance. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 8.5 above.	IFRS 15 sets out additional criteria, all must be met, in determining whether a customer obtained control of a product in a bill-and-hold arrangement: ▪ The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement) ▪ The product must be identified separately as belonging to the customer ▪ The product currently must be ready for physical transfer to the customer ▪ And ▪ The entity cannot have the ability to use the product or to direct it to another customer
Adjustment to measure of progress when using the input method based on costs incurred	Similar to IFRS 15, input method based on costs incurred might be appropriate when the method includes costs that reflect an entity's performance to date and contribute to the entity's progress in transferring control of goods or services promised to customer. However, there is no specific guidance in relation to 'materials delivered to a customer site but are uninstalled'. An entity could consider the requirements and guidance in IFRS 15. See further discussion in 8.1.4.D above.	If an entity is using an input method based on costs incurred to measure its progress and a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation (e.g., materials are delivered to a customer site but are uninstalled), an entity might need to adjust the input method to recognise the revenue only to the extent of that cost incurred. An adjustment to the input method might also be necessary to exclude costs incurred that do not contribute to an entity's progress in satisfying the performance obligation (e.g., when costs incurred are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract).

FRS 102		IFRS 15
Sale-based or usage-based royalties	An entity does not apply the general requirements related to variable consideration in FRS 102.23.44-23.47 (see 6.2.2 to 6.2.4 above) to a sales-based or usage-based royalty provided in exchange for a licence of intellectual property when the licence of intellectual property is the sole or predominant item to which the royalty relates. Instead, royalties received in exchange for licences of intellectual property are recognised at the later of when: ▪ The subsequent sale or usage takes place - And ▪ The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied) See further discussion in 9.5 above.	An entity does not apply the requirements on constraining and updating estimates of variable consideration in IFRS 15.56-59 to a sales-based or usage-based royalty provided in exchange for a licence of intellectual property when the licence of intellectual property is the sole or predominant item to which the royalty relates. Instead, an entity recognises revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs: ▪ The subsequent sale or usage occurs - And ▪ The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)
Contract costs		
Capitalisation of costs to obtain a contract	An entity has an accounting policy choice on whether to expense or capitalise its incremental costs to obtain a contract with a customer that the entity expects to recover. However, a practical expedient similar to IFRS 15 is available where an entity adopts a policy of recognising costs to obtain a contract as an asset. Criteria an entity is required to satisfy, if it selects to capitalise such costs, is similar to IFRS 15. See further discussion in 10.3.1 above.	An entity recognises as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. However, as a practical expedient, an entity could recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.
Measurement after recognition - impairment of capitalised contract costs (i.e., costs to obtain and fulfil a contract)	No prescriptive steps in assessing impairment of capitalised contract costs. Except for estimating recoverable amount of contract costs, guidance on impairment is referred to Section 27. However, an entity could consider the requirements and guidance in IFRS 15. See further discussion in 10.3.4 above.	Provides prescriptive steps in assessing impairment of capitalised contract costs. The impairment requirements must be applied in the following order: ▪ Apply impairment guidance for specific assets (for example, IAS 2 <i>Inventories</i>). ▪ Apply impairment requirements for contract costs under the revenue standard (IFRS 15.101). ▪ Include the resulting carrying amount of contract costs in the carrying amount of the cash-generating unit to which it belongs for the purposes of applying IAS 36 <i>Impairment of Assets</i> to that cash-generating unit.

FRS 102		IFRS 15
Contract balances		
Impairment of contract assets and receivables	An entity must assess a contract asset (and receivables) for impairment, and recognise any impairment loss, in accordance with Section 11. Unless an entity chooses to apply the recognition and measurement provisions of IFRS 9 (as a policy choice) to account for all its financial instruments, impairment of a contract asset would be based on 'incurred loss' model. Compared to IFRS 9's 'expected loss approach', entities recognise impairment losses earlier than entities applying the incurred loss model under Section 11. See further discussion in 11.1.3 above.	An entity must assess a contract asset (and receivables) for impairment in accordance with IFRS 9, which uses an 'expected credit loss' model.
Derecognition of contract assets and contract liabilities	Section 23 explicitly requires an entity to derecognise a contract asset when the customer pays the consideration or the consideration becomes due (i.e., when it becomes a receivable). Section 23 explicitly requires an entity to derecognise a contract liability (or part of a contract liability) when (or as) the entity transfers the promised goods or services to the customer and recognise revenue. See further discussion in 11.1.4 above.	IFRS 15 does not provide any additional requirements for derecognising contract assets. However, IFRS 15 contains illustrative examples that provides guidance on the timing of derecognition of contract assets, which is similar to Section 23. IFRS 15 provides guidance on derecognition of contract liabilities through certain application guidance (e.g., customers' unexercised rights) and illustrative examples, which is similar to the derecognition guidance in Section 23.
Initial measurement of receivable	There is no specific guidance on how to present any difference between the initial measurement of the receivable and the corresponding amount of revenue recognised (see discussion in 11.1.5 above). However, an entity could consider the requirements and guidance in IFRS 15.	Under IFRS 15, if upon initial measurement there is a difference between the measurement of the receivable under IFRS 9 and the corresponding amount of revenue, that difference is presented immediately in profit or loss (e.g., as an impairment loss).
Disclosures		
Overall	The disclosure requirements are based on IFRS 15, but at a reduced level to provide proportionate and practical solutions that are cost effective to apply. In addition, FRS 102 provides certain disclosure exemptions to qualifying entities. See further discussion in 11 above.	IFRS 15 requires a comprehensive and coherent set of revenue recognition disclosures. It contains a disclosure objective and detailed disclosure requirements including both quantitative and qualitative disclosures.

FRS 102		IFRS 15
Amount of revenue recognised during the period	Similar to IFRS 15. For qualifying entities, there are available exemptions from disclosing revenue recognised from contracts with customers separately from its other sources of revenue and disaggregated revenue. However, all UK entities applying FRS 102 are still required to disclose particulars of turnover (see discussion in 11.4.1.B above). [1 Sch 68].	IFRS 15 requires disclosure of revenue recognised from contracts with customers separately from its other sources of revenue. It also requires quantitative and qualitative information by providing disaggregated revenue from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors.
Segmental disclosures	Similar to IFRS 15. For qualifying entities, there is an exemption from disclosing additional information that enables users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information disclosed for each reportable segment. See further discussion in 11.4.1.A above.	In addition to the disclosure requirements of IFRS 8 <i>Operating Segments</i> , entities within the scope of (or voluntarily applying) IFRS 8 are also required by IFRS 15 to disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information disclosed for each reportable segment.
Disclosures on contract balances	Section 23 requires the following quantitative disclosures specific to contract balances: - Opening and closing balances of receivables, contract assets and contract liabilities - Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period See further discussion in 11.4.1.C above.	IFRS 15 requires the following quantitative and qualitative disclosures specific to contract balances: - Opening and closing balances of receivables, contract assets and contract liabilities - Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period - Explanation of how the timing of satisfaction of performance obligations relates to the typical timing of payment and the effect thereof on contract assets and liabilities - Explanation of the significant changes in the contract asset and contract liability balances during the reporting period
Disclosures on performance obligations	Similar to IFRS 15. For qualifying entities, there are available exemptions from disclosing descriptive information about an entity's performance obligations related to the following: - When typically satisfied - Significant payment terms - And - Nature of goods and services See further discussion in 11.4.1.D above.	IFRS 15 requires the following quantitative and qualitative disclosures specific to performance obligations: - Descriptive information about an entity's performance obligations related to the following: - When typically satisfied - Significant payment terms - Nature of goods and services - Obligations for returns, refunds, and other similar obligations - And

FRS 102		IFRS 15
		- Types of warranties and related obligations) - Revenue recognised in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods
	Similar to IFRS 15. Subject to certain optional exemptions (i.e., optional for contracts with an original expected duration of one year or less or those that meet the requirements of the right to invoice practical expedient - see 8.1.4.B above), Section 23 requires an entity to provide a quantitative or qualitative explanation of the significance of unsatisfied performance obligations and when they are expected to be satisfied. However, for qualifying entities, there is an exemption from disclosing the information described above. In addition, no further information is required to be disclosed when related optional exemptions are applied. See further discussion in 11.4.1.D above.	Subject to certain optional exemptions (i.e., optional for contracts with an original expected duration of one year or less or those that meet the requirements of the right to invoice practical expedient), IFRS 15 requires disclosure of the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially satisfied) as of the end of the reporting period and quantitative or qualitative explanation of when the related revenue is expected to be recognised. An entity is required to explain qualitatively whether it is applying the optional exemptions and whether any consideration from contracts with customers is not included in the transaction price and, therefore, not included in the information disclosed (e.g., an estimate of the transaction price would not include any estimated amounts of variable consideration that are constrained).
Disclosures on significant judgements made in determining the timing of satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations	The general requirement in FRS 102.8.6 is applied in respect of Section 23 when disclosing the significant judgements made in determining the timing of satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations (see 11 and 11.4.2 above). For performance obligations satisfied over time, Section 23 requires disclosure of the methods used to recognise revenue and how those methods are applied. However, an exemption from providing this specific disclosure requirement is available for qualifying entities. See further discussion in 11.4.1.D above.	IFRS 15 requires qualitative disclosures specific to significant judgements (and changes in judgements) made in determining the timing of satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations, including: - For performance obligations satisfied over time, the method used to recognise revenue and why the method faithfully depicts the transfer of goods and services - For performance obligations satisfied at a point in time, significant judgements made in evaluating when control transfers to a customer - Methods, inputs and assumptions used to estimate variable consideration, adjust consideration for the effects of time value of money, measure non-cash consideration and apply the constraint

FRS 102		IFRS 15
		- Methods, inputs and assumptions used to estimate stand-alone selling prices and the use of any allocation exceptions - Methods, inputs and assumptions used to measure obligations for returns, refunds and other similar obligations
Disclosures on contract costs i.e., costs to obtain or fulfil a contract	Section 23 requires the following quantitative disclosures specific to contract costs: - Closing balances of capitalised contract costs by main category or asset - Amount of amortisation and any impairment losses recognised in the period The general requirement in FRS 102.8.6 is applied in respect of Section 23 when disclosing the judgements made in determining the amount of costs to obtain or fulfil a contract with a customer and the method used to determine amortisation for each reporting period. See further discussion in 11.4.3 above.	IFRS 15 requires the following quantitative and qualitative disclosures specific to contract costs: - Judgements made in determining the amount of costs to obtain or fulfil a contract - Method used to determine amortisation for each reporting period - Closing balances of capitalised contract costs - Amount of amortisation and any impairment losses recognised in the period
Disclosures on practical expedients	Section 23 requires disclosures on the use of the following available options: - Option to make no adjustments for the time value of money (see 'Time value of money' above) - Option to recognise costs incurred to obtain a contract as an asset (see 'Capitalisation of costs to obtain a contract' above) - Option to expense incremental costs of obtaining a contract when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less (see 'Capitalisation of costs to obtain a contract' above) For qualifying entities, exemption from providing the disclosure requirement, as described above, is available. See further discussion in 11.4.4 above.	IFRS 15 requires disclosures on the use of the following practical expedients: - Practical expedient on the existence of a significant financing component (see 'Time value of money' above) - Practical expedient to expense incremental costs of obtaining a contract when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less (see 'Capitalisation of costs to obtain a contract' above)
Illustrative examples		
Illustrative examples	No illustrative examples provided.	Includes illustrative examples which illustrate aspects of IFRS 15.

Appendix A – Defined terms

Extract from FRS 102

Appendix I

Glossary

contract	An agreement between two or more parties that creates enforceable rights and obligations.
contract asset	An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time (eg the entity's future performance).
contract liability	An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
income	Increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity investors.
performance obligation	A promise in a contract with a customer to transfer to the customer either: (a) a distinct good or service (or a distinct bundle of goods or services); or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
revenue	Income arising in the course of an entity's ordinary activities.

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Chapter 26

Government grants

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Overview

Section 24 *Government Grants* applies to the accounting for, and the disclosure of, government grants and to the disclosure of other forms of government assistance. The distinction between government grants and other forms of government assistance is important because the section's accounting requirements only apply to the former.

Government grants are government assistance in the form of resource transfer to an entity in exchange of past or future compliance with specified conditions relating to the operating activities of the entity. [FRS 102 Appendix I]. The purpose of government grants, which may be called subsidies, subventions or premiums, and other forms of government assistance is often to encourage a private sector entity to take a course of action that it would not normally have taken if the assistance had not been provided. Government grants are also used to provide financial support as was abundantly illustrated during the coronavirus pandemic when governments all over the world introduced measures to provide financial assistance to businesses to mitigate the significant impact of the pandemic on their economies.

The main accounting issue that arises from government grants is how to deal with the benefit that the grant represents in the profit and loss account. Section 24 allows the application of either the performance model or the accrual model in recognising grants. [FRS 102.24.4]. Under the performance model, grants are recognised as income at the time the performance-related conditions are satisfied. [FRS 102.24.5B]. Under the accrual model, grants related to revenue are recognised as income on a systematic basis over the periods in which the entity recognises, as expenses, the costs that the grants are intended to compensate, whereas grants related to assets must be recognised in income on a systematic basis over the expected useful life of the related asset. [FRS 102.24.5D, FRS 102.24.5F].

This chapter covers the requirements of Section 24 of FRS 102 in relation to recognition, measurement and presentation of government grants and looks at specific examples of government grants. It also covers the required disclosures for grants and other forms of government assistance.

What you need to know

- Grants are not recognised until there is reasonable assurance that the entity will comply with the conditions specified in the grant, and that the grant will be received by the entity.
- An entity must measure the amount of a grant at the fair value of the asset received or receivable.
- For the recognition of grants, Section 24 allows the application of either the performance model or the accrual model, applied on a class-by-class basis.
- Under the performance model, the grants are recognised as income in profit or loss once the performance-related conditions of the grant are satisfied.
- Under the accrual model, the entity will need to classify the grant as relating either to revenue or to assets.
- Grants relating to revenue are recognised in income on a systematic basis over the periods in which the entity recognises the related costs and grants relating to assets are recognised in income on a systematic basis over the expected useful life of the related asset.
- Grants relating to assets must be presented in the statement of financial position as deferred income. Deducting the amount from the carrying amount of the related asset is not permitted.
- The nature of significant other forms of government assistance that do not meet the definition of a government grant must be disclosed.

1 Introduction

Government grants typically involve a transfer of resources by a government body to an entity to support specified activities or projects. The transfer of funds is usually dependent on past or future compliance with certain conditions relating to the entity's operating activities. The exact nature of the support varies over time as governments and their priorities change. For example, financial assistance was provided by governments during the coronavirus pandemic to mitigate the significant impact in their economies.

The main accounting issue that arises from government grants is how to deal with the benefit that the grant represents in the profit and loss account. Section 24 *Government Grants* gives an accounting policy choice over one of two models for recognising the benefit: the performance model and the accrual model.

[FRS 102.24.4]. These methods are discussed at 5 and 6 below.

Section 24 also recognises that an entity may receive other forms of government assistance, such as free technical or marketing advice and the provision of guarantees, including assistance which cannot reasonably have a value placed upon them. Rather than prescribe how these need to be accounted for, it requires disclosure about such assistance. [FRS 102.24.6(d)].

The FRC made minor changes to Section 24 in the September 2024 edition of FRS 102. For example, an amendment was made to clarify that, under the accruals model, grants related to assets includes right-of-use assets. [FRS 102.24.5F].

2 Comparison between Section 24 and IFRS

There are some differences between the accounting and disclosure requirements in Section 24 compared to IFRS accounting standards (IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*). The key differences are discussed at 2.1 to 2.3 below and are summarised at 9 below.

2.1 Recognition

Section 24 provides an accounting policy choice for recognising grants as income using either a performance model or an accrual model. [FRS 102.24.4]. The performance model means the grant is recognised as income as the performance-related conditions are satisfied. [FRS 102.24.5B]. The accrual model means that grants relating to revenue are recognised as income on a systematic basis over the same periods as the related expenses, and grants relating to assets are recognised in income on a systematic basis over the useful life of the asset. [FRS 102.24.5D, FRS 102.24.5F].

IAS 20 follows an accruals-based approach requiring grants to be recognised in profit or loss on a systematic basis in the same period or periods as the entity recognises as expenses the costs that the grants are intended to compensate. [IAS 20.12]. IAS 20 does not permit a performance model approach.

2.2 Measurement

Section 24 requires that all government grants are measured on initial recognition at the fair value of the asset received or receivable. [FRS 102.24.5].

IAS 20 allows non-monetary government grants to be recorded initially at fair value, or alternatively at a nominal amount. [IAS 20.23].

2.3 Presentation

Section 24 prohibits the deferred element of a grant that relates to an asset being deducted from the carrying amount of the asset. [FRS 102.24.5G].

IAS 20 allows two options in presenting the deferred element in the statement of financial position. The deferred element can be presented either as deferred income or as a deduction against the asset. [IAS 20.24].

3 Requirements of Section 24 for government grants

3.1 Scope

Section 24 applies in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance. The distinction between government grants and other forms of government assistance is important because the section's accounting requirements only apply to the former. The term 'government' includes agencies of the government and similar bodies whether local, national or international. [FRS 102 Appendix I]. Section 24, however, gives no further guidance on what is meant by 'similar bodies', therefore the assessment of whether a body providing support to an entity is regarded as a 'similar body' under Section 24 is a judgemental area dependent on the specific facts and circumstances.

The accounting for incoming resources from non-exchange transactions other than government grants by public benefit entities or entities within a public benefit entity group is addressed in Section 34 *Specialised Activities*. [FRS 102.PBE24.1A]. See Chapter 36 at 6.

3.1.1 Government assistance

Government assistance is defined as the action, by a government, which is designed to provide economic benefit specific to an entity or range of entities which qualify under specified criteria. [FRS 102 Appendix I]. Examples of government assistance include free marketing or technical advice and the provision of guarantees. [FRS 102.24.6(d)]

3.1.2 Government grants

Government grants are a specific form of government assistance. Under FRS 102, government grants represent government assistance in the form of transfers of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity. [FRS 102 Appendix I].

Governments may provide grants to entities to motivate them to engage in projects or activities that are considered 'green'. These grants must be recognised and measured in accordance with Section 24 using either the performance or accrual model. There are grants that are named using other terms. For example, an incentive called a 'green tax credit' may fall within the scope of Section 24 if it is not calculated by reference to taxable profits or income tax liabilities.²²⁰

Grants of emission rights may meet the definition of government grants under Section 24. Grants of renewable energy certificates can also meet the definition of government grants, in some cases. The rights and certificates themselves might be classified as intangible assets under Section 18 *Intangible Assets other than Goodwill* or, if they meet the definition of inventory under Section 13 *Inventories*, it might be appropriate to classify them as inventory rather than intangible assets. Entities may wish to consider guidance in the EY publication, International GAAP®, in formulating appropriate accounting policies under FRS 102. Caution must be taken when considering this guidance due to the differences in the requirements between IFRS accounting standards and FRS 102 (see 9 below).

There are other emerging schemes, for example schemes relating to carbon credit projects. It is important that the specific facts and circumstances of a scheme are determined to be able to assess whether the scheme involves a government grant or not. Factors to consider include the primary reason for the scheme, whether there is a transfer of economic benefit from the government and, if so, what conditions are attached and what type of expense the government support may be compensating for.

²²⁰ [FRS 102 Factsheet 8, Climate-related matters](#), Financial Reporting Council, page 16

3.1.3 Scope exclusions

The recognition and measurement provisions of Section 24 do not apply to government assistance that does not meet the definition of a grant and to any forms of government assistance that:

- (a) Cannot reasonably have a value placed on them. [FRS 102.24.2].
 - (b) Comprise transactions with government that cannot be distinguished from the normal trading transactions of the entity. [FRS 102.24.2].
- Or
- (c) Are in the form of reliefs and deductions that are available in determining an entity's taxable profit/loss or are determined or limited based on income tax liability. Examples would include income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates. [FRS 102.24.3].

FRS 102 does not provide examples of assistance that might be incapable of reasonable measurement or examples of transactions that are indistinguishable from the normal trading transactions of the entity in (a) and (b) above. Such examples might include cases when financial guarantees are provided by government in the absence of any commercial alternative source or where the entity is being favoured by a government's procurement policy.

Minor amendments in the September 2024 edition of FRS 102 were introduced to refine the description of the forms of government assistance delivered through the corporation tax system that are excluded from the scope of Section 24 (item (c) above). The accounting treatment of government assistance in (c) is addressed by Section 29 *Income Tax*. [FRS 102.24.3]. There is further discussion related to this in the context of investment tax credits in 3.1.5 below and in Chapter 31 at 3.3.

Whilst the recognition and measurement provisions of Section 24 do not apply to the forms of government assistance noted above, certain disclosures are required, as discussed at 8.4 below.

3.1.4 Determining the recipient of a government grant

It may not always be clear who the recipient of a government grant is due to the involvement of multiple parties. In certain cases, an entity might receive cash from the government but is merely acting as a 'facilitator' to ensure the benefit of the cash is passed on to the intended beneficiary of the government support. In cases where there are multiple parties, it is important to have a full understanding of the terms of the relevant government support scheme to determine which party needs to be recognising a government grant.

Illustration 3-1: Recipient of a government grant

The government has a scheme in place whereby they will provide £1,000 of financial support to commercial electricity users over 12 months. This support will be provided by way of part settlement of their energy bills. The government provides cash to energy suppliers, and this must be used only for the partial settlement of customer bills. The terms of the scheme state that it does not reduce the amount the energy supplier is able to charge its electricity customers. Any cash remaining after the 12 months must be returned to the government.

In this case, who is the recipient of the government grant, is it the supplier or the electricity users?

Although the energy supplier receives a resource (cash) from the government, it is required to pass that resource on to its customer. The energy supplier still has a right to supply energy at the price in the customer contract, so the provision of support does not affect the supplier's contract with its customer. It is merely the settlement party that has changed, i.e., the energy bill is now part settled by the customer and part settled by the government. It is therefore appropriate, in this case, to consider the customer (not the supplier) as the grant recipient. The supplier is merely facilitating the provision of support to the customer and recognises a liability upon receiving cash from the government that it must use for the partial settlement of customer bills.

3.1.5 Investment tax credits

Section 24 excludes from its scope government assistance provided by way of a reduction in taxable profit or determined or limited according to an entity's income tax liability, citing income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates as examples. Taxes based on income are required to be accounted under Section 29. [FRS 102.24.3]. This implies that those investment tax credits that are excluded from the scope of Section 24 would be accounted for under Section 29 (see Chapter 31). However, if government assistance is described as an investment tax credit, but it is neither determined nor limited by the entity's income tax liability, nor provided in the form of an income tax deduction, the requirements of Section 24 apply.

Investment tax credits are not defined in FRS 102 and can take different forms and be subject to different terms. Sometimes a tax credit is given as a deductible expense in computing the entity's tax liability, and sometimes as a deduction from the tax liability, rather than as a deductible expense. In some cases, the assistance is chargeable to corporation tax and in others it is not. Entitlement to assistance can be determined in a variety of ways. Investment tax credits may relate to direct investment in property, plant and equipment, research and development or other specific activities. Some credits may be realisable only through a reduction in current or future corporation tax payable, while others may be settled directly in cash if the entity is loss-making or otherwise does not have sufficient corporation tax payable to offset the credit within a certain period. Access to the credit may be limited according to the total of all taxes paid to the government providing the assistance, including employment taxes (such as PAYE and NIC) and VAT, in addition to corporation tax. There may be other conditions associated with receiving the investment tax credit, for example with respect to the conduct and continuing activities of the entity, and the credit may become repayable if ongoing conditions are not satisfied.

This raises the question as to how an entity must account for those forms of government incentives for specific kinds of investments that are delivered through the tax system. Entities must carefully consider the nature of such incentives, and the conditions attached to them to determine whether they fall in the scope of Section 24 or Section 29.

How we see it

In our view, the determination of which framework to apply to a particular investment tax credit (Section 24 or Section 29) is a matter of judgement and all facts and circumstances relating to the specific incentive need to be considered in assessing the substance of the arrangement.

The following factors will often be relevant, but this list of factors must not be considered exhaustive, and entities may identify other factors which they consider to be more important than those listed below.

Feature of credit	Indicator of Section 24 treatment	Indicator of Section 29 treatment
Method of realisation	Directly settled in cash where there are insufficient taxable profits to allow credit to be fully recovered, or available for set off against non-income taxes, such as payroll taxes, sales taxes or other amounts owed to government.	Only available as a reduction in income taxes payable (i.e., benefit is forfeited if there are insufficient income taxes payable). However, a lengthy period allowed for carrying forward unused credits may make this indicator less relevant.
Number of non-income tax conditions attached to initial receipt of grant (e.g., minimum employment, ongoing use of purchased assets)	Many	None or few
Restrictions as to nature of expenditure required to receive the grant	Highly specific	Broad criteria encompassing many different types of qualifying expenditures.
Income tax status of grant income	Taxable	Not taxable

In group accounts, in which entities from several different jurisdictions are consolidated, it may be desirable that all 'investment tax credits' are consistently accounted for, either as a Section 24 government grant or as an income tax under Section 29. However, the judgement as to which section applies is made by reference to the nature of each type of investment tax credit and the conditions attached to it. This may mean that the predominant practice in a particular jurisdiction for a specific type of investment tax credit has evolved differently from the consensus in another tax jurisdiction for what could appear to be a substantially similar credit. We believe that, in determining whether the arrangement is of a type that falls within the scope of Section 24 or Section 29, an entity will need to consider the following factors in the order listed below:

- If there is a predominant local treatment by FRS 102 reporters for a specific investment tax credit as to whether a specific credit in the relevant tax jurisdiction falls within the scope of Section 24 or Section 29, this must take precedence.
- If there is no predominant local treatment by FRS 102 reporters, the group-wide approach to determining the section that applies to such a credit must be applied.
- In the absence of a predominant local consensus or a group-wide approach to making the determination, the indicators listed in the table above provide guidance.

This may mean that an FRS 102 reporter operating in several territories adopts different accounting treatments for apparently similar arrangements in different countries, but it at least ensures a measure of comparability between different FRS 102 reporters operating in the same tax jurisdiction.

How we see it

It is important to note that this is not an accounting policy choice. Accordingly, an entity operating in several territories could be required to adopt different accounting treatments for apparently similar arrangements in different countries if predominant local practice for a specific type of investment tax credit has evolved differently from the consensus in another jurisdiction.

For investment tax credits subject to Section 24 and therefore treated as government grants, the requirements in relation to recognition and measurement of government grant (see 4 below) and presentation (see 8 below) applies.

The treatment of investment tax credits accounted for under Section 29 is discussed in Chapter 31 at 3.3.

3.1.6 Interaction of Section 24 with Section 23

The situation can arise whereby a contract with a customer, accounted for under Section 23 *Revenue from Contracts with Customers*, also includes a government grant that falls within the scope of Section 24, for example as illustrated below:

Illustration 3-2: Contract with a customer contains a government grant

A pharmaceutical entity has a contract with the government of the jurisdiction within which it operates. The contract includes a grant relating to the development of a vaccine and an obligation to deliver a specific quantity of vaccines, with an option to purchase additional vaccines at a discount.

How does the entity allocate the contract between Section 23 and Section 24?

Section 23 applies to all contracts with customers, except when certain other sections apply. [FRS 102.23.1, FRS 102.23.2]. When other sections specify how to separate or initially measure any parts of the contract, entities are required to consider firstly the separation or measurement requirements of that other section. Otherwise, the entity must apply Section 23 to separate or initially measure those parts of the contract. [FRS 102.23.3]. In this example, Section 24 does not specify the requirements to separate or measure parts of the contract, therefore an entity must apply the requirements of Section 23. As a result, the consideration for the portion of the contract that is within the scope of Section 23 (the delivery of specific quantity of vaccines) is measured in accordance with Section 23 (at stand-alone selling price). The difference between the contract value and the consideration for the delivery of the vaccines is the benefit from the government grant that is in scope of Section 24.

4 Recognition and measurement

4.1 General requirements of Section 24

Section 24 requires that: [FRS 102.24.3A]

Extract from Section 24

- 24.3A** Government grants, including non-monetary grants, shall not be recognised until there is reasonable assurance that:
- (a) the entity will comply with the conditions attaching to them; and
 - (b) the grants will be received

The standard does not define 'reasonable assurance', which raises the question of whether or not it means the same as 'probable' (or more likely than not'). [FRS 102.21.4(b)]. The phrase 'reasonable assurance' is generally interpreted as being a high threshold which implies a significantly higher probability than 'more likely than not'. Therefore, an entity cannot recognise government grants before it is significantly more likely than probable that the entity will comply with the conditions attached to them and that the grants will be received. In assessing the likelihood of compliance with conditions attached to the grant, it is acknowledged the conditions may relate to future performance and other future events.

For a grant accounted for under the accrual model related to an asset, a grant cannot be recognised before the asset is acquired, regardless of how likely the acquisition of the asset is. If the grant is also conditional on maintaining a number of jobs to operate the asset, the grant must be recognised as soon as the asset is acquired as long as there is (and continues to be throughout the period during which the grant can be claimed back by government) reasonable assurance that the jobs will be maintained as required.

Receiving a grant usually does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled. This is particularly true since there sometimes exists a supranational legal framework to comply with in addition to the eligibility criteria in local jurisdictions. For example, EU Member State aids also need to comply with EU laws, e.g., in the context of the coronavirus pandemic. A grant may need to be recognised before it is received (in cash or otherwise) or even before the entity formally files a request to receive the grant (i.e., as soon as it becomes eligible to receive the grant). The grant receivable would not generally be a financial asset as it does not arise from contractual rights but rather arises due to government legislation.

The assessment about the existence of a 'reasonable assurance' must be made before the initial recognition of any grant income as well as subsequently, on a continuous basis, until the end of the period during which any grant received could be claimed back by the government. Such assessment requires the entity to understand fully the exact conditions that apply before it can make a valid judgement on whether it is entitled to the grant, and to what extent.

The Illustration below considers two examples.

Illustration 4-1: Recognition of a government grant

- (a) The government has announced that, as a result of the coronavirus pandemic, it is introducing a scheme whereby entities will receive financial support for their employee costs. This support is available to all companies, there are no performance-related conditions and once the entity submits details of all their employees, there is a routine verification process to confirm the identity of the applicant, and the grant is automatically paid.

In this Illustration, there are no conditions attached, and the scheme is very simple by design so that the outcome is known by the entity with certainty. Hence, assessing whether there is 'reasonable assurance' is relatively straightforward.

- (b) The government, with the aim of driving investment in artificial intelligence, has announced a scheme whereby they will provide entities in this industry financial support for the next two years but only for very specific cost types. The application process is complex and requires applicants to submit detailed cost information and forecasts alongside the specific amount of funding they will require to cover both past and future costs. Once the submission is made, there is an extensive approval process by an independent reviewer, which may require further information to be submitted by the entity as the approval process progresses. As this is a new scheme, there is no past experience of approvals that the industry can consider.

In this Illustration, once due care has been applied by the entity to identify eligible projects and costs as set out in the scheme rules, and provide appropriate documentation, it will normally be reasonably assured that the entity will comply with the conditions attaching to the grant. However, caution may need to be exercised when measuring the amount expected to be received.

When the terms and conditions of a grant have been communicated before the end of a reporting period, then in determining whether it is reasonably assured that the entity will comply with the conditions attached to a grant and that the grant will be received as per Section 24, information obtained after the reporting period, (e.g., confirmation of the entity receiving the grant), may provide evidence of an adjusting subsequent event.

Conversely, no 'reasonable assurance' can exist if the terms and conditions of a grant have not been communicated before the end of a reporting period.

How we see it

In our view, entitlement to a grant does not exist before the terms of the grant have been established by the government and clearly communicated publicly or confirmed to the entity for entity-specific grants.

If a new law or regulation introduces a government grant after the end of the reporting period, it will represent a non-adjusting subsequent event.

Illustration 4-2: Date of entitlement to a government grant

An entity has a 31 March year end and on 20 March 20X3 there is an earthquake in the jurisdiction in which it operates. There is severe damage to the company's facilities. The government of that jurisdiction announces on 21 March that it will introduce assistance, but the exact nature and terms of such assistance are not communicated until 4 April 20X3. Hence, the criteria in paragraph 3A of Section 24 cannot be met on 31 March 20X3. The announcement on 4 April 20X3 confirming the conditions related to the grant is a non-adjusting post balance sheet event.

If the facts and circumstances supporting the recognition of the government grant change and it is no longer 'reasonably assured' that the entity will retain the grant it has initially recognised, then the entity needs to derecognise any grant income and reverse any related asset or, to the extent the grant has already been received in cash, recognise a refund liability. This may be before it becomes 'more likely than not' that the entity may need to refund the grant (i.e., before the recognition threshold for a provision is met under Section 21 *Provisions and Contingencies*).

When a grant is derecognised consideration must be given as to whether there has been a change in facts and circumstances or there was an error in the initial application of the recognition criteria. In the case of the latter, please refer to the guidance in Section 10 *Accounting Policies, Estimates and Errors* as discussed in Chapter 9 at 3.5.

Illustration 4-3: Derecognition of a government grant - accrual model

A pharmaceutical company recognised a government grant two years ago based on meeting future conditions on their performance. It has reassessed their future performance and no longer believes it is reasonably assured they will comply with the conditions attached to the government grant. This is due to a decline in performance that could not be foreseen when making the initial judgement on recognising the government grant. Any grant funding already received is required to be repaid.

The company accounts for this government grant using the accrual model. The government grant the company was initially entitled to was £500 to be recognised in the income statement on a straight-line basis over 5 years. Currently, the company has deferred income of £300 and as £250 had already been received in cash, the remaining £250 is held as a receivable on the balance sheet.

On derecognition, the accounting entries will be:

Dr	Grant income (income statement)	£200	
Dr	Deferred income (balance sheet)	£300	
	Cr Government grant receivable (balance sheet)		£250
	Cr Payable to Government (balance sheet)		£250

4.2 Measurement

On initial recognition, all government grants are measured at the fair value of the asset received or receivable. [FRS 102.24.5]. The asset will normally be cash but could be a non-monetary asset such as land or other resources. Fair value is defined as the price, as at the measurement date, that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. [FRS 102 Appendix I]. Where guidance on determining the fair value of a specific asset is not available in the relevant section of FRS 102, the guidance in Section 2A *Fair Value Measurement* must be used (see Chapter 10).

4.3 Recognition in the income statement

Section 24 provides entities with an accounting policy choice over the method of recognition of government grants in the income statement:

- Performance model (see 5 below)

Or

- Accrual model (see 6 below)

The policy choice must be applied on a class-by-class basis. [FRS 102.24.4].

A class of underlying assets is defined in FRS 102 as a grouping of underlying assets of a similar nature and use in an entity's operations. [FRS 102 Appendix I]. A class of financial assets is then defined as a grouping that is appropriate to the nature of the information disclosed in the financial statements and that takes into account the characteristics of financial assets. [FRS 102.11.48(c)]. Therefore, it appears that government grants of a similar nature and subject to similar conditions will need to be recognised in income in a similar way.

Any accounting policy choice must be made according to the requirements of Section 10 *Accounting Policies, Estimates and Errors*. This requires that the chosen accounting policy results in information that is relevant to the decision-making needs of users of the financial statements and reflects the economic substance of transactions, other events and conditions, and not merely their legal form. [FRS 102.10.4]. In that regard, an understanding of the purpose for which the grant was awarded is a relevant consideration.

5 The performance model

Under this model, grant income is recognised by reference to the achievement of performance-related conditions in the grant imposed on the entity, as follows:

- If there are no imposed specified performance-related conditions on the entity, then the grant is recognised in income when the grant proceeds are received or receivable.
- If there are imposed specified performance-related conditions on the entity, then the grant is recognised in income only when the performance-related conditions are satisfied.
- If the grant is received in advance of being able to be recognised as income under either of the above circumstances, then the amount of the grant is recognised as a liability. [FRS 102.24.5B].

FRS 102 defines performance-related condition as “a condition under which entitlement to resources is conditional on the performance of a specified activity, or a particular level of service or units of outputs to be delivered.” [FRS 102 Appendix I].

When the performance model is applied, a grant with no performance-related conditions will be recognised in income in full when received or receivable (i.e., when the general recognition requirements at 4.1 above are met), irrespective of the nature or timing of the expenditure to which it is contributing.

If a performance-related condition is imposed over a period of time, the question arises as to how the grant is recognised. In the Financial Reporting Council's *Staff Education Note 8 (SEN 8) Government Grants*, an example illustrates where a grant contributed to the build cost of a factory but with a performance-related condition of usage and employment (see Illustration 5-1 below). SEN 8 states that “the mechanism for recognising the grant during the specified period would depend on the detailed terms and conditions, but it would not generally be based on the expected useful life of the building”.²²¹ The Staff Education Notes were published in December 2013 and were subsequently superseded by Staff Factsheets in 2018. The new Staff Factsheets do not include a specific replacement for SEN 8, however, we believe that the SEN 8 guidance remains relevant in the application of Section 24.

One of the most relevant terms and conditions to consider in determining how income must be recognised in profit or loss under the performance model will be how any potential obligation to repay the grant varies as the performance period elapses. There are two most likely scenarios:

- If the potential obligation to repay the grant remains equal to the full amount of the grant throughout the performance period and that obligation is only discharged in full at the end of the performance period then, the full grant must be recognised in profit or loss at the end of the performance period.
- If the potential obligation to repay the grant reduces as the performance period progresses, then it may be appropriate to recognise the release of the grant to income over the performance period in line with the corresponding reduction in the amount potentially repayable.

Illustration 5-1: Grant towards a fixed asset - performance model

A manufacturing company secures a UK government grant of £200,000 as an incentive to open a factory in a region of high unemployment. There are no further conditions associated with the grant, other than that it is used to pay for the construction of this factory. A second grant is secured from the European Union of £130,000 in relation to the construction of the same factory. An additional condition relating to this grant is that the company continues to operate the factory for a period of five years, subject to repayment of the grant on a time-apportioned basis. The company constructs the factory for a total cost of £600,000 and begins to use it. In the same year in which the factory begins operating the company receives both grants. The company has a policy of depreciating buildings over a useful life of 50 years.

How will the company recognise the grants in the income statement?

Under the performance model, the whole of the UK government grant is recognised in income when the factory is opened, because this is the only condition imposed under the grant. However, the grant from the European Union is subject to an additional condition requiring use of the asset for at least five years. This grant would be recognised in income evenly over that five-year period as the performance-related condition is satisfied.

221 [Accounting and Reporting Policy: FRS 102 - Staff Education Note 8 Government Grants](#), Financial Reporting Council, page 5.

6 The accrual model

Under this model, the entity is required to classify a grant, or each part of a grant, as relating to either revenue or assets. [FRS 102.24.5C]. Grants may be received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, care is needed in identifying the conditions giving rise to the costs and expenses which determine the periods over which the grant will be recognised as income. It may also be appropriate to allocate a part of the grant on one basis and a different part on another.

6.1 Grants relating to revenue

Grants relating to revenue must be recognised in the income statement on a systematic basis that matches them with the related costs that they are intended to compensate. [FRS 102.24.5D].

Grants that become receivable as compensation for costs or losses already incurred (i.e., the related costs have been previously recognised in the income statement) or to provide immediate financial support to the entity with no future related costs must be recognised in income when they become receivable.

[FRS 102.24.5E].

The requirement to match a grant relating to revenue against the costs that it is intended to compensate can be difficult to apply in practice, because grants are sometimes given for a particular kind of expenditure that forms a component of a larger project. For example, in trying to determine an appropriate accounting policy for government assistance that is in the form of a grant against training costs incurred as part of a larger project, an entity might consider recognition in income in one of the following ways:

- Matching against direct training costs
- Or
- Matching rateably against total project costs

How we see it

Determining a reasonable approach is dependent on the specific facts and circumstances, including not only the terms of the arrangement but also other facts that might highlight the purpose of the grant, including those relating to the context in which the grant was offered, the conditions attached to it and the consequences of failing to meet those conditions.

Under the accrual method, recognition of a grant related to revenue in income when received in cash is unlikely to be an appropriate method, because it is not obviously linked to the recognition of the related expenditure and would be acceptable only in the rare circumstances where no basis exists for allocating a grant to periods other than the one in which it is received.

In some jurisdictions, grants are taxed as income on receipt; consequently, this is often the argument advanced for taking grants to income when received in cash. However, it is clear that the treatment of an item for tax purposes does not necessarily determine its treatment for accounting purposes, and recognition in the income statement on receipt may result in an unacceptable departure from the principle that government grants accounted under the accrual method and relating to revenue must be matched with the costs that they are intended to compensate. [FRS 102.24.5D]. The recognition of a grant in the income statement in a different period from that in which it is taxed, gives rise to a timing difference that must be accounted for in accordance with Section 29 (see Chapter 31).

How we see it

In attributing a grant relating to revenue to related costs, entities will have to make their own determination as to how the matching principle must be applied in light of the specific facts and circumstances of the case. The only overriding considerations are that the determination must be consistently applied to similar grants and the policy adopted, if material, must be adequately disclosed along with any significant judgements relevant to the application of Section 24.

6.2 Grants relating to assets

Grants relating to assets, including right-of-use assets, must be recognised in the income statement on a systematic basis over the expected useful life of the related asset. [FRS 102.24.5F].

Grants related to depreciable assets are recognised as income over the periods in which, and in proportion to, depreciation on those assets is charged. Grants related to non-depreciable assets may also require the fulfilment of certain obligations, in which case they would be recognised as income over the periods in which the costs of meeting the obligations are incurred. For example, a grant of land may be conditional upon the erection of a building on the site, and it may be appropriate to recognise it as income over the life of the building.

The Regulations prohibit the offset of items that represent assets against items that represent liabilities. [1 Sch 8J. FRS 102 does not therefore permit grants relating to an asset to be deducted from the carrying amount of the asset. The grant must instead be recognised as deferred income. [FRS 102.24.5G].

6.3 Particular issues arising from grants relating to assets accounted for as deferred income

When grants related to assets are accounted for as deferred income, an entity must reflect the unamortised balance carried in the statement of financial position in determining an impairment loss, a gain on disposal or in a reassessment of the useful life of the asset. Further guidance on these situations is provided in the EY publication, International GAAP®.

7 Practical issues

7.1 Separating grants into components

A grant received may relate to a package of activities, the components of which have different costs and conditions. In such cases, it is common that the components for which the grant is given are not specifically identified or quantified. It might be appropriate to treat these different components on different bases rather than accounting for the entire grant in one way, however, this will not always be practicable.

Under the accrual model, an entity is required to classify a grant, or each part of a grant, either as a grant relating to revenue or grant relating to assets. [FRS 102.24.5C]

How we see it

Under the accrual model, the assessment of the appropriate classification of a grant or a part of a grant requires the careful analysis of the facts and circumstances. The final determination as to which classification is appropriate must reflect not only the terms of the arrangement but also other facts that might highlight the purpose of the grant.

Classification of a grant, or a part of a grant, under the accrual model between the components will often involve judgement and entities may place more emphasis on some features than on others. In these cases, and where the effect is material, the financial statements must explicitly state what judgement has been made when applying the standard and disclose the corresponding financial effect.

For a class of grants accounted under the performance model, an entity is not required to separate the grant into components because the recognition of income under this model is based on the satisfaction of the performance-related conditions attached to the grant and not based on the purpose of the grant (i.e., whether the grant relates to revenue or to assets).

7.2 Leases at below-market rates

Section 20 *Leases* requires a lessee to use the information readily available to it to determine whether the arrangement provides the lessee with incoming resources from a government grant, for example, where the lease payments are significantly below-market rate. [FRS 102.20.35]. It is important to note that not all leases at below-market rates contain incoming resources from a government grant, so an entity must carefully assess the fact pattern. The incoming resources from the government grant will be recognised as part of the cost of the right-of-use asset. [FRS 102.20.35]. If the lease is modified, and the modification is not accounted for as a separate lease, having remeasured the lease liability, the lessee must do the following:

- For lease modification that decreases the scope of the lease, recognise a proportionate reduction in the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, account for any incoming resources from government grant in the modified lease, and recognise any resulting gain or loss in profit or loss.
- For all other lease modifications, make a corresponding adjustment to the right-of-use asset, net of any adjustment for incoming resources from a government grant in the modified lease. [FRS 102.20.73].

Lease modifications under Section 20 are discussed further in Chapter 23 at 6.5.

7.3 Loans at lower than market rates of interest

An entity may receive a loan from the government that either is interest-free or has a below-market rate of interest. Section 24 does not explicitly cover such loans, however, IAS 20 requires that the difference between the initial fair value of a government loan that has a below-market rate of interest, and the proceeds received is treated as a government grant. [IAS 20.10A].

As FRS 102 does not address specifically this transaction, we consider it appropriate that an entity consider the requirements and guidance in IFRS accounting standards in developing and applying an accounting policy that results in information that is relevant and reliable. [FRS 102.10.6].

How we see it

In our view, government loans that are interest free or have a below-market rate of interest are in scope of Section 24. The difference between the initial carrying value of the loan and the proceeds received is treated as a government grant and recognised under either the accrual or performance model. The initial carrying value of the loan is the present value of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition adjusted for transaction costs.

Illustration 7-1: Interest-free loan from a government agency - accounting under Section 11 and accrual model

Company A secures an interest-free loan of £1,000 from a local government agency to ensure that the company invests in new equipment at its manufacturing facility. The loan is repayable at the end of five years and carries no interest. Company A can draw down the loan on demonstrating that it has incurred qualifying expenditure on property, plant and equipment. The Company adopts the accrual model in accounting for government grants. The Company has chosen to apply the requirements of Section 11 and Section 12 in accounting for its financial instruments.

The loan is a basic financial instrument as defined in Section 11. On initial recognition, the market rate of interest for a similar five-year loan for Company A is 10% per year. The initial fair value of the loan is the present value of the future payment of £1,000, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to £621.

The value of the government incentive to Company A to invest in its factory is £379, which is the difference between the total consideration received of £1,000 and the loan's initial value of £621. This difference is treated as a government grant.

Subsequently, interest will be imputed to the loan using the effective interest method, taking account of any transaction costs (see Chapter 13 at 6.2). Under the accrual model, grants will need to be classified as either relating to revenue or relating to assets. [FRS 102.24.5C]. In this example, the benefit of the loan is to help fund the purchase of new equipment. Therefore, it would be appropriate to recognise the grant as relating to an asset. The grant is recognised in income on a systematic basis over the useful life of the new equipment.

Governments sometimes provide assistance in arrangements that are similar in substance to loans by allowing entities to retain sums that they collect on behalf of the government (e.g., value added taxes) until a future event, as in the following Illustration:

Illustration 7-2: Entity allowed to retain amounts owed to government - accrual model

The local government of an underdeveloped region is trying to stimulate investment in fixed assets by allowing local companies to delay payment of the value added tax (VAT) on their sales. An entity participating in this scheme is entitled to retain an amount up to 40% of its investment in fixed assets. The retained VAT must be paid to the local government after 5 years and does not bear interest.

The fact that amounts retained by the entity are required to be repaid after 5 years makes this arrangement similar in nature to an interest-free loan. Accordingly, the entity would determine a value for the government assistance by comparing the amounts retained to the fair value of a 5-year loan at market rates of interest, as illustrated in Illustration 7-1 above. Where the entity accounts the grant under the accrual model, the entity must determine whether the grant is relating to revenue or assets. [FRS 102.24.5C].

In Illustration 7-2 above, because the grant is intended to stimulate investment in fixed assets, the grant is relating to assets. Therefore, it would be appropriate to recognise the grant in income over the useful life of the asset.

7.3.1 Considerations under the accrual model when accounting for loans at lower than market rates of interest

As discussed in 7.3 above, the difference between the initial value of a government loan that has a below-market rate of interest, and the proceeds received is treated as a government grant.

The issue that then arises is how to recognise the grant in profit or loss if the entity adopted the accrual model in accounting for the government grants. As noted in 6 above, Section 24 requires that the grant accounted for under the accrual model is classified either as a grant relating to revenue or as a grant relating to assets. If a grant is relating to revenue, it is required that the grant is recognised in profit or loss on a systematic basis that matches it with the related costs it is intended to compensate. [FRS 102.24.5D]. If a grant is relating to asset, then the grant is recognised in income on a systematic basis over the expected useful life of the related asset. [FRS 102.24.5F].

The assessment of an appropriate method of allocation requires the entity to identify the nature of the grant which is driven by a careful analysis of the facts and circumstances. The final determination as to which treatment is appropriate must reflect not only the terms of the arrangement but also other facts that might highlight the purpose of the loan, for example:

- Where it is determined that the grant is a grant related to an asset, as in Illustration 7-1 in 7.3 above, recognition as the asset is depreciated would be appropriate.
- Where the grant is a grant related to revenue and is intended to compensate for a specific expense, then recognition at the same time as that expense is recognised in profit or loss would be appropriate. [FRS 102.24.5D]. This could include immediate recognition for expenses or losses that had already been incurred. Where the grant is intended to compensate for the cost of funding, then recognition on the same basis as the interest is charged (i.e., over the term of the loan) would be appropriate. This is shown in the following Illustration.

Illustration 7-3: Below-market interest rate loan from the government - accrual model

Company A secures a low interest loan of £1,000 from the government as part of its support measures for the coronavirus pandemic. The loan is repayable at the end of five years and carries an interest rate of 5%, demonstrably below the market rate. There are no conditions attached regarding the expenditure that the loan must be used for. Also, the grant benefit of the below-market rate loan cannot be attributed to any specific costs, past or future, neither based on the terms of the arrangement nor on other facts and circumstances, other than the cost of funding. The purpose of the grant is to provide the entity with immediate liquidity support by allowing it to borrow more money than it could have based on the market rate. The Company accounts for similar grants under the accrual model.

On initial recognition, the market rate of interest for a similar five-year loan is 10% per year. The initial fair value of the loan is the present value of the future payments for the loan, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to £621.

The value of the government incentive to Company A is £379 being the difference between the total consideration received of £1,000 and the loan's initial fair value of £621. This difference is treated as a government grant.

In this Illustration, the grant is compensating Company A for the higher market rate of interest that would otherwise have been charged as an expense on the loan. Company A recognises the grant benefit on the same basis as the interest is charged, over the term of the loan, thereby matching the benefit with the interest cost.

7.4 Forgivable loans

Section 24 does not specifically identify forgivable loans from the government as a grant. However, in certain circumstances, it may be appropriate to account for all, or part of such a loan, as a government grant. IAS 20 recognises a forgivable loan as a government grant when there is reasonable assurance that the entity will meet the terms of the forgiveness of the loan. [IAS 20.10]. Similar to loans at lower than market rates of interest, we consider it appropriate that an entity consider the requirements and guidance in IFRS accounting standards in developing and applying an accounting policy that results in information that is relevant and reliable. [FRS 102.10.6].

How we see it

In our view, a forgivable loan from government, the repayment of which will be waived under certain prescribed conditions, is to be treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

Illustration 7-4 below is an example of a forgivable loan from the government.

Illustration 7-4: Government grant by way of forgivable loan

An entity participates in a government-sponsored research and development programme under which it is entitled to receive a government grant of up to 50% of the costs incurred for a particular project. The government grant is interest-bearing and fully repayable based on a percentage ('royalty') of the sales revenue of any products developed. Although the repayment period is not limited, no repayment is required if there are no sales of the products.

The entity must account for this type of government grant as a forgivable loan, either under the performance or accrual model, as follows:

- Depending on the policy adopted by the entity in accounting financial instruments, initially recognise the cash received as a liability, applying the initial measurement principles in either IAS 39 *Financial Instruments: Recognition and Measurement*, IFRS 9 *Financial Instruments*, or Section 12 *Other Financial Instruments Issues*.
 - Apply the subsequent measurement principles based on the policy adopted by the entity in accounting for financial instruments.
 - Review at each reporting date whether there is reasonable assurance that the entity will meet the terms for forgiveness of part, or all of the loan based on expected future royalty repayments. If this is the case, derecognise the part or all of the liability initially recorded with a corresponding adjustment to recognise the government grant. Applying the general principles in Section 24, this adjustment is made either through income in the income statement or deferred income in the statement of financial position.
- And
- If the entity subsequently revises its estimates of future sales upwards, it adjusts the amount of the liability in accordance with the subsequent measurement principles adopted by the entity and recognises a corresponding adjustment either as a loss in the income statement for any amounts previously included in profit, a reversal of a deferred income, or a combination of both (i.e., in cases where the reversal is greater than the deferred income balance prior to the adjustment).

However, an arrangement only meets the definition of a forgivable loan if its terms provide for circumstances where repayment would be waived (i.e., forgiven), without any other form of settlement. In Illustration 7-4 above, the entity either repays some or all of the loan if the project generates any sales, or, if no sales are made, its liability is waived in full, with no further recourse to the government. If any other consideration is required to be given in settlement of the obligation, then the arrangement is not a forgivable loan.

Where an entity receives a loan to finance a research and development project and the loan will be forgiven if the project is not successful, then the existence of the forgivable loan has no bearing on assessing the project for capitalisation under the criteria in Section 18 *Intangible Assets other than Goodwill*. One of the criteria for capitalisation of development costs is that the entity must demonstrate that the intangible asset will generate probable economic benefits. [FRS 102.18.8H(d)]. The existence of the forgivable loan does not mean that this requirement is always met. The criteria in Section 18 must be assessed on their own merits.

7.5 Repayment of government grants

A government grant that becomes repayable must be recognised as a liability when the repayment meets the definition of a liability. [FRS 102.24.5A]. A liability is defined as an entity's present obligation to transfer an economic resource as a result of past events. [FRS 102 Appendix I]. An entity must carefully assess the existence of a 'reasonable assurance' required to account for the grant initially so that if the grant subsequently becomes repayable, this is generally not the correction of a prior period error but the consequence of a change in circumstances or new information. Hence it is accounted for as a change in accounting estimate.

Repayment of a grant must be charged first against the related unamortised deferred credit and any excess must be recognised as an expense immediately. Where an entity applies the accrual model in a grant relating to an asset, the previously recognised income must be reversed and charged immediately to profit or loss as expense. This expense must be recorded and presented separately from the depreciation expense. The previously recognised income would have not been offset against the depreciation of the related asset as FRS 102 prohibits the netting against the expense to which the asset is related (see 8.2 below). The expense may be recorded in the same line where the previously recognised income was recorded.

The circumstances giving rise to the repayment of a grant related to an asset may require that consideration be given to the possible impairment of the asset.

7.6 Government assistance

Government assistance is defined by the standard as the “action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under specified criteria”.

[FRS 102 Appendix I].

Government assistance that cannot reasonably have a value placed upon them and transactions with government that cannot be distinguished from the normal trading transactions of the entity are excluded in the definition of a government grant. Examples include free technical or marketing advice and the provision of guarantees. The entities are required to disclose this government assistance from which the entity has directly benefited. [FRS 102.24.6(d)].

The following Illustration describes two different forms of government assistance:

Illustration 7-5: Government assistance

(a) Assistance in the form of priority bidding status

A government specifies that entities below a certain size are to be given priority in bidding for a particular type of government contract by mandating a minimum number of such entities to obtain bidding status. Although the entities will benefit from the quota, the value cannot be identified, and the effects of the assistance cannot be segregated from the trading activities of the qualifying entities.

(b) Assistance in the form of credit facilities at market rates

Three governments that between themselves own just over 50% of the shares in an airline participate in granting it a revolving credit facility at a market rate of interest. This is not a government grant as it is on terms that a private market participant might have accepted but it is government assistance as the benefit cannot be distinguished from normal trading activities of the airline.

8 Presentation

8.1 Statement of financial position

Under the performance model, grants received before the performance-related conditions are satisfied are recognised as liability. [FRS 102.24.5B(c)]. The amount must be presented separately or within an applicable account heading such as 'deferred income'.

Under the accrual model, and where grants are relating to assets, the portion of the grant which is deferred must be recognised and presented as deferred income. [FRS 102.24.5G]. FRS 102 does not allow this amount to be deducted from the carrying amount of the asset. For grants under the accrual model that relate to revenue, any amount received that is not recognised in the income statement at the end of the reporting period must also be presented as deferred income.

8.2 Income statement

FRS 102 does not specifically state where grant income must be presented in the income statement. Although not specifically referred to in Section 24, the amount recognised as income cannot be offset against the expense to which the grant is related. The Regulations do not allow offsetting of income against expenditure. [1 Sch 8]. Therefore, income from grants must be presented as a credit, either separately or under a general heading such as 'other operating income'.

In some instances, grants may be presented as revenue if it meets the definition in the standard.

How we see it

Section 23 defines revenue as income arising in the course of an entity's ordinary activities. [FRS 102 Appendix I]. Determining whether a government grant is income arising in the course of an entity's ordinary activities is a matter of judgement after considering all the facts and circumstances relevant to an entity. Facts to consider relevant to this judgement include consideration of the business model of the entity as well as the frequency and purpose of grants received.

Accordingly, some grants may be presented as revenue while others, that are determined not to arise in the course of an entity's ordinary activities, cannot be presented as revenue.

However, any grant revenue recognised that is outside the scope of Section 23 will need to be presented either separately from revenue from contracts with customers within the income statement or disclosed separately within the notes. This is due to entities being required to present in the statement of comprehensive income, or disclose within the notes, the amount of revenue recognised from contracts with customers separately from other sources of revenue.

It is important to distinguish between those transactions which arise in the course of an entity's ordinary activities, and therefore may be presented as revenue, and transactions that are incidental to the main revenue-generating activities, but do not generate revenue themselves.

8.3 Statement of cash flows

The receipt of grants can cause major movements in the cash flows of an entity.

However, neither Section 24 nor Section 7 *Statement of Cash Flows* (see Chapter 7 at 3.4.14) provide guidance on where in the statement of cash flows to present the cash inflows from the receipt of government grants. As a result, there is likely to be diversity in practice for the presentation of all grants in the statement of cash flows. Cash flows received from grants could be considered to be financing by nature because they provide a source of financing to the entity. Alternatively, cash flows received from grants could be presented as operating cash flows by default since they do not seem to meet the definition of financing activities or investing activities. If an entity accounts for a grant under the accrual model, it may consider cash flows received from these grants as operating cash flows if the grants are related to revenue and cash flows received from grants related to assets could be presented as investing cash flows as they relate to an investing activity. Further discussion on cash flow classification can be found in Chapter 7 at 3.4.14.

How we see it

Selecting the most appropriate presentation will be a matter of judgement. Once adopted, the presentation principles must be applied consistently and clear disclosure of the principles and the impact thereof on the cash flow statement must be provided in accordance with Section 10.

Cash flows from refundable advances must be presented as financing cash flows, whereas their transformation into a grant, if and when the entity meets the conditions for forgiveness of the loan, is a non-cash transaction.

8.4 Disclosure requirements

Section 24 requires, whenever material, that entities must disclose the following information regarding government grants:

- The accounting policy adopted for grants in particular whether the performance or accrual model has been adopted.
 - The nature and extent of grants recognised in the financial statements.
 - Unfulfilled conditions and other contingencies attaching to grants that have been recognised in income.
- And
- An indication of any other forms of government assistance from which the entity has directly benefitted. Examples included free technical or marketing advice and the provision of guarantees. *[FRS 102.24.6]*.

9 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for government grants are set out below.

	FRS 102	IFRS
Recognition	Accounting policy choice using either a performance model (grant is recognised as income as the performance related conditions are satisfied) or an accrual model (If grant is relating to revenue, grant is recognised as income when the related expenses are recognised. If grant is relating to assets, grant is recognised as income on a systematic basis over the useful life of the asset).	Only allows accrual model.
Measurement	All government grants measured on initial recognition at the fair value of the asset received or receivable.	Allows non-monetary government grants to be recorded at a nominal amount as an alternative to fair value.
Presentation	In the statement of financial position, the deferred element of a grant accounted for under the accrual model that relates to an asset can only be presented as deferred income. It is prohibited to be deducted from the carrying amount of the asset. In the statement of profit or loss, the income from grants must be presented as a credit. It is not allowed to be deducted against the corresponding expense.	In the statement of financial position, the deferred element of the grant relating to an asset can be presented as deferred income or deduction against the asset. In the statement of comprehensive income, the income recognised from the grant can be presented separately as a credit in the income statement or a deduction in the related expense.

Appendix A - Defined terms

Extract from FRS 102

Appendix I Glossary

asset	A present economic resource controlled by the entity as a result of past events.
expenses	Decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A Fair Value Measurement shall be used in determining fair value.
government	Government, government agencies and similar bodies whether local, national or international.
government assistance	Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under specified criteria.
government grant	Government assistance in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity.
income	Increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity investors.
income tax	All domestic and foreign taxes that are based on taxable profits. Income tax also includes taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.
liability	A present obligation of the entity to transfer an economic resource as a result of past events.
non-exchange transaction	A transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.
performance-related condition (in respect of funding commitments, government grants and other non-exchange transactions)	A condition under which entitlement to resources is conditional on the performance of: (a) specified activity; or (b) a particular level of service or units of output to be delivered.
taxable profit (tax loss)	The profit (loss) for a reporting period upon which income taxes are payable or recoverable, determined in accordance with the rules established by the taxation authorities. Taxable profit equals taxable income less amounts deductible from taxable income.
useful life	The period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

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Chapter 27

Borrowing costs

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Overview

This chapter covers the requirements of Section 25 *Borrowing Costs*. Borrowings costs include interest and other costs incurred by an entity in connection with the borrowing of funds such as interest expense calculated using the effective interest method, interest in respect of lease liabilities and exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Under FRS 102, capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset is an accounting policy choice applied separately to each class of qualifying assets. Not all assets are considered a qualifying asset under FRS 102. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

This chapter highlights the key considerations when:

- Identifying qualifying assets.
- Determining when borrowing costs are eligible for capitalisation or when capitalisation needs to be suspended or ceased altogether.
- And
- Applying the disclosure requirements.

What you need to know

- Section 25 deals with the assessment of when borrowing costs can be capitalised and the treatment of capitalised borrowing costs.
- Capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' is an accounting policy choice applied separately to each class of qualifying assets. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
- Section 25 prescribes separate requirements for borrowing costs incurred from specific borrowings and general borrowings.
- Section 25 sometimes requires significant judgement when identifying a direct relationship between particular borrowings and a qualifying asset, and when evaluating whether the borrowings could otherwise have been avoided.

1 Introduction

A common question when determining the initial measurement of an asset is whether or not finance costs incurred on its acquisition or during the period of its construction need to be capitalised as part of the cost of the asset or expensed through profit or loss. There have always been a number of strong arguments in favour of the capitalisation of directly attributable finance costs. For example, it is argued that they are just as much a cost as any other directly attributable cost; that expensing finance costs distorts the choice between purchasing and constructing an asset; that capitalising the costs leads to a carrying value that is far more akin to the market value of the asset; and that the financial statements are more likely to represent the true results of the project. Section 25 specifies the accounting for borrowing costs.

2 Comparison between Section 25 and IFRS

Overall, Section 25 is consistent with UK Company Law which allows an entity an accounting policy choice as to whether to capitalise borrowing costs when certain criteria are satisfied. This is different to adopted IFRS since IAS 23 *Borrowing Costs* requires capitalisation of borrowing costs when the criteria are satisfied. The key differences between Section 25 and IFRS are also discussed below. See 5 below for the summary of such GAAP differences.

2.1 Capitalisation of borrowing costs

Under FRS 102, capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset is an accounting policy choice applied separately to each class of qualifying assets (see 3.2 below). [FRS 102.25.2].

Under IFRS, capitalisation of borrowing costs is mandatory for most qualifying assets (i.e., there is no accounting policy choice). However, capitalisation is an accounting policy choice for a qualifying asset measured at fair value or inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis. [IAS 23.4].

2.2 General borrowings

Under FRS 102, the general borrowings on which the capitalisation rate is based, exclude the borrowings specifically for the purpose of obtaining either qualifying assets, until substantially all the activities necessary to prepare that asset for its intended use or sale are complete, and non-qualifying assets. Therefore, only the general borrowings are included in the computation of the capitalisation rate (see 3.4.3.B below). [FRS 102.25.2C]

IFRS explicitly excludes only the borrowings that are specifically for the purpose of obtaining qualifying assets, thus together with all the general borrowings, specific borrowings to obtain non-qualifying assets are also included in computing the capitalisation rate.

2.3 Expenditure on qualifying assets

Under FRS 102, for the purpose of applying the capitalisation rate to the expenditure on the qualifying asset, the expenditure on the asset is the average carrying amount of the asset during the period, including borrowing costs previously capitalised. [FRS 102.25.2C].

Under IFRS, the average carrying amount of the asset during a period, including borrowing costs previously capitalised, is regarded as a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period. Expenditures on a qualifying asset are explicitly limited to those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities and reduced by any progress payments received and grants received in connection with the asset. [IAS 23.18].

2.4 Disclosure differences

Disclosure differences between FRS 102 and IFRS are discussed at 5 below.

3 The requirements of Section 25

3.1 Scope

Section 25 applies to borrowing costs. Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds. Borrowing costs include:

- Interest expense calculated using the effective interest method as set out in Section 11 *Basic Financial Instruments* (see Chapter 13).
 - Interest expense on lease liabilities as set out in Section 20 *Leases* (see Chapter 23).
- And
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see 3.4.4 below). [FRS 102.25.1].

Section 25 does not deal with the actual or imputed costs of equity, including preferred capital and other financial instruments not classified as a liability, that are used to fund the acquisition or construction of an asset. This means that any distributions or other payments made in respect of equity instruments, as defined by Section 22 *Liabilities and Equity*, are not within the scope of Section 25. Conversely, interest and dividends payable on instruments that are legally equity, but classified as financial liabilities under FRS 102, appear to be within the scope of Section 25 (see 3.4.5.D below).

When an entity adopts a policy of capitalising borrowing costs (see 3.2 below), Section 25 addresses whether or not to capitalise borrowing costs as part of the cost of the asset. The identification and measurement of finance costs are not directly dealt with in Section 25 and the section does not address many of the ways in which an entity may finance its operations or other finance costs that it may incur. Examples of these other finance costs and their eligibility for capitalisation under Section 25 are discussed at 3.4.5 below.

Section 25 does not preclude the classification of costs, other than those it identifies, as borrowing costs. However, they must meet the basic criterion in Section 25, i.e., that they are “the costs that are directly attributable to the acquisition, construction or production of a qualifying asset” [FRS 102.25.2A], which would, therefore, preclude treating the unwinding of discounts on provisions as borrowing costs. Many unwinding discounts are treated as finance costs in profit or loss. These include discounts relating to various provisions such as those for onerous leases and decommissioning costs. These finance costs will not be borrowing costs under Section 25 because they do not arise in respect of funds borrowed by the entity that can be attributed to a qualifying asset. Therefore, these costs cannot be capitalised. [FRS 102.25.1, FRS 102.25.2]. In addition, as in the case of exchange differences, capitalisation of such costs can only be permitted “... to the extent that they are regarded as an adjustment to interest costs” (see 3.4.4 below). [FRS 102.25.1].

3.2 Accounting for borrowing costs

For borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, Section 25 provides an accounting policy choice to either:

- Capitalise those borrowing costs.
- Or
- Recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred. [FRS 102.25.2].

Accordingly, all borrowing costs must be recognised as an expense in profit or loss in the period in which they are incurred unless a policy of capitalising borrowing costs is adopted. In addition, borrowing costs that are not directly attributable to a qualifying asset must be expensed as incurred.

Where an entity adopts a policy of capitalisation of borrowing costs for qualifying assets, it must be applied consistently to a class of qualifying assets. [FRS 102.25.2]. The definition of class is discussed at 3.4.1 below.

Since an entity has a policy choice, a change in accounting policy (i.e., capitalisation versus expense) would require retrospective restatements in accordance with Section 10 *Accounting Policies, Estimates and Errors*. [FRS 102.10.11(d), FRS 102.10.12].

3.3 Qualifying assets

Determining whether an asset is considered a qualifying asset is a key step when evaluating whether borrowing costs can be capitalised. The Appendix defines a qualifying asset as follows:

an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:

- Inventories
- Manufacturing plants
- Power generation facilities
- Intangible assets
- Investment properties
- And
- Biological assets

Financial assets, and inventories that are produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

[FRS 102 Appendix I].

How we see it

We consider that financial assets include equity accounted investments and these are therefore, also excluded from the definition of qualifying assets.

Section 25 is silent as to whether other types of assets not mentioned in the definition (e.g., owner-occupied property) can be qualifying assets.

How we see it

In our view, there is nothing to prohibit other assets meeting the definition of a qualifying asset.

Section 25 does not define 'substantial period of time' and this will therefore require the exercise of judgement after considering the specific facts and circumstances.

How we see it

In our view, an asset that normally takes twelve months or more to be ready for its intended use or sale will usually be a qualifying asset.

3.4 Borrowing costs eligible for capitalisation

Borrowing costs are eligible for capitalisation as part of the cost of a qualifying asset if they are directly attributable to the acquisition, construction or production of that qualifying asset (whether or not the funds have been borrowed specifically). [FRS 102.25.2].

Section 25 starts from the premise that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. [FRS 102.25.2A]. Recognising that it might not always be easy to identify a direct relationship between particular borrowings and a qualifying asset, and to determine the borrowings that could otherwise have been avoided, Section 25 includes separate requirements for specific borrowings and general borrowings (see 3.4.2 and 3.4.3 below).

3.4.1 Class of qualifying assets

"Where an entity adopts a policy of capitalisation of borrowing costs, it must be applied consistently to a class of qualifying assets". [FRS 102.25.2]. There is no specific definition of a 'class of qualifying assets'. However, a 'class of assets' is defined as "a grouping of assets of a similar nature and use in an entity's operations." [FRS 102 Appendix I]. Therefore, it may be possible to have a capitalisation policy only in relation to plant under construction but not to machinery under construction or inventories that are qualifying assets.

3.4.2 Specific borrowings

When an entity borrows funds specifically to obtain a particular qualifying asset, the borrowing costs that are directly related to that qualifying asset can be readily identified. The borrowing costs eligible for capitalisation would be the actual borrowing costs incurred on that specific borrowing during the period less any investment income on the temporary investment of those borrowings. [FRS 102.25.2B].

Entities frequently borrow funds in advance of expenditure on qualifying assets and could temporarily invest the borrowings. Section 25 makes it clear that any investment income earned on the temporary investment of those borrowings needs to be deducted from the borrowing costs incurred and only the net amount capitalised (see Illustration 3.2 below). [FRS 102.25.2B].

How we see it

There is no restriction in Section 25 on the type of investments in which the funds can be invested but, in our view, to maintain the conclusion that the funds are specific borrowings, the investment must be of a nature that does not expose the principal amount to the risk of not being recovered. The more risky the investment, the greater is the likelihood that the borrowing is not specific to the qualifying asset. If the investment returns a loss rather than income, such losses are not added to the borrowing costs to be capitalised.

3.4.3 General borrowings

There could be practical difficulties in identifying a direct relationship between particular borrowings and a qualifying asset, and in determining the borrowings that could otherwise have been avoided

This could be the case, for example, if the financing activity of an entity is co-ordinated centrally, with borrowings arranged to meet its funding requirements as a whole. The construction of the qualifying asset is therefore financed out of general borrowings.

Other circumstances that might cause difficulties are as follows:

- A group has a treasury function that uses a range of debt instruments to borrow funds at varying rates of interest and lends those funds on various bases to other entities in the group.
- Or
- Loans are denominated in or linked to foreign currencies and the group operates in highly inflationary economies or there are fluctuations in exchange rates.

In these circumstances, determining the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset could be difficult and require the exercise of judgement.

To the extent that funds applied to obtain a qualifying asset form part of the entity's general borrowings, Section 25 requires the application of a capitalisation rate to the expenditure on that asset in determining the amount of borrowing costs eligible for capitalisation. However, the amount of borrowing costs an entity capitalises during a period must not exceed the amount of borrowing costs it incurred during that period.

[FRS 102.25.2C].

The capitalisation rate used in an accounting period is the weighted average of rates applicable to the general borrowings of the entity that are outstanding during the period. This excludes borrowings made specifically for the purpose of obtaining other qualifying assets, until substantially all the activities necessary to prepare that asset for its intended use or sale are complete, and non-qualifying assets. Specific borrowings made for non-qualifying assets are excluded from the calculation as paragraph 2C of Section 25 explicitly requires that the weighted average of rates be applied to 'general borrowings' (see 3.4.3.B below). The capitalisation rate is then applied to the expenditure on the qualifying asset. For this purpose, the expenditure on the asset is the average carrying amount of the asset during the period, including borrowing costs previously capitalised. [FRS 102.25.2C].

Section 25 does not provide specific guidance regarding interest income earned from temporarily investing excess general funds.

How we see it

We believe that any interest income earned is unlikely to be directly attributable to the acquisition or construction of a qualifying asset. In addition, the capitalisation rate required by Section 25 focuses on the borrowings of the entity outstanding during the period of construction or acquisition and does not include temporary investments. As such, borrowing costs capitalised must not be reduced by interest income earned from the investment of general borrowings nor must such income be included in determining the appropriate capitalisation rate.

In some circumstances, it may be appropriate for all borrowings made by the group (i.e., borrowings of the parent and its subsidiaries) to be taken into account in determining the weighted average of the borrowing costs. In other circumstances, it may be appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. It is likely that this will largely be determined by the extent to which borrowings are made centrally (and, perhaps, interest expenses met in the same way) and passed through to individual group companies via intercompany accounts and intra-group loans. The capitalisation rate is discussed further at 3.4.3.E below.

3.4.3.A Borrowing costs on borrowings related to completed qualifying assets

As noted at 3.4.3 above, determining general borrowings will not always be straightforward and, as a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset could be difficult and judgement is required.

The question has arisen as to whether a specific borrowing undertaken to obtain a qualifying asset ever changes its nature into a general borrowing. Historically, different views existed as to whether or not borrowings change their nature throughout the period they are outstanding. Some considered that once the asset for which the borrowing was incurred has been completed, and the entity chooses to use its funds on constructing other assets rather than repaying the loan, this changes the nature of the loan into a general borrowing. However, to the extent that the contract links the repayment of the loan to specific proceeds generated by the entity, its nature as a specific borrowing would be preserved. Others took the view that once the borrowing has been classified as specific, its nature does not change while it remains outstanding.

Entities may wish to consider using the related guidance in IFRS as permitted by Section 10 (see Chapter 9 at 3.1). IAS 23 paragraph 14 clarifies that when a qualifying asset is ready for its intended use or sale, an entity treats any outstanding borrowings made specifically to obtain that qualifying asset as part of general borrowings. [IAS 23.BC14D].

Refer also to further discussion in 3.5.3 below to determine when all the activities necessary to prepare the qualifying asset for its intended use or sale are 'substantially' complete.

3.4.3.B General borrowings related to specific non-qualifying assets

Another question that arises is regarding the treatment of general borrowings used to purchase a specific asset other than a qualifying asset for the purpose of capitalising borrowing costs.

Section 25 explicitly states that the capitalisation rate to be used must be the "weighted average of rates applicable to the entity's general borrowings that are outstanding during the period". [FRS 102.25.2C]. This means that any specific borrowings related to obtaining either qualifying assets, until substantially all the activities necessary to prepare that asset for its intended use or sale are complete, and non-qualifying assets would be excluded. Therefore, only the general borrowings are included in the computation of capitalisation rate.

3.4.3.C Expenditure on the asset

Section 25 explicitly states that for purposes of applying the capitalisation rate to the expenditure on the qualifying asset, "the expenditure on the asset is the average carrying amount of the asset during the period, including borrowing costs previously capitalised". [FRS 102.25.2C].

Accordingly, unlike in IFRS (see 2.3 above), expenditure is not restricted to that resulting in the payment of cash, the transfer of other assets or the assumption of interest-bearing liabilities. Therefore, in principle, costs of a qualifying asset that have only been accrued but have not yet been paid in cash would also be included although, by definition, no interest can have been incurred on an accrued payment. The same principle can be applied to non-interest bearing liabilities e.g., non-interest-bearing trade payables or retention money that is not payable until the asset is completed.

A related issue that can arise in practice is about whether an entity includes expenditures on a qualifying asset incurred before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalisation. Consider the fact pattern below:

- An entity constructs a qualifying asset.
- The entity has no borrowings at the start of the construction of the qualifying asset.
- Partway through construction, it borrows funds generally and uses them to finance the construction of the qualifying asset.

And

- The entity incurs expenditures on the qualifying asset both before and after it incurs borrowing costs on the general borrowings.

An entity applies paragraph 25.2D(a) of FRS 102 to determine the commencement date for capitalising borrowing costs. This paragraph requires an entity to begin capitalising borrowing costs when it meets all of the following conditions:

- It incurs expenditures on the asset.
- It incurs borrowing costs.

And

- It undertakes activities necessary to prepare the asset for its intended use or sale (see also 3.5.1 below). [FRS 102.25.2D(a)].

Applying paragraph 25.2D(a) of FRS 102 to the fact pattern described above, the entity would not begin capitalising borrowing costs until it incurs borrowing costs.

Once the entity incurs borrowing costs and therefore satisfies all the three conditions described above, it then applies paragraph 25.2C of FRS 102 to determine the expenditures on a qualifying asset to which it applies the capitalisation rate.

How we see it

We believe the entity does not disregard expenditures on the qualifying asset incurred before the entity obtains the general borrowings. For this purpose, the expenditure on the asset is the average carrying amount of the asset during the period, including borrowing costs previously capitalised.

The above issue was also discussed by the International Financial Reporting Interpretations Committee (the 'Interpretations Committee') in its June 2018²²² and September 2018²²³ meetings and a similar conclusion was reached.

3.4.3.D Assets carried below cost in the statement of financial position

An asset can be recognised in the financial statements during the period of production on a basis other than cost, i.e., it might have been written down below cost as a result of being impaired. An asset is impaired when its carrying amount or expected ultimate cost, including costs to complete and the estimated capitalised interest thereon, exceeds its estimated recoverable amount or net realisable value (see 3.5.2.A below).

The question then arises as to whether the calculation of interest to be capitalised is based on the cost or the carrying amount of the impaired asset. It could be argued that in this case, cost must be used, as this is the amount that the entity or group has had to finance. However, Section 25 explicitly states that the expenditure on the asset is the average carrying amount (not the cost) of the asset during the period.

3.4.3.E Calculation of capitalisation rate

As noted at 3.4.3 above, determining general borrowings will not always be straightforward, it will be necessary to exercise judgement to meet the main objective - a reasonable measure of the directly attributable finance costs.

The following Illustration sets out the practical application of the method of calculating the amount of finance costs to be capitalised:

²²² [IFRIC Update](#), June 2018, available on the IFRS Foundation's website.

²²³ [IFRIC Update](#), September 2018, available on the IFRS Foundation's website.

Illustration 3-1: Calculation of capitalisation rate (no investment income)

On 1 April 20X2 a company engages in the development of a property, which is expected to take five years to complete, at a cost of £6,000,000. The statements of financial position at 31 December 20X1 and 31 December 20X2, prior to capitalisation of interest, are as follows:

	31 December 20X1	31 December 20X2
	£	£
Development property	-	1,200,000
Other assets	6,000,000	6,000,000
	<u>6,000,000</u>	<u>7,200,000</u>
Loans		
5.5% debenture stock	2,500,000	2,500,000
Bank loan at 6% p.a.	-	1,200,000
Bank loan at 7% p.a.	1,000,000	1,000,000
	<u>3,500,000</u>	<u>4,700,000</u>
Shareholders' equity	<u>2,500,000</u>	<u>2,500,000</u>

The bank loan with an effective interest rate of 6% was drawn down to match the development expenditure on 1 April 20X2, 1 July 20X2 and 1 October 20X2.

Expenditure was incurred on the development as follows:

	£
1 April 20X2	600,000
1 July 20X2	400,000
1 October 20X2	200,000
	<u>1,200,000</u>

As the bank loan at 6% p.a. is a new borrowing specifically to finance the development then the amount of interest to be capitalised for the year ended 31 December 20X2 would be the amount of interest charged by the bank of £42,000 ((£600,000 × 6% × 9/12) + (£400,000 × 6% × 6/12) + (£200,000 × 6% × 3/12)).

However, if all the borrowings were general (i.e., the bank loan at 6% was not specific to the development) and would have been avoided but for the development, then the amount of interest to be capitalised would be:

$$\frac{\text{Total interest expense for period}}{\text{Weighted average total borrowings}} \times \text{Development expenditure}$$

Total interest expense for the period

	£
£2,500,000 × 5.5%	137,500
£1,200,000 (as above)	42,000
£1,000,000 × 7%	70,000
	<u>249,500</u>

Therefore the capitalisation rate would be calculated as:

$$\frac{249,500}{3,500,000 + 700,000^*} = 5.94\%$$

* Weighted average total borrowings is computed as the sum of £3,500,000 (or £3,500,000 × 12/12) and £700,000 (or (£600,000 × 9/12) + (£400,000 × 6/12) + (£200,000 × 3/12)).

The capitalisation rate would then be applied to the expenditure on the qualifying asset, resulting in an amount to be capitalised of £41,580 as follows:

	£
£600,000 × 5.94% × 9/12	26,730
£400,000 × 5.94% × 6/12	11,880
£200,000 × 5.94% × 3/12	2,970
	<u>41,580</u>

In the Illustration above, all borrowings are at fixed rates of interest and, the period of construction extends at least until the end of the period simplifying the calculation. The same principle is applied if borrowings are at floating rates i.e., only the interest costs incurred during that period, and the weighted average borrowings for that period, will be taken into account.

Note that the company's shareholders' equity (i.e., equity instruments - see further discussion at 3.4.5.D below) cannot be taken into account. Also, at least part of the outstanding general borrowings is presumed to finance the acquisition or construction of qualifying assets. Regardless of whether they are financing qualifying or non-qualifying assets, all of the outstanding borrowings are presumed to be general borrowings - unless they are specific borrowings (see discussions at 3.4.3.A and 3.4.3.B above).

The above Illustration also assumes that loans are drawn down to match expenditure on the qualifying asset. If, however, a loan is drawn down immediately and investment income is received on the unapplied funds, then the calculation differs from that in Illustration 3.1 above. This is explained further in Illustration 3.2 below.

Illustration 3-2: Calculation of amount to be capitalised - specific borrowings with investment income

On 1 April 20X2 a company engages in the development of a property, which is expected to take five years to complete, at a cost of £6,000,000. In this scenario, a bank loan of £6,000,000 with an effective interest rate of 6% was taken out on 31 March 20X2 and fully drawn. The total interest charge for the year ended 31 December 20X2 was consequently £270,000.

However, investment income was also earned at 3% on the unapplied funds during the period as follows (assume the same timings and expenditures incurred as in Illustration 3.11 above):

	£
$£5,400,000 \times 3\% \times 3/12$	40,500
$£5,000,000 \times 3\% \times 3/12$	37,500
$£4,800,000 \times 3\% \times 3/12$	36,000
	<u>114,000</u>

Consequently, the amount of interest to be capitalised for the year ended 31 December 20X2 is:

	£
Total interest charge	270,000
Less: investment income	<u>(114,000)</u>
	<u>156,000</u>

3.4.4 Exchange differences as a borrowing cost

An entity might borrow funds in a currency that is not its functional currency e.g., a Euro loan financing a development in a company which has Sterling as its functional currency. This might have been done on the basis that, over the period of the development, the borrowing costs, even after allowing for exchange differences, were expected to be less than the interest cost of an equivalent Sterling loan.

Section 25 defines borrowing costs as including exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. [FRS 102.25.1(c)].

Section 25 does not expand on this point. Therefore, judgement will be required in its application and appropriate disclosure of accounting policies and judgements would provide users with the information they need to understand the financial statements (see 3.5.2 below).

How we see it

In our view, as exchange rate movements are partly a function of differential interest rates, in many circumstances the foreign exchange differences on directly attributable borrowings will be an adjustment to interest costs that can meet the definition of borrowing costs. However, care is needed if there are fluctuations in exchange rates that cannot be attributed to interest rate differentials. In such cases, we believe that a practical approach is to limit exchange losses taken as borrowing costs such that the total borrowing costs capitalised do not exceed the amount of borrowing costs that would be incurred on functional currency equivalent borrowings, taking into consideration the corresponding market interest rates and other conditions that existed at inception of the borrowings.

If the approach discussed above is used – i.e., exchange losses taken as borrowing cost have been limited – and the construction of the qualifying asset takes more than one accounting period, there could be situations where in one period only a portion of foreign exchange differences could be capitalised (i.e., discrete period approach). However, in subsequent years, if the borrowings are assessed on a cumulative basis, foreign exchange losses previously expensed might now meet the recognition criteria (i.e., cumulative approach).

How we see it

In our view, whether foreign exchange gains and losses are assessed on a discrete period basis or cumulatively over the construction period as described above is a matter of accounting policy, which must be consistently applied. As alluded to above, Section 8 *Notes to the Financial Statements* requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements (see 3.6.2 below).

The impact of the two approaches described above are demonstrated in Illustration 3-3 below.

Illustration 3-3: Foreign exchange differences in more than one period

Method A - The discrete period approach

The amount of foreign exchange differences eligible for capitalisation is determined for each period separately. Foreign exchange losses that did not meet the criteria for capitalisation in previous years are not capitalised in subsequent years.

Method B - The cumulative approach

The borrowing costs to be capitalised are assessed on a cumulative basis based on the cumulative amount of interest expense that would have been incurred had the entity borrowed in its functional currency. The amount of foreign exchange differences capitalised cannot exceed the amount of foreign exchange losses incurred on a cumulative basis at the end of the reporting period. The cumulative approach looks at the construction project as a whole as the unit of account ignoring the occurrence of reporting dates. Consequently, the amount of the foreign exchange differences eligible for capitalisation as an adjustment to the borrowing cost in the period is an estimate, which can change as the exchange rates vary over the construction period.

An illustrative calculation of the amount of foreign exchange differences that may be capitalised under Method A and Method B is set out below.

	Year 1	Year 2	Total
	£	£	£
Interest expense in foreign currency (A)	25,000	25,000	50,000
Hypothetical interest expense in functional currency (B)	30,000	30,000	60,000
Foreign exchange loss (C)	6,000	3,000	9,000
Method A - Discrete Approach			
Foreign exchange loss capitalised - lower of C and (B minus A)	5,000	3,000	8,000
Foreign exchange loss expensed	1,000	-	1,000
Method B - Cumulative Approach			
Foreign exchange loss capitalised	5,000*	4,000**	9,000
Foreign exchange loss expensed	1,000	(1,000)	-

* Lower of C and (B minus A) in Year 1.

** Lower of C and (B minus A) in total across the two years. In this Illustration this represents the sum of the foreign exchange loss of £3,000 capitalised using the discrete approach plus the £1,000 not capitalised in year 1.

3.4.5 Other finance costs as a borrowing cost

An entity may incur other finance costs. Section 25 does not specifically address these. Below are Illustrations of other finance costs including discussion on their eligibility for capitalisation under Section 25.

3.4.5.A Derivative financial instruments

Many derivative financial instruments such as interest rate swaps, floors, caps and collars are commonly used to manage interest rate risk on borrowings. The most straightforward and commonly encountered derivative financial instrument used to manage interest rate risk is a floating to fixed interest rate swap, as explained in the following Illustration.

Illustration 3-4: Floating to fixed interest rate swaps

Entity A has borrowed £4 million for five years at a floating interest rate to fund the construction of a building. In order to hedge the cash flow interest rate risk arising from these borrowings, A has entered into a matching pay-fixed receive-floating interest rate swap, based on the same underlying nominal sum and duration as the original borrowing, that effectively converts the interest on the borrowings to fixed rate. The net effect of the periodic cash settlements resulting from the hedged and hedging instruments is as if A had borrowed £4 million at a fixed rate of interest.

Section 25 is silent on the use of hedging instruments in determining directly attributable borrowing costs. Section 12 *Other Financial Instruments Issues* - sets out the basis on which derivatives are recognised and measured. Accounting for hedges is discussed in Chapter 14.

An entity might consider that a specific derivative financial instrument, such as an interest rate swap, is directly attributable to the acquisition, construction or production of a qualifying asset. If the instrument does not meet the conditions for hedge accounting then the effects on profit or loss will be different from those if it does, and they will also be dissimilar from year to year. What is the impact of the derivative on borrowing costs eligible for capitalisation? In particular, does the accounting treatment of the derivative financial instrument affect the amount available for capitalisation? If hedge accounting is not adopted, does this affect the amount available for capitalisation?

The following Illustration highlights the potential implication of these questions.

Illustration 3-5: Cash flow hedge of variable-rate debt using an interest rate swap

Entity A is constructing a building and expects it to take 18 months to complete. To finance the construction, on 1 January 20X1, the entity issues an eighteen-month, £20,000,000 variable-rate note payable, due on 30 June 20X2 at a floating rate of interest plus a margin of 1%. At that date the market rate of interest is 8%. Interest payment dates and interest rate reset dates occur on 1 January and 1 July until maturity. The principal is due at maturity. On 1 January 20X1, the entity also enters into an eighteen-month interest rate swap with a notional amount of £10,000,000 from which it will receive periodic payments at the floating rate and make periodic payments at a fixed rate of 9%, with settlement and rate reset dates every 30 June and 31 December. The fair value of the swap is zero at inception.

On 1 January 20X1, the debt is recorded at £20,000,000. No entry is required for the swap on that date because its fair value was zero at inception.

During the eighteen-month period, floating interest rates change as follows:

	Floating rate	Rate paid by Entity A on note payable
Period to 30 June 20X1	8%	9%
Period to 31 Dec 20X1	8.5%	9.5%
Period to 30 June 20X2	9.75%	10.75%

Under the interest rate swap, Entity A receives interest at the market floating rate as above and pays at 9% on the nominal amount of £10,000,000 throughout the period.

At 31 December 20X1, the swap has a fair value of £37,500, reflecting the fact that it is now in the money as Entity A is expected to receive a net cash inflow of this amount in the period until the instrument is terminated. There are no further changes in interest rates prior to the maturity of the swap and the fair value of the swap declines to zero at 30 June 20X2.

Note that this Illustration excludes the effect of issue costs and discounting. In addition, it is assumed that, if Entity A is entitled to, and applies, hedge accounting, there will be no ineffectiveness.

At 31 December 20X1, the swap has a fair value of £37,500, reflecting the fact that it is now in the money as Entity A is expected to receive a net cash inflow of this amount in the period until the instrument is terminated. There are no further changes in interest rates prior to the maturity of the swap and the fair value of the swap declines to zero at 30 June 20X2.

The cash flows incurred by the entity on its borrowing and interest rate swap are as follows:

	Cash payments		
	Interest on principal	Interest rate swap (net)	Total
	£	£	£
30 June 20X1	900,000	50,000	950,000
31 Dec 20X1	950,000	25,000	975,000
30 June 20X2	1,075,000	(37,500)	1,037,500
Total	2,925,000	37,500	2,962,500

There are a number of different ways in which Entity A could calculate the borrowing costs eligible for capitalisation, including the following.

- (i) The interest rate swap meets the conditions for, and entity A applies, hedge accounting. The finance costs eligible for capitalisation as borrowing costs will be £1,925,000 in the year to 31 December 20X1 and £1,037,500 in the period ended 30 June 20X2.
- (ii) Entity A does not apply hedge accounting. Therefore, it will reflect the fair value of the swap in profit or loss in the year ended 31 December 20X1, reducing the net finance costs by £37,500 to £1,887,500 and increasing the finance costs by an equivalent amount for the 6 months to 30 June 20X2 to £1,075,000. Under this method, it will not be appropriate to reflect the cash payments received in 20X2 for the settlement of the fair value of the swap in the borrowing costs eligible for capitalisation in the period ended 30 June 20X2 because the fair value of the swap is recognised in the income statement and already reflected in the amount of borrowing costs capitalised in 20X1.
However, if Entity A considers that it is inappropriate to reflect the fair value of the swap in borrowing costs eligible for capitalisation, it capitalises costs based on the net cash cost on an accrual accounting basis. In this case this will give the same result as in (i) above.
- (iii) Entity A does not apply hedge accounting and considers only the costs incurred on the borrowing, not the interest rate swap, as eligible for capitalisation. The borrowing costs eligible for capitalisation would be £1,850,000 in 20X1 and £1,075,000 in 20X2.

How we see it

In our view, all these methods are valid interpretations of Section 25; however, the preparer will need to consider the most appropriate method in the particular circumstances after taking into consideration the discussion below.

If using method (ii), it is necessary to demonstrate that the gains or losses on the derivative financial instrument are directly attributable to the construction of a qualifying asset. In making this assessment it is necessary to consider the term of the derivative and this method might not be appropriate if the derivative has a different term to the underlying directly attributable borrowing. If the entity is not hedge accounting for the derivative financial instrument but considers its fair value movement to be directly attributable to the construction of a qualifying asset, then it will have to consider whether part of such fair value movement of the derivative relates to a period after the construction is completed and, therefore, excludes this part of the fair value movement when determining the borrowing costs eligible for capitalisation.

Based on the facts in the Illustration above, and assuming that entering into the derivative financial instrument is considered to be related to the borrowing activities of the entity, method (iii) might not be an appropriate method to use because it appears to be inconsistent with the underlying principle of Section 25 - that the costs eligible for capitalisation are those costs that would have been avoided if the expenditure on the qualifying asset had not been made. [FRS 102.25.2A]. However, method (iii) could be an appropriate method to use in certain circumstances where it is not possible to demonstrate that the gains or losses on a specific derivative financial instrument are directly attributable to a particular qualifying asset, rather than being used by the entity to manage its interest rate exposure on a more general basis.

Note that the discussions above mainly relate to derivative financial instruments entered into to manage the interest rate risk on specific borrowings.

How we see it

In our view, the same methods and considerations can be applied when determining the borrowing costs eligible for capitalisation when derivative financial instruments were entered into to manage the interest rate risk in relation to general borrowings.

Whichever policy is chosen by an entity, it needs to be consistently applied in similar situations.

3.4.5.B Gains and losses on derecognition of borrowings

If an entity repays borrowings early, in whole or in part, then it might recognise a gain or loss on the early settlement. Such gains or losses include amounts attributable to expected future interest rates; in other words, the settlement includes an estimated prepayment of the future cash flows under the instrument. The gain or loss is a function of relative interest rates and how the interest rate of the instrument differs from current and anticipated future interest rates. There might be circumstances in which a loan is repaid while the qualifying asset is still under construction. Section 25 does not address this issue.

Section 11 requires that gains and losses on extinguishment of debt must be recognised in profit or loss (see Chapter 13 at 7.4.3).

How we see it

In our view, gains and losses on derecognition of borrowings are not eligible for capitalisation. It would be extremely difficult to determine an appropriate amount to capitalise and it would be inappropriate thereafter to capitalise any interest amounts (on specific or general borrowings) if doing so would amount to double counting. Decisions to repay borrowings early are not usually directly attributable to the qualifying asset but to other circumstances of the entity.

The same approach would be applied to gains and losses arising from a refinancing when there is a substantial modification of the terms of borrowings as this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability (see Chapter 13 at 7.4.2 to 7.4.3).

3.4.5.C Gains or losses on termination of derivative financial instruments

If an entity terminates a derivative financial instrument, for example, an interest rate swap, before the end of the term of the instrument, it will usually have to either make a payment or receive a payment, depending on the fair value of the instrument at that time. The fair value is typically based on expected future interest rates; in other words it is an estimated prepayment of the future cash flows under the instrument.

The treatment of the gain or loss for the purposes of capitalisation will depend on the following:

- The basis on which the entity capitalises the gains and losses associated with derivative financial instruments attributable to qualifying assets (see 3.4.5.A above).

And

- Whether the derivative is associated with a borrowing that has also been terminated.

Entities must adopt a treatment that is consistent with their policy for capitalising the gains and losses from derivative financial instruments that are attributable to qualifying assets (see 3.4.5.A above).

The accounting under Section 12 will differ depending on whether the instrument has been designated as a hedge or not. Assuming the instrument has been designated as a cash flow hedge and that the borrowing has not also been repaid, the entity will usually maintain the cumulative gain or loss on the hedging instrument, subject to reclassification to profit or loss during the same period that the hedged cash flows affect profit or loss. In such a case, the amounts that are reclassified from other comprehensive income will be eligible for capitalisation for the remainder of the period of construction. On the other hand, if the borrowing has been repaid, the cumulative gain or loss in the cash flow hedge equity reserve will be reclassified immediately to profit or loss and will not be eligible for capitalisation. This aligns to the view that gains and losses on derecognition of borrowings are not eligible for capitalisation (see section 3.4.5.B above).

Similarly, assuming the instrument has been designated as a fair value hedge and that the borrowing has not also been repaid, entities would continue to recognise the cumulative gain or loss on the hedging instrument in the carrying amount of the hedged item and this amount would form part of the ongoing determination of amortised cost of the financial liability using the effective interest rate method. Interest expense calculated using the effective interest method is eligible for capitalisation for the remainder of the period of construction (see 3.1 above).

If the entity has not applied hedge accounting for the derivative financial instrument and the borrowing has not also been repaid, but the entity considers it to be directly attributable to the construction of the qualifying asset then it will have to consider whether part of the gain or loss relates to a period after construction is complete.

If the underlying borrowing is also terminated then the gain or loss will not be capitalised and the treatment will mirror that applied on derecognition of the borrowing, as described at 3.4.5.B above.

3.4.5.D Dividends payable on shares classified as financial liabilities

An entity might finance its operations in whole or in part by the issue of preference or other types of shares and in some cases, these will be classified as financial liabilities (see Chapter 12). In some circumstances the dividends payable on these instruments would meet the definition of borrowing costs. For example, an entity might have funded the development of a qualifying asset by issuing preference shares that are classified as financial liabilities under Section 22. In this case, the 'dividends' would be treated as interest and meet the definition of borrowing costs and therefore could be capitalised following the principles on specific borrowings discussed at 3.4.2 above.

Companies with outstanding preference shares which are treated as liabilities under Section 22 might subsequently obtain a qualifying asset. In such cases, these preference share liabilities would be considered to be part of the company's general borrowings. The related 'dividends' would meet the definition of borrowing costs and could be capitalised following the principles on general borrowings discussed at 3.4.3 above - i.e., that they are directly attributable to a qualifying asset.

Capitalisation of dividends or other payments made in respect of any instruments that are classified as equity in accordance with Section 22 is not appropriate as these instruments would not meet the definition of financial liabilities. In addition, as discussed at 3.1 above, Section 25 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

3.4.6 Capitalisation of borrowing costs in hyperinflationary economies

While Section 31 *Hyperinflation* provides guidance on situations where an entity's functional currency is the currency of a hyperinflationary economy, it does not provide specific guidance on the impact of inflation to accounting for borrowing costs. Thus, under the GAAP hierarchy in Section 10 (see Chapter 9 at 3.1) entities may wish to consider the specific guidance in IFRS. Under IFRS, in situations where IAS 29 *Financial Reporting in Hyperinflationary Economies* applies, an entity needs to distinguish between borrowing costs that compensate for inflation and those incurred in order to acquire or construct a qualifying asset.

[IAS 29.21].

IAS 29 states that "the impact of inflation is usually recognised in borrowing costs. It is not appropriate both to restate the capital expenditure financed by borrowing and to capitalise that part of the borrowing costs that compensates for the inflation during the same period. This part of the borrowing costs is recognised as an expense in the period in which the costs are incurred." [IAS 29.21].

Accordingly, IAS 23 specifies that when an entity applies IAS 29, the borrowing costs that can be capitalised must be restricted and the entity must expense the part of borrowing costs that compensates for inflation during the same period in accordance with paragraph 21 of IAS 29 (as described above).

[IAS 23.9].

Detailed discussion and requirements of IAS 29 can be found in the EY publication, International GAAP®.

3.4.7 Group considerations

3.4.7.A Borrowings in one company and development in another

A question that can arise in practice is whether it is appropriate to capitalise interest in the group financial statements on borrowings that appear in the financial statements of a different group entity from that carrying out the development.

How we see it

Based on the underlying principle of Section 25, capitalisation in such circumstances would only be appropriate if the amount capitalised fairly reflected the interest cost of the group on borrowings from third parties that could have been avoided if the expenditure on the qualifying asset was not made.

Although it would be appropriate to capitalise interest in the group financial statements, if that policy choice was taken, the entity carrying out the development must not capitalise any interest if it has no borrowings in its own financial statements. If, however, the entity has intra-group borrowings or other external borrowings then interest on such borrowings would be capitalised in its own financial statements.

3.4.7.B Qualifying assets held by joint ventures

A number of sectors carry out developments through joint ventures (see Chapter 18) - this is particularly common with property developments. In such cases, the joint venture might be financed principally by equity and the joint venturers might have financed their participation in this equity through borrowings.

In situations where the joint venture is classified as a jointly controlled entity (JCE) in accordance with Section 15 *Investments in Joint Ventures*, it is not appropriate to capitalise interest suffered in the JCE on the borrowings of the venturers as the interest charge is not a cost of the JCE. Neither would it be appropriate to capitalise interest in the financial statements of the venturers, whether in separate or consolidated financial statements, because the qualifying asset does not belong to them. The investing entities have an investment in a financial asset (i.e., an equity instrument of another entity) which is excluded by Section 25 from being a qualifying asset (see 3.3 above).

In situations where loans and borrowings exist between the reporting entity and a joint venture, see discussion in Chapter 18 at section 3.7.3.

In situations where the joint venture is classified as a jointly controlled operation (JCO) or jointly controlled assets (JCA) in accordance with Section 15 and the venturers are accounting for their own and their share of the assets, liabilities, revenue and expenses of the JCO or JCA, then the venturers can choose to capitalise borrowing costs incurred that relate to their own qualifying asset or their share of any qualifying asset. Borrowing costs eligible for capitalisation would be based on the venturer's obligation for the loans of such JCO or JCA together with any direct borrowings of the venturer itself if the venturer funds part of the acquisition of such joint venture's qualifying asset.

3.5 Commencement, suspension and cessation of capitalisation

3.5.1 Commencement of capitalisation

Section 25 requires that an entity capitalise borrowing costs as part of the cost of a qualifying asset from the point when the entity first meets all of the following conditions:

- It incurs expenditure on the asset.
- It incurs borrowing costs.

And

- It undertakes activities necessary to prepare the asset for its intended use or sale. [FRS 102.25.2D(a)].

Section 25 has no further guidance on 'activities necessary to prepare an asset for its intended use or sale'. However, some guidance is provided by IAS 23 which states that the activities necessary to prepare an asset for its intended use or sale can include more than the physical construction of the asset. Necessary activities can start before the commencement of physical construction and include, for example, technical and administrative work such as the activities associated with obtaining permits prior to the commencement of the physical construction. [IAS 23.19]. However, the general principle in capitalisation and recognition of an asset apply, therefore, borrowing costs are only capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably [IAS 23.9]. Borrowing costs cannot be capitalised if the permits that are necessary for the construction are not expected to be obtained.

How we see it

In assessing whether borrowing costs can be capitalised in advance of obtaining permits - assuming the borrowing costs otherwise meet the criteria - a judgement must be made, at the date the expenditure is incurred, as to whether it is sufficiently probable that the relevant permits will be granted.

In line with the discussion above, if during the application and approval process of such permits it is no longer expected that the necessary permits will be granted, capitalisation of borrowing costs must cease, any related borrowing costs that were previously capitalised written off in accordance with Section 27 *Impairment of Assets* and accordingly, the carrying amount of any related qualifying asset subject to development or redevelopment (or, if appropriate, the cash generating unit where such an asset belongs) will be tested for impairment, where applicable (see 3.5.2.A below).

Borrowing costs cannot be capitalised during a period in which there are no activities that change the condition of the asset. For example, a house-builder or property developer would not capitalise borrowing costs on its 'land bank' i.e., that land which is held for future development. Borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity represent a holding cost of the land. Such costs do not qualify for capitalisation and hence would be considered a period cost (i.e., expensed as incurred). [IAS 23.19].

An entity might make a payment to a third-party contractor before that contractor commences construction activities. It is unlikely to be appropriate to capitalise borrowing costs in such a situation until the contractor commences activities that are necessary to prepare the asset for its intended use or sale. However, that would not preclude the payment being classified as a prepayment until such time as construction activities commence.

3.5.2 Suspension of capitalisation

An entity might incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. In such a case, Section 25 states that capitalisation of borrowing costs must be suspended during extended periods in which active development of the asset has paused. [FRS 102.25.2D(b)]. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, no further guidance is provided. For example, Section 25 does not distinguish between extended periods of interruption (when capitalisation would be suspended) and periods of temporary delay that are a necessary part of preparing the asset for its intended purpose (when capitalisation is not normally suspended).

Applying guidance provided by IAS 23, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. Also, capitalising borrowing costs would not be suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation would continue during the extended period in a situation where construction of a bridge is delayed by temporary adverse weather conditions or high-water levels, if such conditions are common during the construction period in the geographical region involved. [IAS 23.21]. Similarly, capitalisation continues during periods when inventory is undergoing slow transformation - for example, inventories taking an extended time to mature such as Scotch whisky or Cognac.

Borrowing costs incurred during extended periods of interruption caused, for example, by a lack of funding or a strategic decision to hold back project developments during a period of economic downturn are not considered a necessary part of preparing the asset for its intended purpose and must not be capitalised. Other circumstances might not be as straightforward as the examples described above.

How we see it

The nature of the interruption, its duration, and the level of development activities during such period will inform the determination as to whether the delay is a necessary part of the process of bringing the qualifying asset ready for its intended use or sale (and therefore, whether continuous capitalisation of eligible borrowing costs during such period is appropriate). This will require judgement to be exercised based on particular facts and circumstances. Disclosure of this judgement is required if it is significant to the understanding of the financial statements.

3.5.2.A Impairment considerations

When it is determined that capitalisation is appropriate, an entity continues to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the asset even if the capitalisation causes the expected ultimate cost of the asset to exceed its net realisable value (for inventories that are qualifying assets) or recoverable amount (for all other qualifying assets).

When the carrying amount of the qualifying asset exceeds its recoverable amount or net realisable value (depending on the type of asset), the carrying amount of the asset must be written down or written off in accordance with the Section 27 (see Chapter 29). In certain circumstances, the amount of the write-down or write-off is written back in accordance with Section 27. Section 25 does not have specific guidance in instances where an asset is incomplete thus, an entity may wish to consider the related guidance in IFRS. Under IAS 23, if the asset is incomplete, the impairment assessment is performed by considering the expected ultimate cost of the asset. [IAS 23.16]. The expected ultimate cost, which will be compared to recoverable amount or net realisable value, must include costs to complete and the estimated capitalised interest thereon.

3.5.3 Cessation of capitalisation

Section 25 requires capitalisation of borrowing costs to cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. *[FRS 102.25.2D(c)]*.

IAS 23 provides additional guidance that may be useful in assisting preparers of financial statements as to when a qualifying asset is considered as complete, including when such assets are completed in parts.

IAS 23 states that an asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete. *[IAS 23.23]*.

How we see it

In some cases, there might be a requirement for inspection (e.g., to ensure that the asset meets safety requirements) before the asset can be used. Usually 'substantially all the activities' would have been completed before this point in order to be ready for inspection. In such a situation, capitalisation would cease prior to the inspection.

When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation must cease for the borrowing costs on the portion of borrowings attributable to that part when substantially all the activities necessary to prepare that part for its intended use or sale are completed. *[IAS 23.24]*. An example of this might be a business park comprising several buildings, each of which is capable of being fully utilised individually while construction continues on other parts. *[IAS 23.25]*. This principle also applies to single buildings where one part is capable of being fully utilised even if the building as a whole is incomplete (for example, individual floors of a high-rise office building).

For a qualifying asset that needs to be complete in its entirety before any part can be used as intended, it would be appropriate to capitalise related borrowing costs until all the activities necessary to prepare the entire asset for its intended use or sale are substantially complete. An example of this is an industrial plant, such as a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site. *[IAS 23.25]*. However, other circumstances may not be as straightforward.

How we see it

Because neither IAS 23 nor IAS 16 provide guidance on what constitutes a 'part', it will therefore depend on particular facts and circumstances and would require the exercise of judgement as to what constitutes a 'part'. Disclosure of this judgement is required if it is significant to the understanding of the financial statements.

3.5.3.A Borrowing costs on 'land expenditures'

An issue may arise about when an entity ceases capitalising borrowing costs on land, for example, consider the fact pattern below:

- An entity acquires and develops land and thereafter constructs a building on that land - the land represents the area on which the building will be constructed.
 - Both the land and the building meet the definition of a qualifying asset.
- And
- The entity uses general borrowings to fund the expenditures on the land and construction of the building.

The issue is whether the entity ceases capitalising borrowing costs incurred in respect of expenditures on the land ('land expenditures') once it starts constructing the building or whether it continues to capitalise borrowing costs incurred in respect of land expenditures while it constructs the building.

How we see it

In our view, in applying Section 25 to determine when to cease capitalising borrowing costs incurred on land expenditures, an entity considers:

- The intended use of the land.
And
- In applying paragraph 25.2D(c) of FRS 102, whether the land is capable of being used for its intended purpose while the construction continues on the building.

Land and buildings are used for owner-occupation (and therefore recognised as property, plant and equipment applying Section 17 *Property, Plant and Equipment*); rent or capital appreciation (and therefore recognised as investment property applying Section 16 *Investment Property*); or for sale (and therefore recognised as inventory applying Section 13 *Inventories*). The intended use of the land is not simply for the construction of a building on the land, but rather to use it for one of these three purposes.

If the land is not capable of being used for its intended purpose while construction continues on the building, the entity considers the land and the building together to assess when to cease capitalising borrowing costs on the land expenditures. In this situation, the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and building for that intended use or sale are complete (see 3.5.3 above).

The above issue was also discussed by the Interpretations Committee in its June 2018²²⁴ and September 2018²²⁵ meetings and a similar conclusion was reached.

²²⁴ [IFRIC Update](#), June 2018, available on the IFRS Foundation's website.

²²⁵ [IFRIC Update](#), September 2018, available on the IFRS Foundation's website.

4 Disclosures

The disclosure requirements of Section 25 are set out at 4.1 below. Disclosures in respect of borrowing costs required by other sections of FRS 102 and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 ('The Regulations') in respect of borrowing costs are set out at 4.2 and 4.3 below.

4.1 Disclosures required by Section 25

When a policy of capitalising borrowing costs is not adopted, Section 25 does not require any additional disclosure. [FRS 102.25.3]. However, other sections of FRS 102 require certain disclosures in respect of borrowing costs (see 4.2 below).

Where a policy of capitalisation is adopted, an entity must disclose:

- The amount of borrowing costs capitalised in the period.
- And
- The capitalisation rate used. [FRS 102.25.3A].

4.2 Disclosures required by other sections of FRS 102 in respect of borrowing costs

In addition to the disclosure requirements in Section 25, an entity may need to disclose additional information in relation to its borrowing costs in order to comply with requirements in other sections of FRS 102. These include:

- Presentation requirements for items of profit or loss including interest payable, are addressed by Section 5 *Statement of Comprehensive Income and Income Statement* (see Chapter 6). [FRS 102.5.5, 5.5B].
- Disclosure of total interest expense (using effective interest method for financial liabilities that are not at fair value through profit or loss) is required by Section 11 (see Chapter 15 at 4.1). [FRS 102.11.48(b)].
- And
- Section 8 (see Chapter 6) requires disclosure of the following:
 - The measurement bases used in preparing the financial statements and other accounting policies used that are relevant to an understanding of the financial statements (e.g., clear policy to adopt capitalisation of borrowing costs). [FRS 102.8.5].
 - And
 - The significant judgements made in the process of applying an entity's accounting policies that have the most significant effect on the recognised amounts (e.g., criteria in determining a qualifying asset or a 'part' of a qualifying asset, including definition of 'substantial period of time'; determination of capitalisation rate; and treatment of foreign exchange gains and losses as part of borrowing costs, including any derivatives used to hedge such foreign exchange exposures). [FRS 102.8.6].

4.3 Additional disclosures required by The Regulations

Where a policy of capitalisation is adopted, The Regulations require an entity to disclose in the notes: [1 Sch 27(3), 2 Sch 35(3), 3 Sch 45(3)]

- The fact that interest is included in determining the production cost of the qualifying asset (usually achieved by a clear accounting policy - see 3.6.2 above).
- And
- The aggregate amount of interest so included in the cost of qualifying assets.

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for borrowing costs are set out below.

	FRS 102	IFRS
Scope	Section 25 applies to all 'qualifying assets' which is defined in the same way as IAS 23 except it has no reference to 'bearer plants'. Instead, qualifying assets include biological asset (a living animal or plant that may or may not be intended for use on a continuing basis in the entity's activities).	IAS 23 applies to all qualifying assets and has same definition of qualifying asset as FRS 102 except that it includes biological assets that meet the definition of bearer plants.
Capitalisation of borrowing costs	Capitalisation of eligible borrowing costs in respect of qualifying assets is a policy choice (i.e., optional).	Capitalisation of eligible borrowing costs is mandatory. However, IAS 23 need not be applied to a qualifying asset measured at fair value or inventories that are manufactured or otherwise produced, in large quantities on a repetitive basis.
	Where an entity adopts a policy of capitalisation of borrowing costs, it must be applied consistently to a class of qualifying assets.	An accounting policy choice exists only for a qualifying asset measured at fair value or inventories that are manufactured or otherwise produced, in large quantities on a repetitive basis. Capitalisation of eligible borrowing costs is mandatory for all other qualifying assets.
	There is no guidance concerning the impact of inflation to the treatment of borrowing costs when an entity's functional currency is the currency of a hyperinflationary economy.	When an entity applies IAS 29, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period.
Capitalisation rate	The capitalisation rate is the weighted average of rates applicable to 'general borrowings' outstanding in the period. This excludes borrowings made specifically for the purpose of obtaining other qualifying assets, until substantially all the activities necessary to prepare that asset for its intended use or sale are complete, and non-qualifying assets.	The capitalisation rate is the weighted average of the borrowing costs applicable to borrowings outstanding in the period other than borrowings made specifically for the purpose of obtaining a qualifying asset. This means that specific borrowings to acquire non-qualifying assets would be included in the computation.
	For purposes of applying the capitalisation rate to the expenditure on the qualifying asset, the expenditure on asset is the average carrying amount of the asset during the period, including borrowing costs previously capitalised.	Expenditures on a qualifying asset are explicitly limited to those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities and reduced by any progress payments received and grants received in connection with the asset. However, IAS 23 accepts that, when funds are borrowed generally, the average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the

FRS 102		IFRS
		expenditure to which the capitalisation rate is applied in that period.
Commencement, suspension and cessation of capitalisation	There is no guidance on 'activities that are necessary to prepare the asset for its intended use or sale'. However, we expect entities will follow the guidance under IFRS.	Additional guidance is provided e.g., borrowing costs incurred are expensed if the asset is held without any associated development activities i.e., activities that change the physical condition of the asset.
	There is no guidance about treatment of borrowing costs in periods of temporary delay. However, we expect entities will follow the guidance under IFRS.	Capitalisation is not normally suspended when substantial technical and administrative work are being carried out or when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.
	There is no guidance about cessation of capitalisation of borrowing costs for qualifying assets being constructed in parts. However, we expect entities will follow the guidance under IFRS.	Explicit guidance is provided for construction of a qualifying asset in parts and each part is capable of being used or sold while construction continues on other parts.
Disclosures	If the company adopts a policy of capitalising borrowing costs, disclosure is required of the amount of borrowing costs capitalised during the period and the capitalisation rate used. It also needs to disclose the aggregate amount of interest so included in the cost of qualifying assets.	An entity must disclose the amount of borrowing costs capitalised during the period and the capitalisation rate used.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

asset	A present economic resource controlled by the entity as a result of past events.
borrowing costs	Interest and other costs incurred by an entity in connection with the borrowing of funds.
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.
effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
expenses	Decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A Fair Value Measurement shall be used in determining fair value.
financial liabilities	Any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
profit or loss	The total of income less expenses, excluding the components of other comprehensive income.
qualifying asset	An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets: (a) inventories; (b) manufacturing plants; (c) power generation facilities; (d) intangible assets; (e) investment properties; and (f) biological assets.

Extract from FRS 102

Financial assets, and inventories that are produced over a short period of time, are not qualifying assets.

Assets that are ready for their intended use or sale when acquired are not qualifying assets.

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Chapter 28

Share-based payment

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Overview

This chapter discusses the requirements of Section 26 *Share-based Payment* ('Section 26'), that provides accounting requirements when an entity enters into a share-based payment transaction that includes an entity receiving goods or services from a supplier of those goods or services in a share-based payment arrangement or incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives the goods or services. Where the supplier of the goods or services receives; cash or assets of an entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or equity instruments (including shares or share options) of the entity or another group entity, when vesting conditions are met, such an arrangement would be in scope of Section 26.

Section 26 is applied in accounting for all share-based payment transactions, whether an entity can identify specifically some, or all, of the goods or services received. Share-based payment transactions include equity-settled share-based payments, cash-settled share-based payments and those transactions where the entity or the supplier has a choice of settlement in cash or equity instruments.

Section 26 is also applied to share-based payment transactions where the transaction is settled by another group entity (or a shareholder), in such instances Section 26 applies to the recipient group entity of the goods or services and the group entity (or shareholder) settling the transaction.

The recognition rules in Section 26 are based on a so-called 'service date model'. In other words, Section 26 requires the goods or services received or acquired in a share-based payment transaction to be recognised when the goods are acquired or the services rendered. However, for awards to employees (or others providing similar services), the measurement rules require a share-based payment transaction to be measured at the date on which the transaction was entered into (grant date model), whereas a transaction with non-employees, is measured at the service date.

The point at which the cost is recognised for goods or services in a share-based payment arrangement depends on the concept of 'vesting'. A share-based payment arrangement vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions (service or performance condition). The cost is recognised during the vesting period, which is the period that all vesting conditions for the share-based payment arrangement are to be satisfied.

Section 26 contains accounting requirements for vesting conditions and conditions that are not vesting conditions ('non-vesting conditions'), in addition to accounting requirements for modification and cancellation of share-based payment transactions. The modification and cancellation accounting requirements equally apply to the replacement of awards in a business combination applying Section 19 *Business Combinations and Goodwill*.

Section 26, in many respects contains rules-based 'anti-avoidance' guidance, which often requires an expense to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty actually has no entitlement at all.

Most share-based payment transactions undertaken by entities are awards of shares and options as remuneration to employees, in particular senior management and directors. For this reason, the main focus of this chapter is accounting for share-based payment transactions with employees. Other forms of employee benefits that are not share-based payment transactions would fall within the scope of Section 28 *Employee Benefits*, as discussed in Chapter 30.

What you need to know

- An entity applies Section 26 when the entity receives goods or services in a share-based payment transaction that is settled by the entity itself, another group entity or shareholder.
- An entity settling a share-based payment transaction when another group entity receives the goods or services is in scope of Section 26.
- Section 26 applies whether an entity can identify specifically some, or all, of the goods or services received.
- Awards to employees and others providing similar services are measured using the 'grant date model', whereas services provided by others and goods acquired are measured using the 'service date model' for the share-based payment arrangement.
- The cost is recognised over the vesting period, which is the period that all vesting conditions are satisfied.
- Vesting conditions include service conditions or performance conditions. Share-based payment arrangements can also contain non-vesting conditions.
- Section 26 contains specific rules on accounting for modification and cancellation of share-based payment transactions.
- Section 26 in many respects contains rules-based 'anti-avoidance' guidance, which often requires an expense to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty has no entitlement at all.

1 Introduction

1.1 Background

Most share-based payment transactions undertaken by entities are awards of shares and options as remuneration to employees, in particular senior management and directors. One advantage of shares and options as remuneration is that they need not entail any cash cost to the entity. If an executive is entitled under a bonus scheme to a free share, the entity can satisfy this award simply by printing another share certificate, which the executive can sell, so that the cash cost of the award is effectively borne by shareholders rather than by the entity itself. However, this very advantage was the source of controversy surrounding share-based remuneration.

Investors became increasingly concerned that share-based remuneration was resulting in a significant cost to them, through dilution of their existing shareholdings. As a result, there emerged an increasing consensus among investors that awards of shares and share options must be recognised as a cost in the financial statements.

Accounting for share-based payment transactions is addressed in Section 26 *Share-based Payment*. However, many of the requirements of Section 26 are virtually impossible to interpret without recourse to IFRS 2 *Share-based Payment*, from which many of the requirements and definitions of Section 26 were ultimately derived.

The IASB published IFRS 2 in February 2004. There have been three subsequent sets of amendments to IFRS 2 as well as further clarifications through the IASB's Annual Improvements process.

In September 2024, the FRC issued amendments to FRS 102 ('Periodic Review 2024') which resulted in Section 26 being more converged with IFRS 2. The key differences between Section 26 and IFRS 2 are explained in this chapter (see 2 below).

The key changes to Section 26, arising from the Periodic Review 2024 can be summarised as follows:

- Consistent with IFRS 2, Section 26 clarifies that equity instruments issued in a business combination in exchange for control of the acquiree are not in scope of Section 26. However, equity instruments issued, cancelled or modified to employees of the acquiree in their capacity as employees are in scope of Section 26. Previously, Section 26 was silent on this matter.
- There is additional guidance on the settlement of a share-based payment transaction, requiring that the payment made be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments that would otherwise have been issued, measured at the settlement or repurchase date. Any such excess is recognised as an expense. The guidance now aligns more closely to IFRS 2.
- There is clarification that cash-settled share-based payment transactions are measured at fair value, with guidance provided explaining how to account for vesting conditions and conditions that are not vesting conditions. The guidance is consistent with IFRS 2.

And

- For share-based payment transactions that contain a net settlement feature where there is an obligation on the entity under tax laws or regulations to withhold an amount for an employee's tax obligation associated with that share-based payment, the transaction is accounted for as wholly equity-settled (for the amount that relates to the employee's tax obligation and no more) rather than cash-settled. This guidance is consistent with IFRS 2.

These amendments have been incorporated in the discussions within this chapter.

1.2 Scope of Chapter 28 and referencing convention

This chapter discusses the requirements of Section 26 for entities applying FRS 102 in accounting periods beginning on or after 1 January 2026. It is based on the September 2024 version of FRS 102 which is referred to as 'FRS 102' throughout this chapter.

As noted at 1.1 above, the requirements of Section 26 are virtually impossible to interpret without recourse to IFRS 2, which contains extensive application and implementation guidance. Without this guidance, the practical application of the requirements of Section 26 is difficult and we therefore draw on the guidance in IFRS 2 as part of the explanations in this chapter, applying the hierarchy on selecting accounting policies as set out in Section 10 Accounting Policies, Estimates and Errors (see Chapter 9 at 3.1).

The application of Section 26, and IFRS 2, to a variety of practical situations is unclear. Whilst this chapter addresses some of the complexities, other areas of discussion are beyond the scope of this publication. EY's publication International GAAP® includes a more detailed analysis in certain areas, as indicated within this chapter.

1.3 Overall approach to Section 26

The overall approach to accounting for share-based payment transactions is complex, in part because it is something of a hybrid. Essentially the total cost (i.e., measurement) of an award is calculated by determining whether the award is a liability or an equity instrument, using criteria somewhat different from those used in accounting for financial instruments but then applying measurement principles based on those generally applicable to financial liabilities or equity instruments. However, the periodic allocation (i.e., recognition) of the cost is determined using something closer to a straight-line accruals methodology, which would not generally be used for financial instruments. For convenience, throughout this chapter we refer to the recognition of a cost for share-based payments. In some cases, however, a share-based payment transaction may initially give rise to an asset (e.g., where employee costs are capitalised as part of the cost of PP&E or inventories).

This approach inevitably results in transactions, which convey the same value to the recipients, but which have different legal forms, having several different potential charges in profit or loss. Moreover, many of the requirements are rules derived from the 'anti-avoidance' approach of IFRS 2. This means that an expense often has to be recorded for transactions that either have no ultimate value to the counterparty or to which, in some cases, the counterparty actually has no entitlement at all.

1.3.1 Classification differences between share-based payments and financial instruments

As noted above, not only are there differences between the accounting treatment of liabilities or equity in a share-based payment transaction as compared with that of other transactions involving liabilities or equity instruments (Section 22 Liabilities and Equity), but the classification of a transaction as a liability or equity transaction may differ.

The most important difference is that a share-based payment transaction involving the delivery of equity instruments is always accounted for as an equity transaction, whereas a similar transaction outside the scope of the share-based payment accounting requirements might well be classified as a liability if the number of shares to be delivered varies.

2 Comparison between Section 26 and IFRS

As a result of the Periodic Review 2024 amendments to Section 26 some differences with IFRS have been eliminated by providing additional guidance to assist in applying the principles and promoting greater consistency with IFRS. This section summarises the remaining principal differences between Section 26 and the requirements of IFRS 2. In some of the areas referred to below, the difference between the standards is explicit, but there are others where the lack of guidance or explanation in Section 26 means that it is unclear whether a different accounting treatment is intended.

All the areas below, which set out the differences, are addressed in more detail in the remainder of this chapter, as indicated.

2.1 Scope

2.1.1 Definitions and transactions within scope

Unlike IFRS 2, Section 26 does not provide guidance or examples in areas such as:

- The meaning of 'goods' in 'goods and services' when used in the definition of a share-based payment transaction.
 - Vested transactions.
 - Transactions with shareholders as a whole.
 - The interaction with the requirements of FRS 102 relating to financial instruments.
- And
- The contribution of a business on formation of a joint venture.

The differences are discussed in more detail at 3.2 and 3.3 below.

2.2 Recognition

2.2.1 Accounting after vesting date

FRS 102 includes no guidance on accounting for awards after vesting, whereas IFRS 2 specifically prohibits a reversal of expense (see 7.1.3 below).

2.2.2 Equity instruments vesting in instalments ('graded' vesting)

The implementation guidance of IFRS 2 requires that the graded vesting accounting approach be used for equity instruments vesting in instalments. Section 26 does not explicitly require this approach as there is no similar guidance, as such, a simpler alternative may be acceptable (see 7.2.2 below).

2.3 Measurement of equity-settled share-based payment transactions

2.3.1 Non-vesting conditions

Section 26 refers to 'conditions that are not vesting conditions' and that is a term which is neither defined in FRS 102 or IFRS 2. IFRS 2 however includes examples of such conditions as part of its implementation guidance (see 4 and 7 below).

Section 26 provides an example of a condition that is not a vesting condition, such as a condition that an employee contributes to a saving plan, which is one of the examples provided in the implementation guidance of IFRS 2 as a non-vesting condition.

How we see it

We believe that both terms, 'non-vesting conditions' and 'conditions that are not vesting conditions', are similar and we will refer to the terms interchangeably throughout this chapter.

2.3.2 Employees and others providing similar services

Both Section 26 and IFRS 2 distinguish between awards to employees (and others providing similar services) and those to other parties providing goods or services. The recognition and measurement of equity-settled share-based payment transactions differ according to whether the counterparty is treated as an employee including others providing similar services.

Section 26 provides no additional guidance on the meaning of 'others providing similar services' whereas IFRS 2 defines/explains this term in Appendix A (see 6.2.1 below).

In dealing with the recognition and measurement of share-based payments, FRS 102 sometimes refers only to employees without specifying the treatment for non-employee awards. In such cases, we assume that a similar accounting treatment is intended for non-employee awards.

2.3.3 Valuation methodology

IFRS 2 requires the use of a market price or an option pricing model for the valuation of equity-settled share-based payment transactions. FRS 102 draws a more explicit distinction than IFRS 2 between the valuation of shares and the valuation of options and appreciation rights. Section 26 specifies the following valuation hierarchy:

- Observable market price
- Entity-specific observable market data

And

- Directors' valuation using a generally accepted methodology,
- and gives limited examples for both shares and options/appreciation rights of the type of approach that might be taken. [FRS 102.26.10, FRS 102.26.11]. Section 26 does not mandate the use of an option pricing model for the valuation of share options when market prices are unavailable; instead, it allows use of a valuation methodology 'such as an option pricing model'.

In practical terms, it is not entirely clear what alternatives to an option pricing model are likely to provide a reliable indication of the fair value (see 9.2 and 9.3 below).

IFRS 2 includes guidance in Appendix B about the selection and application of option pricing models, none of which is reproduced in FRS 102 (see 9 below).

2.3.4 Awards where fair value cannot be measured reliably

Section 26 assumes as part of its requirements relating to the measurement of equity-settled share-based payment transactions that it will always be possible to derive a fair value for the award (see 9.2 and 9.3 below). IFRS 2 includes an approach based on the intrinsic value of the equity instruments for the 'rare cases' in which an entity is unable to measure reliably the fair value of those instruments. [IFRS 2.24]. The intrinsic value approach is not addressed in this chapter.

2.3.5 Cancellation of awards

IFRS 2 makes clear that an award may be cancelled either by the entity or by the counterparty and that a failure to meet non-vesting conditions must, in certain situations, be considered to amount to the cancellation of an award. Section 26 includes no explicit requirements to mirror those in IFRS 2 (see 7.4.3 and 8.4 below).

2.3.6 Replacement awards following a cancellation or settlement

Section 26 includes no guidance on the accounting treatment of equity-settled awards to replace an award cancelled during the vesting period and whether, as under IFRS 2, they may be accounted for based on their incremental fair value rather than being treated as a completely new award (see 8.4.4 below).

2.4 Share-based payment transactions with cash alternatives

2.4.1 Entity or counterparty has choice of equity or cash settlement

Where the counterparty has a choice of settlement in equity or cash, Section 26 requires the entity to account for the transaction as wholly cash-settled unless the choice of settlement in cash has no commercial substance (in which case the transaction is accounted for as wholly equity-settled). IFRS 2 requires a split accounting approach (between a liability and equity) for such arrangements (see 11.2 below).

There are no significant differences between the classification requirements of Section 26 and those of IFRS 2 for transactions where the entity has a choice of equity or cash settlement.

2.4.2 Settlement of an award with cash alternatives when the entity has choice of settlement

Section 26 contains no guidance on how to account for the settlement in equity of an award accounted for as cash-settled. This is similar to IFRS 2, however it is clear from other provisions in IFRS 2 on how to account for the settlement in equity of cash-settled accounted transactions (see 11.1.1 below).

When an entity settles in cash an award that has been accounted for as equity-settled, where that award provides an entity with a choice of settlement, paragraph 13A of Section 26 requires the payment made to be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments that would otherwise have been issued, measured at the settlement date, with any excess recognised as an expense. This is different from IFRS 2, which requires an entity that has accounted for the transaction as equity-settled to recognise an additional expense for the excess value provided on settlement if the entity chooses the settlement alternative with a higher value. The excess value provided is the difference between cash paid and the fair value of the equity instruments that would have been issued. If settled in equity, as that has the higher value, the excess value provided is the difference between the fair value of the equity instruments issued and the amount of the cash that would have been paid (see 11.1.1.B below).

2.5 Modification of award from equity-settled to cash-settled and vice versa

Section 26 contains no guidance when an equity-settled award is modified to cash-settled or *vice versa*. Whilst IFRS 2 also does not contain guidance on when an equity-settled award is modified to cash-settled, it does contain specific guidance when a cash settled award is modified to equity-settled.

IFRS 2 requires on modification from a cash-settled award to an equity-settled award, that the equity-settled award is measured at modification date, with a credit to equity to the extent goods or services have been received, the liability is derecognised, with the difference between the two amounts recognised immediately in profit or loss (i.e., the difference between the carrying amount of the liability derecognised and the amount recognised in equity on modification date). This IFRS 2 accounting approach also applies when a cash-settled award is cancelled, and an equity-settled award granted is identified as a replacement for that cancelled cash-settled award (see 8.3.5 and 10.4 below).

2.6 Group plans - alternative accounting treatment

Where a share-based payment award is granted by an entity to the employees of one or more members of a group, those members are permitted, as an alternative to the general measurement requirements of Section 26, to measure the share-based payment expense based on a reasonable allocation of the group expense (see 13.2.3.A below). There is no corresponding alternative treatment in IFRS 2.

2.7 Unidentifiable goods or services in Government-mandated plans

For certain government-mandated plans where the goods or services received or receivable in exchange for equity instruments are not identifiable, Section 26 requires the award to be valued based on the equity instruments rather than the goods or services. Under IFRS 2, the scope is not restricted to government-mandated plans.

As the requirements are placed within the section heading 'Government-mandated plans' in Section 26, it appears that the requirements of unidentifiable goods or services are restricted only to certain government arrangements (see 3.2.3 below) and is consistent with the guidance published by the FRC²²⁶ at the time of writing this chapter.

2.8 Disclosures

The disclosure requirements of Section 26 are generally derived from, but less extensive than, those of IFRS 2. However, Section 26 has three specific requirements that are not found in IFRS 2:

- If a valuation methodology is used to determine the fair value of equity-settled awards, the entity is required to disclose both the method and reason for choosing it.
 - For cash-settled share-based payment transactions, an entity is required to disclose how the liability was measured.
- And
- Where the alternative accounting treatment is adopted for group plans, disclosure of this fact is required together with the basis of allocation.

More generally, unlike IFRS 2, FRS 102 includes exemptions from disclosure for certain entities.

The disclosure requirements are discussed at 14 below.

2.9 First-time adoption

The first-time adoption provisions of FRS 102 are set out in Section 35 *Transition to this FRS*. The specific requirements relating to share-based payments are discussed at 17 below. Unlike IFRS 1 First-time Adoption of International Financial Reporting Standards, Section 35 does not specify the accounting treatment of an award that was granted prior to transition but subsequently modified.

²²⁶ [Significant differences between FRS 102 and the IFRS for SMEs Accounting Standard](#), updated in March 2024, on the FRC's website. Accessed 16/12/2025.

3 Scope of Section 26

This section covers the scope of the share-based payment accounting requirements of Section 26 as follows:

- Definitions from Appendix I to FRS 102 that are relevant to determining whether transactions are within the scope of Section 26 (see 3.1 below).
- A discussion of transactions that fall within the scope of Section 26 (see 3.2 below) including group arrangements (see 3.2.1 below), transactions with employee benefit trusts (EBTs) and similar vehicles (see 3.2.2 below) and transactions where the consideration received might not be clearly identifiable (see 3.2.3 below).
- A discussion of transactions that fall outside the scope of Section 26 (see 3.3 below).
And
- Some examples of situations commonly encountered in practice and a discussion of whether they are within scope of Section 26 (see 3.4 below).

3.1 Definitions

The following definitions from Appendix I: Glossary to FRS 102 are relevant to the scope of Section 26.

Extract from FRS 102

Appendix I

Glossary

cash-settled share-based payment transaction	A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of the equity instruments (including shares and share options) of the entity or another group entity.
equity (equity instrument is not defined)	The residual interest in the assets of the entity after deducting all its liabilities.
equity-settled share-based payment transaction	A share-based payment transaction in which the entity: (a) receives goods or services as consideration for its own equity instruments (including shares or share options); or (b) receives goods or services but has no obligation to settle the transaction with the supplier.
group (group entity is not defined)	A parent and all its subsidiaries.
share-based payment	The equity instruments (including shares and share options), cash or other assets to which a counterparty may become entitled in a share-based payment transaction.
share-based payment arrangement	An agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive: (a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity; or (b) equity instruments (including shares or share options) of the entity or another group entity, provided the specified vesting conditions, if any, are met.

share-based payment transaction	A transaction in which the entity: (a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement; or (b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.
share option	A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specific period of time.

It will be seen from these definitions that FRS 102 applies not only to awards of shares and share options but also to awards of cash (or other assets) of a value equivalent to the value, or a movement in the value, of a particular number of shares.

3.2 Transactions within the scope of Section 26

Subject to the exceptions noted at 3.3 below, Section 26 must be applied to all share-based payment transactions, including:

- (a) Equity-settled share-based payment transactions (discussed at 5 to 9 below)
- (b) Cash-settled share-based payment transactions (discussed at 10 below)
- (c) Transactions where either the entity or the supplier of goods or services can choose whether the transaction is to be equity-settled or cash-settled (discussed at 11 below) [FRS 102.26.1]

Whilst the boundaries between these types of transaction are reasonably self-explanatory, there may be transactions, as discussed in more detail at 10 and 11 below, that an entity may intuitively regard as equity-settled which are in fact required to be treated as cash-settled.

Although most share-based payment transactions are with employees, the scope of Section 26 is not restricted to employee transactions. For example, if an external supplier of goods or services, including another group entity, is paid in shares or share options, or cash of equivalent value, Section 26 must be applied.

A share-based payment transaction as defined in FRS 102 (see 3.1 above) requires goods or services to be received or acquired, but FRS 102 does not define 'goods' or give any additional guidance as to what might be included within such a term. IFRS 2 includes the following within its scope, and it seems appropriate to use this guidance for the purposes of Section 26:

- Inventories
- Consumables
- Property, plant and equipment (PP&E)
- Intangibles
- Other non-financial assets [IFRS 2.5]

It will be seen that 'goods' do not include financial assets, which raises some further issues (see 3.3.6 below).

Although not always explicitly stated, the scope of Section 26 extends to:

- Certain transactions by other group entities and by shareholders of group entities (see 3.2.1 below).
- Transactions with employee benefit trusts ('EBTs') and similar vehicles (see 3.2.2 below).
- Certain transactions where the identifiable consideration received appears to be less than the consideration given (see 3.2.3 below).
- 'All employee' share plans (see 3.2.4 below).

Section 26 is silent on certain other transactions or arrangements, including vested transactions (see 3.2.5 below), where it is unclear whether these transactions or arrangements fall within the scope of the share-based payment accounting requirements.

In the absence of specific guidance in FRS 102 we suggest that entities follow the requirements of IFRS 2, or general practice that has evolved through the application of IFRS 2, as set out in the sections below. This is on the basis that the definitions applicable to scoping (see 3.1 above) are the same as IFRS 2 and applying the hierarchy in Section 10 on selecting relevant and reliable accounting policies (see 1.2 above).

3.2.1 Transactions by other group entities and shareholders

The definition of 'share-based payment transaction' (see 3.1 above) and additional requirements in paragraph 1A of Section 26 have the effect that the scope of Section 26 is not restricted to transactions where the reporting entity acquires goods or services in exchange for providing its own equity instruments (or cash or other assets based on the cost or value of those equity instruments). Within a group of companies, it is common for one member of the group (typically the parent) to have the obligation to settle a share-based payment transaction in which services are provided to another member of the group (typically a subsidiary). This transaction is within the scope of Section 26 for the entity receiving the services (even though it is not a direct party to the arrangement between its parent and its employee), the entity settling the transaction and the group as a whole.

Accordingly, Section 26 requires an entity to account for a transaction in which it either:

- Receives goods or services when another entity in the same group (or shareholder of any group entity) has the obligation to settle the share-based payment transaction.
- Or
- Has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services.

Unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them. [FRS 102.26.1A].

Moreover, the definition of 'equity-settled share-based payment transaction' (see 3.1 above) has the effect that the analysis of the transaction as equity-settled or cash-settled (and its accounting treatment) may differ when viewed from the perspective of the entity receiving the goods or services, the entity settling the transaction and the group as a whole, depending on whether or not an entity is required to settle the award and whether that settlement is in its own equity instruments.

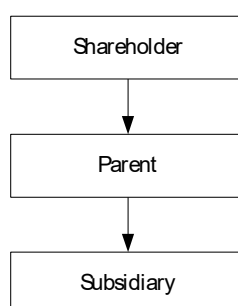
An entity settling a share-based payment when another entity in the group receives the goods or services recognises the transaction as an equity-settled share-based payment transaction only if it is settled in its own equity instruments. Otherwise, the transaction is recognised as a cash-settled share-based payment transaction. [FRS 102.26.2A].

3.2.1.A Scenarios illustrating scope requirements for group entities

In this section we consider seven scenarios, all based on the simple structure in Figure 3-1. These scenarios are by no means exhaustive but cover the situations commonly seen in practice.

The scenarios below are based on the scope requirements of Section 26 as set out at 3.2.1 above and do not reflect the alternative accounting treatment for members of group schemes. This alternative accounting treatment allows the group expense to be allocated between members of the group on a reasonable basis, rather than requiring each group entity to recognise and measure its expense in accordance with the general requirements of Section 26. [FRS 102.26.16]. The exemption and the accounting treatment of group share schemes generally are discussed in more detail at 13 below.

Figure 3-1: Scope of Section 26



The scenarios assume that:

- the shareholder is not a group entity
- And
- the subsidiary is directly owned by the parent company (see also 13.2.1 below in relation to intermediate parent companies).

Scenario	Who grants the award?	Which entity receives the goods or services?	Who settles the award?	On which entity's shares is the award based?	Award settled in shares or cash?
1	Parent	Subsidiary	Parent	Parent	Shares
2	Shareholder	Subsidiary	Shareholder	Parent	Shares
3	Subsidiary	Subsidiary	Subsidiary	Parent	Shares
4	Subsidiary	Subsidiary	Subsidiary	Subsidiary	Shares
5	Parent	Subsidiary	Parent	Subsidiary	Shares
6	Parent	Subsidiary	Parent	Parent	Cash
7	Shareholder	Subsidiary	Shareholder	Parent	Cash

Scenario 1

Parent awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary.

▪ Consolidated financial statements of Parent

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] ... receives goods or services ... in a share-based payment arrangement ...". A share-based payment arrangement includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... equity instruments ... of the entity ...".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of the group.

▪ Separate financial statements of Parent

Parent does not receive the goods or services, but it does have the obligation to settle. This is within the scope of paragraph 1A(b) of Section 26 as Parent "has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services". The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of Parent. [FRS 102.26.2A].

▪ Subsidiary

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] ... receives goods or services ... in a share-based payment arrangement ...". A 'share-based payment arrangement' includes "an agreement between ... another group entity [i.e., Parent] ... and another party (including an employee) that entitles the other party to receive ... equity instruments of ... another group entity".

The transaction is classified as an equity-settled transaction because Subsidiary "has no obligation to settle the transaction with the supplier".

Even if Subsidiary is not a party to the agreement with its employees, it nevertheless records a cost for this transaction. In effect, the accounting treatment is representing that Subsidiary has received a capital contribution from Parent, which Subsidiary has then 'spent' on employee remuneration. This treatment is often referred to as 'push-down' accounting - the idea being that a transaction undertaken by one group entity (in this case, Parent) for the benefit of another group entity (in this case, Subsidiary) is 'pushed down' into the financial statements of the beneficiary entity.

Scenario 2

Shareholder awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Shareholder settles the award with the employees of Subsidiary.

▪ Consolidated financial statements of Parent

Paragraph 1A of Section 26 refers to awards settled by a shareholder of a group entity on behalf of the entity receiving the goods or services.

The transaction is classified as an equity-settled transaction, because the Parent group 'receives goods or services but has no obligation to settle the transaction with the supplier'.

▪ Separate financial statements of Parent

Scenario 2 is not within the scope of Section 26 for the separate financial statements of Parent because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

- *Subsidiary*

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] ... receives goods or services ... in a share-based payment arrangement ...". A 'share-based payment arrangement' includes "an agreement between ... another group entity [i.e., Parent] ... and another party (including an employee) that entitles the other party to receive ... equity instruments of ... another group entity".

The transaction is classified as an equity-settled transaction because Subsidiary "has no obligation to settle the transaction with the supplier".

Scenario 3

Subsidiary awards equity shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Subsidiary settles the award with its employees.

- *Consolidated financial statements of Parent*

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] ... receives goods or services ... in a share-based payment arrangement ...". A share-based payment arrangement includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... equity instruments ... of the entity ...".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of Parent. [FRS 102.26.2A].

- *Separate financial statements of Parent*

Scenario 3 is not within the scope of Section 26 for the separate financial statements of Parent because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

- *Subsidiary*

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] ... receives goods or services ... in a share-based payment arrangement ...". A 'share-based payment arrangement' includes "an agreement between ... another group entity [i.e., Parent] ... and another party (including an employee) that entitles the other party to receive ... equity instruments of ... another group entity".

The transaction is classified as a cash-settled transaction because Subsidiary has the obligation to settle the award with equity instruments issued by Parent - i.e., a financial asset in Subsidiary's separate financial statements - rather than with Subsidiary's own equity instruments.

However, for the approach in this Scenario to apply, it must be the case that Subsidiary grants the award as a principal rather than acting as agent for Parent. If Subsidiary appears to be granting an award but is really doing so only on the instructions of Parent, as will generally be the case for UK companies, then the approach in Scenario 1 above is more likely to apply. This is discussed in more detail at 13.2.5.B below.

Scenario 4

Subsidiary awards equity shares in Subsidiary to employees of Subsidiary in exchange for services to Subsidiary. Subsidiary settles the award with the employees of Subsidiary.

- *Consolidated financial statements of Parent*

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] ... receives goods or services ... in a share-based payment arrangement". A share-based payment arrangement includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... equity instruments ... of the entity ...".

In the consolidated financial statements of Parent, shares of Subsidiary not held by Parent are a non-controlling interest.

- *Separate financial statements of Parent*

Scenario 4 is not within the scope of Section 26 for the separate financial statements of Parent because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

- *Subsidiary*

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] ... receives goods or services ... in a share-based payment arrangement". A share-based payment arrangement includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... equity instruments ... of the entity ...".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of Subsidiary.

Scenario 5

Parent awards equity shares in Subsidiary to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary.

- *Consolidated financial statements of Parent*

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] ... receives goods or services ... in a share-based payment arrangement". A share-based payment arrangement includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... equity instruments of the entity ...".

The transaction is classified as an equity-settled transaction because it is settled in an equity instrument of the group. In the consolidated financial statements of Parent, shares of Subsidiary not held by Parent are a non-controlling interest.

- *Separate financial statements of Parent*

Parent does not receive the goods or services, but it does have the obligation to settle. This is within the scope of paragraph 1A(b) of Section 26 as Parent "has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services". The transaction is classified as a cash-settled transaction as Parent is settling the award not in its own equity instrument but in an equity instrument issued by a subsidiary and held by Parent - i.e., a financial asset in Parent's separate financial statements. [FRS 102.26.2A].

- *Subsidiary*

Under the definition of 'share-based payment transaction', "the entity [i.e., Subsidiary] ... receives goods or services ... in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between ... another group entity [i.e., Parent] ... and another party (including an employee) that entitles the other party to receive equity instruments of the entity...".

The transaction is classified as an equity-settled transaction, because Subsidiary "has no obligation to settle the transaction with the supplier".

Scenario 6

Parent awards cash based on the value of shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Parent settles the award with the employees of Subsidiary.

- *Consolidated financial statements of Parent*

Under the definition of 'share-based payment transaction', "the entity [i.e., the Parent group] ... receives goods or services ... in a share-based payment arrangement". A 'share-based payment arrangement' includes "an agreement between the entity ... and another party (including an employee) that entitles the other party to receive ... cash ... of the entity ... based on the price (or value) of equity instruments ... of the entity ...".

The transaction is classified as a cash-settled transaction, because it is settled in cash of the group.

- *Separate financial statements of Parent*

Parent does not receive the goods or services, but it does have the obligation to settle. This is within the scope of paragraph 1A(b) of Section 26 as Parent "has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services". The transaction is classified as a cash-settled transaction, because it is settled not in an equity instrument issued by Parent, but in cash based on the value of shares in Parent.

- *Subsidiary*

When the drafting of the definition of a 'share-based payment transaction' is examined closely, it is not absolutely clear that this arrangement is within the scope of Section 26 for Subsidiary. To be a share-based payment transaction (and therefore in the scope of Section 26) for the reporting entity, a transaction must also be a share-based payment arrangement. A share-based payment arrangement is defined as one in which the counterparty receives (our emphasis added):

Cash or other assets of the entity

Or

Equity of the entity or any other group entity

- As drafted, the definition has the effect that a transaction settled in equity is in the scope of Section 26 for a reporting entity, whether the equity used to settle the transaction is the entity's own equity or that of another group entity. Where a transaction is settled in cash, however, the definition has the effect that a transaction is in the scope of Section 26 for a reporting entity only when that entity's own cash (or other assets) is used in settlement, and not when another group entity settles the transaction.

How we see it

When read with the general scope requirements in paragraphs 1 and 1A of Section 26, we believe that the apparent omissions from the definition of 'share-based payment transaction' must be ignored. We see it as a drafting slip and that the transaction must be classified as an equity-settled transaction by Subsidiary, because Subsidiary "receives goods or services but has no obligation to settle the transaction with the supplier". Appendix B to IFRS 2 provides guidance on cash-settled payments to employees when the subsidiary itself does not have the obligation.

Scenario 7

Shareholder awards cash based on the value of shares in Parent to employees of Subsidiary in exchange for services to Subsidiary. Shareholder settles the award with the employees of Subsidiary.

- This transaction is within the scope of paragraph 1A of Section 26 for the consolidated financial statements of Parent and for the separate financial statements of Subsidiary as it is a transaction where the shareholder has an obligation to settle on behalf of the entity receiving the goods or services. However, it does not strictly meet the definitions in Appendix I. As noted at Scenario 6 above, the definitions of 'share-based payment transaction' and 'cash-settled share-based payment transaction' as drafted do not explicitly address any arrangement that is settled in cash by a party other than the reporting entity.

How we see it

We believe that the above transaction is required to be treated as being within the scope of Section 26 for the consolidated financial statements of Parent and the separate financial statements of Subsidiary and the transaction accounted for as equity-settled.

- The transaction is not within the scope of Section 26 for the separate financial statements of Parent, because Parent (as a separate entity) receives no goods or services, nor does it settle the transaction.

3.2.2 Transactions with employee benefit trusts and similar vehicles

It is common for an entity to establish a trust to hold shares in the entity for the purpose of satisfying share-based awards to employees. In such cases, it is often the trust, rather than any entity within the legal group, that makes share-based awards to employees. Awards by EBTs and similar vehicles are within the scope of Section 26 and are discussed at 13.3 below.

3.2.3 Transactions where the identifiable consideration received appears to be less than the consideration given

3.2.3.A Government-mandated plans

A share-based payment transaction as defined (see 3.1 above) involves the receipt of goods or services. Nevertheless, Section 26 also applies to government-mandated plans "...established under law by which equity investors (such as employees) are able to acquire equity without providing goods or services that can be specifically identified (or by providing goods or services that are clearly less than the fair value of the equity instruments granted). This indicates that other consideration has been or will be received (such as past or future employee services) ...". [FRS 102.26.17].

Such arrangements are treated as equity-settled share-based payment transactions under FRS 102 and the unidentifiable goods or services are measured as the difference between the fair value of the equity instrument and the fair value of any identifiable goods or services received (or to be received) measured at the grant date. [FRS 102.26.17]. The determination of the grant date is addressed at 6.3 below.

Section 26 offers no further explanation or guidance as to the type of arrangement that is expected to fall within the scope of this paragraph. The reference to employees and employee services is somewhat puzzling since share-based payment transactions with employees are always measured at the fair value of the share-based payment rather than the fair value of the employee services, identifiable or otherwise.

What is also not made explicitly clear in paragraph 17 is that, in this situation, the fair value of a share-based payment with a non-employee would need to be that of the equity instruments rather than that of the goods or services (as would normally be the case for an award to a non-employee, see 6.1 and 6.4 below).

As Section 26 refers only to 'programmes mandated under law' beneath the heading 'Government-mandated plans', it appears that the guidance does not require an entity to apply the requirements of paragraph 17 to other transactions with non-employees, in which the value of goods or services received or receivable falls short of the fair value of the equity instruments or cash transferred.

IFRS 2 includes a similar requirement for transactions with non-employees where no specifically identifiable goods or services have been (or will be) received but does not restrict the scope to government-mandated plans. [IFRS 2.2]. Paragraph 1 of Section 26 contains similar wording and requirements to that of paragraph 2 of IFRS 2 but then goes on to restrict the requirement to government mandated plans.

IFRS 2 asserts that, if the identifiable consideration received (if any) appears to be less than the fair value of consideration given in any share-based payment arrangement, the implication is that, in addition to the identifiable goods and services acquired, the entity must also have received some unidentifiable consideration equal to the difference between the fair value of the share-based payment and the fair value of any identifiable consideration received. Accordingly, the cost of the unidentified consideration must be accounted for in accordance with IFRS 2. [IFRS 2.13A].

For example, if an entity agrees to pay a supplier of services with a clearly identifiable market value of £1,000 by issuing shares with a value of £1,500, IFRS 2 requires the entity to recognise an expense of £1,500. This is notwithstanding the normal requirement of IFRS 2 that an equity-settled share-based payment transaction with a non-employee be recognised at the fair value of the goods or services received (see 6.1 and 6.4 below).

3.2.3.B Other transactions

In rare circumstances a transaction may occur in which no goods or services are received by the entity. For example, a principal shareholder of an entity, for reasons of estate planning, may transfer shares to a relative. In the absence of indications that the relative has provided, or is expected to provide, goods or services to the entity in exchange for the shares, such a transfer would be outside the scope of Section 26 as a transaction clearly for a purpose other than payment for goods or services supplied to the entity.

[FRS 102.26.1A].

3.2.4 'All employee' share plans

Many countries, including the UK, encourage wider share-ownership by allowing companies to award a limited number of free or discounted shares to employees without either the employee or the employer incurring tax liabilities which would apply if other benefits in kind to an equivalent value were given to employees. These share schemes are referred to in different jurisdictions by terms such as 'all-employee share plans', 'employee share purchase plans' and 'broad-based plans'.

There is no exemption from the scope of Section 26 for such plans (unless they are immaterial).

3.2.5 Vested transactions

Section 26 does not specifically address the accounting treatment of awards once they have vested, other than on settlement of equity-settled share-based payment transaction where an entity repurchases the vested equity instrument (see 8.4 below). Drawing on the requirements of IFRS 2, a transaction accounted for as a share-based payment does not necessarily cease to be within the scope of Section 26 once it has vested in the counterparty (see 4 below). This is made clear by the numerous provisions of IFRS 2 referring to the accounting treatment of vested awards.

Once equity shares have been unconditionally delivered or beneficially transferred to the counterparty (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares), the holder of those shares will often be in exactly the same position as any other holder of ordinary shares and the shares will generally be accounted for under Section 22, rather than under Section 26.

If, however, the holder of a share or vested option enjoys rights not applicable to all holders of that class of share, such as a right to put the share or the option to the entity for cash, or holds a special class of share with rights that do not apply to other classes of equity, the share or option might remain in the scope of Section 26 as long as any such rights continue to apply. The same is true of modifications made after vesting which add such rights to a vested share or option or otherwise alter the life of the share-based payment transaction. The special terms or rights will often be linked to the holder's employment with the entity but could also apply to an arrangement with a non-employee.

The significance of this is that accounting and disclosure requirements could be very different depending on whether transactions are considered to be within the scope of Section 26.

How we see it

To summarise the above, an equity-settled share-based payment transaction will remain in scope of Section 26 until the equity instruments have been unconditionally delivered or beneficially transferred to the counterparty (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares), and the counterparty enjoys rights that are applicable to all holders of ordinary shares. However, if the counterparty holds a special class of share with rights that do not apply to other classes of equity, the shares might still remain in the scope of Section 26 as long as any such rights continue to apply.

The above discussion on the life of a share-based payment transaction focuses on shares or share options awarded, however, a cash-settled share-based payment transaction is within the scope of Section 26 for its entire life, i.e., until settlement. [FRS 102.26.14, FRS 102.26.14B, FRS 102.26.14C].

3.3 Transactions not within the scope of Section 26

Section 26 simply states that share-based transactions that are clearly for a purpose other than payment to the entity for goods or services are not within its scope. [FRS 102.26.1A]. Other than equity-instruments issued in exchange for control of the acquiree in a business combination, it does not include any more specific examples of transactions that are outside the scope of its requirements. [FRS 102.26.1B]. IFRS 2 includes some specific scope exemptions, and we expect that similar exemptions are intended to apply in the application of Section 26. The following transactions are outside the scope of IFRS 2:

- Transactions with shareholders in their capacity as such (see 3.3.1 below)
 - Transfers of assets in group restructuring arrangements (see 3.3.2 below)
 - Business combinations (see 3.3.3 below)
 - Businesses combinations - common control transactions (see 3.3.3.A below)
 - Contribution of a business on the formation of a joint venture (jointly controlled entity) (see 3.3.4.A below)
- And
- Transactions in the scope of IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* or Section 22 (see 3.3.5 below). In addition, the scope exemptions in IFRS 2 combined with those in IAS 32 and IAS 39 (or IFRS 9) appear to have the effect that there is no specific guidance in IFRS for accounting for certain types of investments when acquired in return for shares (see 3.3.6 below)

However, as noted at 3.2.4 above, there is no exemption for share schemes aimed mainly at lower and middle ranking employees, referred to in different jurisdictions by terms such as 'all-employee share schemes', 'employee share purchase plans' and 'broad-based plans'.

How we see it

In the absence of specific examples in Section 26, other than equity instruments issued in exchange for the acquiree in a business combination, we believe that the scope exemptions included in IFRS 2 also apply to Section 26. See 3.3.1 to 3.3.6 below.

3.3.1 Transactions with shareholders in their capacity as such

IFRS 2 does not apply to transactions with employees (and others) purely in their capacity as shareholders. For example, an employee may already hold shares in the entity as a result of previous share-based payment transactions. If the entity then raises funds through a rights issue, whereby all shareholders (including the employee) can acquire additional shares for less than the current fair value of the shares, such a transaction is not a 'share-based payment transaction' for the purposes of IFRS 2. [IFRS 2.4].

3.3.2 Transfer of assets in group restructuring arrangements

In some group restructuring arrangements, one entity will transfer a group of net assets, which does not meet the definition of a business, to another entity in return for shares. Careful consideration of the precise facts and circumstances is needed in order to determine whether, for the separate or individual financial statements of any entity affected by the transfer, such a transfer meets the definition of a share-based payment transaction.

How we see it

If the transfer is considered primarily to be a transfer of goods by their owner in return for payment in shares, then, in our view, this is to be accounted for as a share-based payment transaction.

Accounting for intra-group asset transfers in return for shares is considered further in Chapter 8 at 4.4.2.B.

3.3.3 Business combinations

Transactions in which equity instruments are issued to acquire goods as part of the net assets in a business combination are outside the scope of Section 26, but equity instruments granted to the employees of the acquiree in their capacity as employees (e.g., in return for continued service following the business combination) are within its scope, as are the cancellation, replacement or modification of a share-based payment transaction as a result of the business combination or other equity restructuring. [IFRS 102.26.1B].

If a vendor of an acquired business remains as an employee of that business following the business combination and receives a share-based payment for transferring control of the entity and for remaining in continuing employment, it is necessary to determine how much of the share-based payment relates to the acquisition of control (and therefore forms part of the consideration for the business combination) and how much relates to the provision of future services (which is a post-combination operating expense). There is further discussion on this issue in Chapter 22 at 3.6.2.C.

3.3.3.A Business combinations - common control transactions

Both IFRS 2 and Section 26 do not apply to a combination of entities or businesses under common control. [IFRS 2.5, FRS 102.26.1B]. Whilst the scope exemption included in paragraph 1B of Section 26, specifies 'business combinations', this includes business combinations under common control. [FRS 102.19.3, FRS 102 Appendix I].

3.3.4 Transactions with jointly controlled entities

3.3.4.A Contribution of a business on the formation of a jointly controlled entity

A jointly controlled entity may issue equity instruments to its venturer as consideration for the contribution of a business on the formation of the jointly controlled entity.

There is a scope exemption in IFRS 2 on accounting for the contribution of a business on the formation of a joint venture as defined by IFRS 11 *Joint Arrangements*, when the joint venture issues equity instruments. [IFRS 2.5]. A 'joint venture' under IFRS 11 is similar to a 'jointly controlled entity' under FRS 102 (see Chapter 18). The scope of Section 26 does not contain a similar scope exemption for jointly controlled entities.

How we see it

We believe that, similar to IFRS 2, Section 26 would not apply to the jointly controlled entity that issues equity instruments on the contribution of a business by the venturer on the formation of a jointly controlled entity, as the entity is not receiving or acquiring goods or services, but a business instead.

Whilst we believe that this type of transaction is not in scope of Section 26, in the absence of specific guidance elsewhere in FRS 102, we expect that entities will apply the requirements of Section 10 in selecting an accounting policy to account for the contribution of a business on the formation of a jointly controlled entity (see Chapter 9 at 2.1).

3.3.4.B Contribution of non-financial assets (which do not constitute a business) and other transactions

When non-financial assets, which do not constitute a business, are contributed to a jointly controlled entity in return for shares, consideration would need to be given as to whether the issue of shares are in scope of Section 26 as they are not specifically scoped out of the Section for the jointly controlled entity. These transactions are in scope of IFRS 2.

How we see it

We believe that Section 26 applies to these transactions in a similar manner to IFRS 2, therefore, the assets must be accounted for at fair value in the jointly controlled entity's books (see 3.2 above).

Both IFRS 2 and Section 26 do not directly address other types of transactions involving jointly controlled entities or transactions involving associates, particularly arrangements granted by the investors to the employees of associates or jointly controlled entities as they do not meet the definition of 'group' entities (see 13 below).

3.3.5 Transactions in the scope of IAS 32, IAS 39 and IFRS 9 or Section 22 (financial instruments)

IFRS 2 does not apply to transactions within the scope of IAS 32, IAS 39 or IFRS 9. Therefore, if an entity enters into a transaction to purchase, in return for shares, a commodity surplus to its production requirements or with a view to short-term profit taking, the contract is treated as a financial instrument under IAS 32 and IAS 39 or IFRS 9 rather than a share-based payment transaction under IFRS 2. [IFRS 2.6]. Some Practical examples of scope issues involving IFRS 2 and IAS 32/IAS 39/IFRS 9 are discussed at 3.4 below.

Whilst Section 26 has no specific corresponding reference to financial assets or liabilities, Section 22 excludes from its scope financial instruments, contracts and obligations under share-based payment transactions (except for the classification requirements that relate to treasury shares) and refers users to Section 26. [FRS 102.22.2(d)].

3.3.6 Transactions relating to investments in subsidiaries, associates and joint ventures

As noted at 3.2 above, IFRS 2 applies to share-based payment transactions involving goods or services, with 'goods' defined so as to exclude financial assets. This means that, when (as is commonly the case) an entity acquires an investment in a subsidiary, associate or joint venture for the issue of equity instruments, there is no explicit guidance as to the required accounting in the separate financial statements of the investor when it chooses to apply a policy of 'cost' under paragraph 24 of Section 9 *Consolidated and Separate Financial Statements* (see Chapter 8 at 4.4.2.B).

3.4 Some practical applications of the scope requirements

This section addresses the application of the scope requirements of Section 26 to a number of situations frequently encountered in practice. The situations are not specifically addressed in Section 26, but the following sections draw on the requirements of Section 26 together with related guidance in IFRS 2 and our experience of the practical application of IFRS 2:

- Remuneration in non-equity shares and arrangements with put rights over equity shares (see 3.4.1 below).
- An increase in the counterparty's ownership interest with no change in the number of shares held (see 3.4.2 below).
- Awards for which the counterparty has paid 'fair value' (see 3.4.3 below).
- A cash bonus which depends on share price performance (see 3.4.4 below).
- Cash-settled awards based on an entity's 'enterprise value' or other formula (see 3.4.5 below).
- Holding own shares to satisfy or 'hedge' awards (see 3.4.6 below).

The following aspects of the scope requirements are covered elsewhere in this chapter:

- Employment taxes on share-based payment transactions (see 15 below).
- Instruments such as limited recourse loans that sometimes fall within the scope of the share-based payment, rather than financial instruments, requirements because of the link both to the entity's equity instruments and to goods or services received in exchange (see 16.2 below).

3.4.1 Remuneration in non-equity shares and arrangements with put rights over equity shares

A transaction is within the scope of Section 26 only where it involves the delivery of an equity instrument, or cash or other assets based on the price or value of "equity instruments (including shares and share options) of the entity or another group entity" (see 3.1 above).

There can sometimes be advantages to giving an employee, in lieu of a cash payment, a share that carries a right to a 'one-off' dividend, or is mandatorily redeemable, at an amount equivalent to the intended cash payment. Such a share would almost certainly be classified as a liability (based on Section 22). Payment in such a share would not fall in the scope of Section 26 since the consideration paid by the entity for services received is a financial liability rather than an equity instrument (see the definitions at 3.1 above).

How we see it

If the amount of remuneration delivered in this way were equivalent to the value of a particular number of equity instruments issued by the entity, then the transaction would be in scope of Section 26 as a cash-settled share-based payment transaction, since the entity would have incurred a liability (i.e., by issuing the redeemable shares) for an amount based on the price of its equity instruments.

Similarly, if an entity grants an award of equity instruments to an employee together with a put right whereby the employee can require the entity to purchase those shares for an amount based on their fair value, both elements of that transaction are in the scope of Section 26 as a single cash-settled transaction (see 10 below).

3.4.2 Increase in ownership interest with no change in number of shares held

An increasingly common arrangement, typically found in entities with venture capital investors, is one where an employee (often part of the key management) subscribes initially for, say, 1% of the entity's equity with the venture capitalist holding the other 99%. The employee's equity interest will subsequently increase by a variable amount depending on the extent to which certain targets are met. This is achieved not by issuing new shares but by cancelling some of the venture capitalist's shares.

How we see it

In our view, such an arrangement falls within the scope of Section 26 as the employee is rewarded with an increased equity stake in the entity if certain targets are achieved. The increased equity stake is consistent with the definition of equity as 'a residual interest' notwithstanding the fact that no additional shares are issued.

In such arrangements, it is often asserted that the employee has subscribed for a share of the equity at fair value. However, the subscription price paid must represent a fair value using a Section 26 valuation basis in order for there to be no additional share-based payment expense to recognise (see 3.4.3 below).

3.4.3 Awards for which the counterparty has paid 'fair value'

In certain situations, such as where a special class of share is issued, the counterparty might be asked to subscribe a certain amount for the share which is agreed as being its 'fair value' for taxation or other purposes.

How we see it

This does not mean that such arrangements fall outside the scope of Section 26, either for measurement or disclosure purposes, if the arrangement meets the definition of a share-based payment transaction. In many cases, the agreed 'fair value' will be lower than a fair value measured in accordance with Section 26 because it will reflect the impact of service and non-market performance vesting conditions which are excluded from a Section 26 fair value (see 7 and 9 below).

This is addressed in more detail in 16.4.5 below.

3.4.4 Cash bonus dependent on share price performance

An entity might agree to pay its employees a £100 cash bonus if its share price remains at £10 or more over a given period. Intuitively, this does not appear to be in the scope of Section 26, since the employee is not being given cash of equivalent value to a particular number of shares. However, it could be argued that it does fall within the scope of Section 26 on the basis that the entity has incurred a liability, and the amount of that liability is 'based on' the share price (in accordance with the definition of a cash-settled share-based payment transaction). It is nil if the share price is below £10 and £100 if the share price is £10 or more.

How we see it

Either interpretation mentioned above is acceptable.

3.4.5 Cash-settled awards based on an entity's 'enterprise value' or other formula

As noted at 3.1 above, Section 26 includes within its scope transactions in which the entity acquires goods or services by incurring a liability "based on the price (or value) of equity instruments (including shares and share options) of the entity or another group entity". Employees of an unquoted entity may receive a cash award based on the value of the equity of that entity. Such awards are typically, but not exclusively, made by venture capital investors to the management of entities in which they have invested and which they aim to sell in the medium term. Further discussion of the accounting implications of awards made in connection with an exit event may be found at 16.4 below.

More generally, where employees of an unquoted entity receive a cash award based on the value of the equity, there is no quoted share price and an 'enterprise value' has therefore to be calculated as a surrogate for it. This begs the question of whether such awards are within the scope of Section 26 (because they are based on the value of the entity's equity) or that of Section 28.

How we see it

In order for an award to be within the scope of Section 26, any calculated 'enterprise value' must represent the fair value of the entity's equity. Where the calculation uses techniques recognised by Section 26 as yielding a fair value for equity instruments (as discussed at 9 below), we believe that the award is regarded as within the scope of Section 26.

An unquoted entity may have calculated the value of its equity based on net assets or earnings (see 9.3 below). In our view, this may be appropriate in some cases, if the value approximates to the fair value of the equity instruments.

Where, however, the enterprise value is based on a constant formula, such as a fixed multiple of earnings before interest, tax, depreciation and amortisation (EBITDA), in our view it is unlikely that this will represent a good surrogate for the fair value of the equity on an ongoing basis, even if it did so at the inception of the transaction.

It is not difficult to imagine scenarios in which the fair value of the equity of an entity could be affected with no significant change in EBITDA, for example as a result of changes in interest rates and effective tax rates, or a significant impairment of assets. Alternatively, there might be a significant shift in the multiple of EBITDA equivalent to fair value, for example if the entity were to create or acquire a significant item of intellectual property.

The accounting treatment of awards based on the 'market price' of an unquoted entity raises similar issues, as discussed more fully at 16.5 below.

3.4.6 Holding own shares to satisfy awards

Entities often seek to 'hedge' the cost of share-based payment transactions by buying their own equity instruments in transactions with existing shareholders. For example, an entity could grant an employee options over 10,000 shares and buy 10,000 of its own shares into treasury, or into its employee benefit trust, at the date that the award is made. If the award is share-settled, the entity will deliver the shares to the counterparty. If it is cash-settled, it may be in a position to sell the shares to raise the cash it is required to deliver to the counterparty. In either case, the cash cost of the award is capped at the amount paid for the shares at the date the award is made, less any amount paid by the employee on exercise. It could of course be argued that such an arrangement only 'hedges' an increase in the price of the shares. If the share price goes down so that the option is never exercised, the entity is left holding 10,000 of its own shares that cost more than they are now worth.

Whilst these strategies may cap the cash cost of share-based payment transactions that are eventually exercised, they will not have any effect on the charge to profit or loss required by Section 26 for such transactions. This is because purchases and sales of own shares are accounted for as movements in equity and are therefore never included in profit or loss, i.e., the recognition of an expense under Section 26 for the share-based payment transaction and accounting for movements in own shares are two completely distinct areas which must be treated separately for accounting purposes (see 5.1 below).

4 General recognition principles

The recognition rules in Section 26 are based on a so-called 'service date model'. In other words, an entity is required to recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. [FRS 102.26.3]. For awards to employees (or others providing similar services), this contrasts with the measurement rules, which normally require a share-based payment transaction to be measured as at the date on which the transaction was entered into, which may be some time before or after the related services are received (see 5 to 8 below).

Where the goods or services received or acquired in exchange for a share-based payment transaction do not qualify for recognition as assets they are recognised as expenses. [FRS 102.26.4]. Typically, services will not qualify as assets and must therefore be expensed immediately, whereas goods will generally be initially recognised as assets and expensed later as they are consumed. However, some payments for services may be capitalised (e.g., as part of the cost of PP&E or inventories) and some payments for goods may be expensed immediately (e.g., where they are for items included within development costs written off as incurred).

The corresponding credit entry when goods are acquired or services are rendered is, in the case of an equity-settled transaction, an increase in equity and, in the case of a cash-settled transaction, a liability (or decrease in cash or other assets). [FRS 102.26.3].

The primary focus of the discussion in the remainder of this chapter is the application of these rules to transactions with employees, with the accounting treatment of transactions with non-employees addressed at 3.2.3 above and 6.1 and 6.4 below.

4.1 Vesting and vesting conditions

Under Section 26, the point at which a cost is recognised for goods or services depends on the concept of 'vesting'. The following definitions in Appendix I to FRS 102 are relevant. [FRS 102 Appendix I].

Extract from FRS 102

Appendix I

Glossary

performance condition

A vesting condition that requires:

- (a) the counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit; and
- (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a).

The period of achieving the performance target(s):

- (a) shall not extend beyond the end of the service period; and
- (b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

A performance target is defined by reference to:

- (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (i.e., a non-market vesting condition); or
- (b) the price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (i.e., a market vesting condition).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

service condition

A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.

vest	Become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.
vesting condition	The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions are either service conditions or performance conditions

This definition of 'vest' refers only to equity instruments of the entity and omits any reference to equity instruments of other group entities. This appears to be a drafting oversight given that the scope of Section 26 and the definitions of equity and cash-settled share-based payment transactions in Appendix I to FRS 102 all refer to the equity instruments of the entity and other group entities.

The definition of vesting conditions emphasises the receipt of services by the entity, therefore a condition that does not contain a corresponding service condition is not a vesting condition. The recognition principles in FRS 102 use this approach to set out the differing accounting treatments, discussed further below, depending on whether the share-based payment transaction includes a service condition.

The absence of a service requirement means that an award will vest, or be deemed to vest, immediately as there is no service to be rendered before the counterparty becomes unconditionally entitled to the award. This concept of immediate vesting is reinforced by the fact that FRS 102 requires an entity to presume, in the absence of evidence to the contrary, that services rendered by the counterparty (for example, an employee) as consideration for the share-based payments have already been received. Where there is immediate vesting, the entity is required to recognise the services received, i.e., the cost of the award, in full on the grant date of the award with a corresponding credit to equity or liabilities. [FRS 102.26.5].

If, as will generally be the case for employee awards, the share-based payments do not vest until the counterparty completes a specified period of service, the entity must presume that the services to be rendered by the counterparty as consideration for those share-based payments will be received in the future, during the vesting period, i.e., the period over which the services are being rendered in order for the award to vest. The entity is required to account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity or liabilities. [FRS 102.26.6]. An example of a service condition is one where an employee is granted a share option with a service requirement of remaining in employment with an entity for three years, the award vests three years after the date of grant. Accordingly, if the employee remains employed by the entity the cost of the award will be recognised over that three-year period.

As mentioned above, the vesting of awards might also be conditional on performance conditions which require both the counterparty to complete a specified period of service and specified performance targets to be met. The definitions of 'vesting condition', 'service condition' and 'performance condition' reproduced above clarify the distinction between different types of conditions attached to a share-based payment.

Examples of performance conditions are; a specified increase in the entity's profit over a specified period of time (a non-market condition, see 7.2 below) or a specified increase in the entity's share price (a market condition, see 7.3 below). [FRS 102.26.9]. As discussed more fully at 4.2 below, performance conditions refer to performance by an employee (such as a personal sales target) or performance by the entity (or part of the entity), rather than an external performance indicator, such as a general stock market index.

Therefore, a condition that an award vests if, in three years' time, earnings per share have increased by 10% and the employee is still in employment, is a performance condition. If, however, the award becomes unconditional in three years' time if earnings per share have increased by 10%, irrespective of whether the employee is still in employment, that condition is not a performance condition, but a 'non-vesting' condition because there is no associated service requirement (see 4.2 below).

In addition to the general discussion above and in the remainder this section, specific considerations relating to awards that vest on a flotation or change of control (or similar exit event) are addressed at 16.4 below.

4.1.1 Vesting conditions based on an employee's performance rating

An entity may grant awards to employees that vest based on conditions that include the employee's performance rating. A performance rating would appear to meet the definition of a non-market performance condition in that it is a vesting condition that requires an employee to render service for a period of time and to achieve a specified performance rating while providing the service in employment of the entity (see 4.1 above). Performance ratings can be influenced by the judgement of the individual(s) conducting an employee's evaluation; therefore, the question often arises whether the inherent subjectivity of a performance evaluation could delay the grant date for the award (see 6.3 below). The impact of such condition on the accounting treatment required by Section 26 depends on the framework that is established by the entity to facilitate an employee's understanding of how their performance will be measured. A framework that clearly articulates criteria and includes more objective measures is more likely to result in a more predictive outcome and, thus likely a non-market performance condition. On the contrary, a framework that contains more subjective measures that provide less clarity and is less predictive of the outcome, would not. The following are aspects of the framework that will need to be considered in making the determination:

- Whether the criteria are sufficiently clear at the inception of the share-based payment arrangement such that there is a mutual understanding between the entity and the employee about how the performance rating will be measured.
 - Whether the criteria relates only to the performance of the individual employee or the employee's performance relative to their peers, over the relevant measurement period.
- And
- Whether the employee is able to predict the outcome under the related performance rating framework, given the set criteria.

In certain cases, the number of instruments underlying the award might vary depending on the employee's performance relative to the criteria in the framework. The entity will be required to estimate the potential outcome during the performance period and to recognise the cost for the number of instruments that the employee is expected to be entitled based on their performance rating (see 7.2.4 below).

4.1.2 Environment Social and Governance ('ESG') related conditions

With the increase in focus by stakeholders of entities on ESG related matters, a growing number of share-based payment arrangements include conditions that require environmental, social and/or governance related targets to be met for the award to vest. An entity that grants such an award will need to assess if the ESG target is a vesting condition or non-vesting condition.

As noted in 4.1 above, a vesting condition is either a service condition or performance condition, with the latter requiring the counterparty to complete a specified period of service and specified performance targets (such as a specified increase in the entity's profit over a specified period of time). A performance condition that is referenced to the entity's own operations (or activities) or the operations or activities of another entity in the same group, is a non-market vesting condition. A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee. Neither Section 26 nor IFRS 2 explicitly defines a 'non-vesting condition' (see 4.2 below) but uses the term to describe a condition that is neither a service condition nor a performance condition.

The identification of an ESG related target as a vesting condition is not always straightforward. One such area is conditions related to climate change. An entity may enter into a share-based payment arrangement with employees that vests on satisfying a service period and on achieving targets based on Scope 1, 2 and/or 3 GHG (greenhouse gas) emissions.²²⁷ In general, Scope 1 emissions arise from sources that are owned or controlled by the entity, while Scope 2 emissions occur indirectly from the generation of purchased energy consumed by the entity. If the service condition requirements in the definition of a performance condition are met, both Scope 1 and Scope 2 emissions targets would meet the definition of performance vesting conditions as they both relate to the performance of the entity's own operations or activities. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain (upstream and downstream) of an entity. Fifteen reporting categories²²⁸ exist for measuring an entity's Scope 3 emissions.

²²⁷ IFRS S2 Climate-related Disclosures, Appendix A Defined terms, available on the [IFRS Foundation's website](#).

²²⁸ [Greenhouse Gas Protocol, Corporate Value Chain \(Scope 3\) Accounting and Reporting Standard](#), available from the [Greenhouse Gas Protocol website](#).

Determining whether a Scope 3 emissions target is a performance condition will require analysis of the conditions that has led to the emissions in determining if the definition of a performance condition is met or whether it represents a non-vesting condition. To meet the definition of a performance condition, the target is required to be referenced to the entity's own operations or activities. Whilst the service condition must not be for a period that is less than the period the Scope 3 target must be met, the following are some factors that could help in determining if the target is a performance condition:

- Whether an entity is able to influence if a target is met through its own actions. For example, when an entity grants a share-based payment award subject to a service condition and achieving a 20% reduction in Scope 3 Category 7 emissions (related to Employee Commuting emissions), as part of the entity's net zero commitment, and the entity has also put in place various policies to help meet the emission targets by providing employees hybrid working arrangements and incentives for carpooling. Another example may be an entity granting a share-based payment award subject to a service condition and achieving a 20% reduction in Scope 3 Category 1 emissions (related to Purchased Goods and Services emissions), as part of the entity's net zero commitment. The entity has introduced penalties into agreements with suppliers where suppliers have not met emission reduction targets agreed with the entity, has terminated some supplier agreements and entered into agreements with new suppliers in order to help meet the entity's emission targets.
- Whether the conditions are related to the entity's activities. For example, the target of achieving a 20% reduction in Scope 3 emissions in the examples in the previous bullet, is referenced to activities the entity is undertaking to meet its own target as part of its overall net zero commitment.

How we see it

Practice is evolving and there is judgement in determining if Scope 3 emission targets are performance conditions. However, in our view if the target is referenced to the entity's operations or activities, the achievement of a target does not need to be solely based on the actions of the entity to meet the definition of a performance condition. An example is when determining whether electric vehicle volume revenue target is met, such a target is also influenced by events outside an entity's direct control, such as consumer choice.

4.2 Non-vesting conditions (conditions that are neither service conditions nor performance conditions)

Some share-based payment transactions are dependent on the satisfaction of conditions that are neither service conditions nor performance conditions. For example, an employee might be given the right to 100 shares in three years' time, subject only to the employee not working in competition with the reporting entity during that time. An undertaking not to work for another entity does not include a requirement for the counterparty to complete a specified period of service with the entity, the employee could sit on a beach for three years and still be entitled to collect the award. Accordingly, such a condition is not regarded as a vesting condition for the purposes of Section 26 but is instead referred to as a 'condition that is not a vesting condition'. [FRS 102.26.9]. Alternatively, IFRS 2 refers to such a condition as a 'non-vesting condition'. Throughout this chapter we will refer to a 'condition that is not a vesting condition' as a 'non-vesting condition' (see 2.3.1 above).

Section 26 introduces the concept of a non-vesting condition when discussing the measurement of equity-settled awards, providing an example of a condition when an employee contributes to a saving plan as a condition that is not vesting condition, but does not otherwise define the term. [FRS 102.26.9]. The accounting impact of non-vesting conditions is discussed in detail at 7.4 below.

Although IFRS 2 contains a little more explanation about non-vesting conditions than is found in FRS 102, it does not explicitly define a 'non-vesting condition' but uses the term to describe a condition that is neither a service condition nor a performance condition. However, the concept of the 'non-vesting' condition is not entirely clear, and the identification of such conditions is not always straightforward. This has sometimes resulted in differing views on the appropriate classification of certain types of conditions depending on whether they were considered to be measures of the entity's performance or its activities and hence performance vesting conditions.

As noted at 4.1 above, FRS 102 and IFRS 2 define a vesting condition as a condition that determines whether the entity receives the services that entitle the counterparty to receive payment in equity or cash. Performance conditions are those that require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

The Basis for Conclusions on IFRS 2 adds that the feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or implicit service requirement and the latter does not. [IFRS 2.BC171A].

In issuing its Annual Improvements to IFRSs 2010-2012 Cycle in December 2013 the IASB considered whether a definition of 'non-vesting condition' was needed. It decided that "the creation of a stand-alone definition ... would not be the best alternative for providing clarity on this issue". [IFRS 2.BC364]. Instead, it sought to provide further clarification in the Basis for Conclusions to IFRS 2, as follows:

"...the Board observed that the concept of a non-vesting condition can be inferred from paragraphs BC170-BC184 of IFRS 2, which clarify the definition of vesting conditions. In accordance with this guidance it can be inferred that a non-vesting condition is any condition that does not determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement. In other words, a non-vesting condition is any condition that is not a vesting condition." [IFRS 2.BC364].

For a condition to be a performance vesting condition, it is not sufficient for the condition to be specific to the performance of the entity. There must also be an explicit or implied service condition that extends to the end of the performance period. For example, a condition that requires the entity's profit before tax or its share price to reach a minimum level, but without any requirement for the employee to remain in employment throughout the performance period, is not a performance condition, but a non-vesting condition.

Specific examples of non-vesting conditions given by IFRS 2 include:

- A requirement to make monthly savings during the vesting period.
- A requirement for a commodity index to reach a minimum level.
- Restrictions on the transfer of vested equity instruments.

And

- An agreement not to work for a competitor after the award has vested (i.e., a 'non-compete' agreement). [IFRS 2.BC171B, IFRS 2.IG24].

The IASB has also clarified that a condition related to a share market index target (rather than to the specific performance of the entity's own shares) is a non-vesting condition because a share market index reflects not only the performance of an entity but also that of other entities outside the group. Even where an entity's share price makes up a substantial part of the share market index, the IASB confirmed that this would still be a non-vesting condition because it reflects the performance of other, non-group, entities.

[IFRS 2.BC354, IFRS 2.BC355, IFRS 2.BC356, IFRS 2.BC357, IFRS 2.BC358].

Thus, whilst conditions that are not related to the performance of the entity are always, by their nature, non-vesting conditions, conditions that relate to the performance of the entity may or may not be non-vesting conditions depending on whether there is also a requirement for the counterparty to render service.

As noted at 4.1 above, both FRS 102 and IFRS 2 define a performance condition. The definition clarifies the extent to which the period of achieving the performance target(s) needs to coincide with the service period and states that this performance period:

- (a) Shall not extend beyond the end of the service period.

And

- (b) May start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period.

There clearly remains an element of judgement in the interpretation of 'substantially' as used in the definition.

There is further discussion of the accounting treatment of non-vesting conditions at 7.4 below.

4.3 Vesting period

FRS 102 defines the vesting period as follows:

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vesting period

The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

The vesting period is not the same as the exercise period or the life of the option, as demonstrated by Illustration 4-1 below.

Illustration 4-1: Meaning of 'vesting period' - award with vesting conditions only

An employee is awarded options that can be exercised at any time between three and ten years from the date of the award, provided the employee remains in service for at least three years from the date of the award. For this award, the vesting period is three years; the exercise period is seven years; and the life of the option is ten years. However, for the purposes of calculating the fair value of the award (see 9 below), the life of the award is taken as the period ending with the date on which the counterparty is most likely actually to exercise the option, which may be some time before the full ten-year life expires.

It is also important to distinguish between vesting conditions and other restrictions on the exercise of options and/or trading in shares, as demonstrated by Illustration 4-2 below.

Illustration 4-2: Meaning of 'vesting period' - award with vesting conditions and other restrictions

An employee is awarded options that can be exercised at any time between five and ten years from the date of the award, provided the employee remains in service for at least three years from the date of the award. In this case, the vesting period remains three years as in Illustration 4-1 above, provided that the employee's entitlement to the award becomes absolute at the end of three years, in other words, the employee does not have to provide services to the entity in years 4 and 5. The restriction on exercise of the award in the period after vesting is a non-vesting condition, which would be reflected in the original valuation of the award at the date of grant (see 5, 6 and 9 below).

The accounting implications of vesting conditions, non-vesting conditions and vesting periods for equity-settled transactions are discussed at 5 to 8 below and for cash-settled transactions at 10 below.

5 Equity-settled transactions – overview

5.1 Summary of accounting treatment

The provisions relating to accounting for equity-settled transactions are complex, even when supplemented by additional guidance found in the appendices and implementation guidance to IFRS 2. As noted at 1.2 above, FRS 102 does not replicate this guidance and therefore we have referred to IFRS 2 to supplement the requirements of FRS 102.

The key points can be summarised as follows:

- (a) All equity-settled transactions are measured at fair value. However, transactions with employees are measured using a 'grant date model' (i.e., the transaction is recorded at the fair value of the equity instrument at the date when it is originally granted), whereas transactions with non-employees are normally measured using a 'service date model' (i.e., the transaction is recorded at the fair value of the goods or services received at the date they are received). As noted at 4 above, all transactions, however measured, are recognised using a 'service date model' (see 6 below).
- (b) Where an award is made subject to future fulfilment of conditions, a 'market condition' (i.e., one related to the market price (or value) of the entity's equity instruments) or a 'non-vesting condition' (i.e., one that is neither a service condition nor a performance condition) is taken into account in determining the fair value of the award. However, the effect of conditions other than market and non-vesting conditions is ignored in determining the fair value of the award (see 4 above and 7 below).
- (c) Where an award is made subject to future fulfilment of service or performance vesting conditions, its cost is recognised over the period during which the service condition is fulfilled (see 4 above and 7 below). The corresponding credit entry is recorded within equity (see 5.2 below).
- (d) Until an equity instrument has vested (i.e., the entitlement to it is no longer conditional on future service) any amounts recorded are in effect contingent and will be adjusted if more or fewer awards vest than were originally anticipated to do so. However, an equity instrument awarded subject to a market condition or a non-vesting condition is considered to vest, irrespective of whether that market or non-vesting condition is fulfilled, provided that all other vesting conditions are satisfied (see 7 below).
- (e) No adjustments are made, either before or after vesting, to reflect the fact that an award has no value to the employee or other counterparty e.g., in the case of a share option, because the option exercise price is above the current market price of the share (see 7.1.1 and 7.1.3 below).
- (f) If an equity instrument is cancelled, whether by the entity or the counterparty (see (g) below) before vesting, any amount remaining to be expensed is charged in full at that point (see 8.4 below). If an equity instrument is modified before vesting (e.g., in the case of a share option, by changing the performance conditions or the exercise price), the financial statements must continue to show a cost for at least the fair value of the original instrument, as measured at the original grant date, together with any excess of the fair value of the modified instrument over that of the original instrument, as measured at the date of modification (see 8.3 below).
- (g) Where an award lapses during the vesting period due to a failure by the counterparty to satisfy a non-vesting condition within the counterparty's control, or a failure by the entity to satisfy a non-vesting condition within the entity's control, the lapse of the award is accounted for as if it were a cancellation (see (f) above and 7.4.3 below).
- (h) In determining the cost of an equity-settled transaction, whether the entity satisfies its obligations under the transaction with a fresh issue of shares or by purchasing its own shares in the financial markets or from private company shareholders is completely irrelevant to the charge in profit or loss, although there is clearly a difference in the cash flows. Where own shares are purchased, they are accounted for as treasury shares (see 3.4.6 above).

The requirements summarised in (d) to (g) above can have the effect that an entity is required to record a cost for an award that is deemed to vest for accounting purposes, but ultimately has no value to the counterparty because the award either does not vest or vests but is not exercised. These rather counter-intuitive requirements are in part 'anti-abuse' provisions to prevent entities from applying a 'selective' grant date model, whereby awards that increase in value after grant date remain measured at grant date while awards that decrease in value are remeasured. This is discussed further in the detailed analysis at 6 to 8 below.

5.2 The credit entry

As noted at (c) in the summary at 5.1 above, the basic accounting entry for an equity-settled share-based payment transaction is: *[FRS 102.26.3]*

Dr	Profit or loss for the period (employee costs)
	Cr Equity

FRS 102 does not prescribe whether the credit is required in a separate reserve or, if the entity chooses to treat it as such, how it must be described. Under the Companies Act 2006, an entity is permitted to credit a separate 'other reserve' rather than the credit being allocated initially to the profit and loss reserve. The 'other reserve' is generally labelled as 'shares to be issued' or 'share-based payment reserve' with the share-based payment credit held within this reserve until the award vests (if an award of free shares), is exercised or lapses (an award of options). When such trigger events occur, it will be appropriate for the entity to make a transfer between reserves.

The credit is not taken to share capital and share premium as these are used to record the legal proceeds of a share issue.

Overall, there will be a net nil impact on equity arising from the accounting as the profit and loss expense is ultimately reflected in the profit and loss reserve and offset by the credit taken directly to equity. The impact on distributable profits of employee share schemes depends on whether the reporting entity is a public company. Whilst FRS 102 is not specifically addressed, the effect of the similar accounting requirements of IFRS 2 is discussed in Section 7 of TECH 02/17BL: *Guidance on Realised and Distributable Profits under the Companies Act 2006* (TECH 02/17BL). *[TECH 02/17BL.7]*.

Occasionally there will be a credit to profit or loss (see for instance Illustration 7-7 at 7.2.4 below) and a corresponding reduction in equity.

6 Equity-settled transactions – cost of awards

6.1 Cost of awards – overview

The general measurement rule in FRS 102 is that an entity must measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the fair value of the goods or services received cannot be estimated reliably, the entity must measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. [FRS 102.26.7].

FRS 102 defines 'fair value' as: [FRS 102.26.1C]

Extract from FRS 102 Appendix I

fair value	fair value is the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Where the share-based payment is measured on the basis of the fair value of the equity instruments rather than the goods or services, Section 26 has its own specific rules in relation to determining the fair value which differ from the more general requirements of Section 2A Fair Value Measurement (see 6.5 below) and definition in FRS 102 Appendix I Glossary of 'fair value'. Section 2A specifically scopes out 'share-based payment transactions within the scope of Section 26. [FRS 102.2A.1(a)].

On their own, the general measurement principles of paragraph 7 of Section 26 might suggest that the reporting entity must determine in each case whether the fair value of the equity instruments granted or that of the goods or services received is more reliably determinable. However, paragraph 7 goes on to clarify that, in the case of transactions with employees and others providing similar services, the fair value of the equity instruments must always be used "because typically it is not possible to estimate reliably the fair value of the services received" (see 6.2 below). [FRS 102.26.7].

Moreover, transactions with employees and others providing similar services are measured at the date of grant (see 6.2 below), whereas those with non-employees are measured at the date when the entity obtains the goods or the counterparty renders service (see 6.4 below). [FRS 102.26.8].

The overall position can be summarised by the following matrix.

Counterparty	Measurement basis	Measurement date	Recognition date
Employee	Fair value of equity instruments awarded	Grant date	Service date
Non-employee	Fair value of goods or services received or, if goods or services not reliably measurable, fair value of equity instruments awarded	Service date	Service date

One effect of a grant date measurement model is that, applied to a grant of share options that is eventually exercised, it 'freezes' the accounting cost at the (typically) lower fair value at the date of grant. This excludes from the post-grant financial statements the increased cost and volatility that would be associated with a model that constantly remeasured the award to fair value until exercise date.

The price to be paid in accounting terms for the grant date model is that, when an award falls in value after grant date, it continues to be recognised at its higher grant date value. It is therefore quite possible that, during a period of general economic downturn, financial statements will show significant costs for options granted in previous years, but which are currently worthless.

6.2 Transactions with employees and others providing similar services

These will comprise the great majority of transactions accounted for as equity-settled share-based payments under Section 26 and include all remuneration in the form of shares, share options and any other form of reward settled in equity instruments of the entity or a member of its group.

6.2.1 Who is an 'employee'?

Given the difference between the accounting treatment of equity-settled transactions with employees and with non-employees, it is obviously important to understand what is meant by 'employees and others providing similar services'. [FRS 102.26.7]. FRS 102 does not provide a definition, but IFRS 2 defines 'employees and others providing similar services' as:

Extract from IFRS 2

Appendix A

Defined terms

employees and others providing similar services

Individuals who render personal services to the entity and either (a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees. For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

The implication of (a) and (b) above is that it is not open to an entity to argue that an individual who is not an employee as a matter of law is therefore automatically a non-employee for the purposes of IFRS 2 and FRS 102.

The implication of (b) and (c) above is that, where a third party provides services pursuant to a share-based payment transaction that could be provided by an employee (e.g., where an external IT consultant works alongside an in-house IT team), that third party is treated as an employee rather than a non-employee for the purposes of IFRS 2 and FRS 102.

Conversely, however, where an entity engages a consultant to undertake work for which there is not an existing in-house function, the implication is that such an individual is not regarded as an employee.

How we see it

In our view, the reference in (c) to "services ... similar to those rendered by employees" is to services rendered by employees that the entity actually has, rather than to employees that the entity might have if it were to recruit them. Otherwise, the distinction in IFRS 2 and FRS 102 between employees and non-employees would have no effect, since it would always be open to an entity to argue that it could employ someone to undertake any task instead of engaging a contractor.

Exceptionally, there might be cases where the same individual is engaged in both capacities. For example, a director of the entity might also be a partner in a firm of lawyers and be engaged in that latter capacity to advise the entity on a particular issue. It might be more appropriate to regard payment for the legal services as made to a non-employee rather than to an employee.

6.2.2 Basis of measurement

As noted above, equity-settled transactions with employees must be measured by reference to the fair value of the equity instruments granted at 'grant date' (see 6.3 below). [FRS 102.26.8]. FRS 102 offers no explanation as to why this is the case, but IFRS 2 asserts that this approach is necessary because shares, share options and other equity instruments are typically only part of a larger remuneration package, such that it would not be practicable to determine the value of the work performed in consideration for the cash element of the total package, the benefit-in-kind element, the share option element and so on. [IFRS 2.12].

In essence, this is really an anti-avoidance provision. The underlying concern is that, if an entity were able to value options by reference to the services provided for them, it might assert that the value of those services was zero, on the argument that its personnel are already so handsomely rewarded by the non-equity elements of their remuneration package (such as cash and health benefits), that no additional services are (or indeed could be) obtained by granting options.

6.3 Grant date

The determination of grant date is critical to the measurement of equity-settled share-based transactions with employees, since grant date is the date at which such transactions must be measured (see 6.2.2 above). Grant date is defined as:

Extract from FRS 102

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grant date	The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

In practice, it is not always clear when a shared understanding of the award (and, therefore, grant date) has occurred. Issues of interpretation can arise as to:

- How precise the shared understanding of the terms of the award must be.
- Exactly what level of communication between the reporting entity and the counterparty is sufficient to ensure the appropriate degree of agreement and 'shared understanding'.

As a consequence, the determination of the grant date is often difficult in practice. We discuss the following issues in more detail in the sections below:

- Basic determination of grant date (see 6.3.1 below).
- The communication of awards to employees and the rendering of services in advance of grant date (see 6.3.2 below).
- Awards where the exercise price or performance target depends on a formula or on a future share price (see 6.3.3 below).
- Awards where the exercise price is paid in shares - net settlement of award (see 6.3.4 below).
- An award of equity instruments to a fixed monetary value (see 6.3.5 below).
- Awards with multiple service and performance periods (see 6.3.6 below).
- Awards subject to modification or discretionary re-assessment by the entity after the original grant date (see 6.3.7 below).
- Mandatory or discretionary awards to 'good leavers' (see 6.3.8 below).

Some arrangements give rise to significant issues of interpretation in relation to the determination of grant date and the appropriate accounting treatment. For example:

- Automatic full or *pro rata* entitlement to awards on cessation of employment (see 6.3.8.C below).
- Awards over a fixed pool of shares (including 'last man standing' arrangements) (see 6.3.9 below).

An outline of the nature of these arrangements is given in this chapter but a detailed discussion is beyond the scope of this publication.

6.3.1 Determination of grant date

The definition of 'grant date' in Appendix I to FRS 102 (see 6.3 above) emphasises that a grant occurs only when all the conditions are understood and agreed by the parties to the arrangement, and any required approval process has been completed. This is reinforced by the implementation guidance accompanying the same definition in IFRS 2 which, in our view, must also be considered by an entity applying FRS 102.

For example, if an entity makes an award 'in principle' to an employee of options whose terms are subject to review or approval by a remuneration committee or the shareholders, 'grant date' is the later date when the necessary formalities have been completed. [FRS 102 Appendix I, IFRS 2.IG1, IFRS 2.IG2, IFRS 2.IG3].

The implementation guidance to IFRS 2 emphasises that “the word ‘agree’ is used in its usual sense, which means that there must be both an offer and an acceptance of that offer”. Therefore, there cannot be a grant unless an offer by one party has been accepted by the other party. The guidance notes that agreement will be explicit in some cases (e.g., if an agreement has to be signed), but in others it might be implicit, such as when an employee starts to deliver services for the award. [IFRS 2.IG2].

How we see it

In our view, determination of when the counterparty has agreed to an offer will often be an area of judgement that depends on the precise facts and circumstances of a particular situation.

The implementation guidance to IFRS 2 further notes that employees may begin rendering services in consideration for an award before it has been formally ratified. For example, a new employee might join an entity on 1 January and be granted options relating to performance for a period beginning on that date, but subject to formal approval by the remuneration committee at its next quarterly meeting on 15 March. In that case, the entity would typically begin expensing the award from 1 January based on a best estimate of its fair value, but would subsequently adjust that estimate so that the ultimate cost of the award was its actual fair value at 15 March (see 6.3.2 below). [IFRS 2.IG4]. This reference to formal approval could be construed as indicating that, in fact, FRS 102 and IFRS 2 require not merely that there is a mutual understanding of the award (which might well have been in existence since 1 January), but also that the entity has completed all processes necessary to make the award a legally binding agreement.

In practice, many situations are much less clear-cut than the examples given in the implementation guidance. Some of the practical interpretation issues are considered further below.

6.3.2 Communication of awards to employees and services in advance of grant date

As discussed at 6.3.1 above, the definition of grant date in FRS 102 together with the implementation guidance to IFRS 2 indicate that, in order for a grant to have been made, there must not merely be a mutual understanding of the terms, including the conditions attached to the award, but there must also be a legally enforceable arrangement. Thus, if an award requires board or shareholder approval for it to be legally binding on the reporting entity, it has not been granted until such approval has been given, even if the terms of the award are fully understood at an earlier date. However, if services are effectively being rendered for an award from a date earlier than the grant date as defined in IFRS 2, the cost of the award is required to be recognised over a period starting with that earlier date. An estimate of the grant date fair value of the award is used (e.g., by estimating the fair value of the equity instruments at the end of the reporting period), for the purposes of recognising the services received during the period between service commencement date and grant date. [IFRS 2.IG4].

How we see it

In some situations, the employee will have a valid expectation of an award, and the entity will have a corresponding obligation, based on an earlier commitment by the entity. However, it might be the case that not all of the precise terms and conditions have been finalised. In our view, provided it is possible to estimate the fair value of the arrangement, an estimated cost for services is to be recognised in advance of grant date in such cases as well as in those situations where formal approval does not take place until a later date.

In situations where the entity estimates at the reporting date the grant date fair value of an award for services received in advance of grant date, the estimate is revised at subsequent reporting periods until the date of grant has been established. Once grant date has been established the entity revises the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments awarded.

The implications of this approach are demonstrated in Illustration 6-1 below for a situation where formal approval of an award is delayed. It is important, however, to retain a sense of proportion in considering the overall impact on the financial statements. For example, in cases where the share price or value is not particularly volatile, whether the grant date is, say, 1 January or 1 April may not make a great difference to the valuation of the award, particularly when set beside the range of acceptable valuations resulting from the use of estimates in the valuation process.

Illustration 6-1: Determination of grant date*Scenario 1*

On 1 January an entity advises employees of the terms of a share award designed to reward performance over the following three years. The award is subject to board approval, which is given two months later on 1 March. Grant date is 1 March. However, the cost of the award would be recognised over the three-year period beginning 1 January, since the employees would have effectively been rendering service for the award from that date.

Scenario 2

On 1 January an entity's board resolves to implement a share scheme designed to reward performance over the following three years. The award is notified to employees two months later on 1 March. Grant date is again 1 March. *Prima facie*, in this case, the cost of the award would be recognised over the two years and ten months beginning 1 March, since the employees could not be regarded as rendering service in January and February for an award of which they were not aware at that time.

However, if a similar award is made each year, and according to a similar timescale, there might be an argument that, during January and February of each year, the employees are rendering service for an award of which there is high expectation, and that the cost is therefore, as in Scenario 1, recognised over the full three year period. The broader issue of the accounting treatment for awards of which there is a high expectation is addressed in the discussion of matching share awards at 16.1 below.

Scenario 3

On 1 January an entity advises employees of the terms of a share award designed to reward performance over the following three years. The award is subject to board approval, which is given two months later on 1 March. However, in giving such approval, the board makes some changes to the performance conditions as originally communicated to employees on 1 January. The revised terms of the award are communicated to employees a month later on 1 April. Grant date is 1 April. However, the cost of the award would be recognised over the three-year period beginning 1 January, since the employees would have effectively been rendering service for the award from that date.

Examples of situations where an employee might render service in advance of the formal grant date because the precise conditions of an award are outstanding are considered at 6.3.3 to 6.3.6 and at 16.4.1 below.

6.3.3 Exercise price or performance target dependent on a formula or future share price

Some share plans define the exercise price not in absolute terms, but as a factor of the share price. For example, the price might be expressed as:

- A percentage of the share price at exercise date.
- Or
- A percentage of the lower of the share price at grant date and at exercise date.

The effect of this is that, although the actual exercise price is not known until the date of exercise, both the entity and the counterparty already have a shared understanding of how the price will be calculated and it is possible to estimate the outcome on an ongoing basis without the need for additional approval or inputs.

A similar approach might be applied in the setting of performance targets, i.e., they are set by reference to a formula rather than in absolute terms and so do not require further input by the entity or its shareholders.

In order for there to be a shared understanding and a grant date, the formula or method of determining the outcome needs to be sufficiently clear and objective to allow both the entity and the counterparty to make an estimate of the outcome of the award during the vesting period. Where there is subjectivity in determining the formula or method of determining the outcome there can be no shared understanding and a grant date (see scenario 2 in Illustration 6-3 in 6.3.6 below).

How we see it

In our view, grant date is the date on which the terms and conditions (including the formula for calculating the exercise price or performance target) are determined sufficiently clearly and agreed by the entity and the counterparty, subject to the matters discussed at 6.3.2 above.

6.3.4 Exercise price paid in shares (net settlement of award)

Some share awards allow the exercise price to be paid in shares. In practical terms, this means that the number of shares delivered to the counterparty will be the total 'gross' number of shares awarded less as many shares as have, at the date of exercise, a fair value equal to the exercise price.

How we see it

The above situation is analogous to that described at 6.3.3 above in that, whilst the absolute 'net' number of shares awarded will not be known until the date of exercise, the basis on which that 'net' number will be determined is established in advance. Accordingly, in our view, grant date is the date on which the terms and conditions (including the ability to surrender shares to a fair value equal to the exercise price) are determined and agreed by the entity and the counterparty, subject to the matters discussed at 6.3.2 above.

Such a scheme could be analysed as a share-settled share appreciation right (whereby the employee receives shares to the value of the excess of the value of the shares given over the exercise price), which is accounted for as an equity-settled award.

Awards settled in shares net of a cash amount to meet an employee's tax liability are considered further at 15.3 below.

6.3.5 Award of equity instruments to a fixed monetary value

Some entities may grant awards to employees of shares equivalent to a fixed value. For example, an entity might award as many shares as are worth £10,000, with the number of shares being calculated by reference to the share price as at the vesting date. The number of shares ultimately received will not be known until the vesting date. This begs the question of whether such an award can be regarded as having been granted until that date, on the argument that it is only then that the number of shares to be delivered, which is a key term of the award, is known, and therefore there cannot be a 'shared understanding' of the terms of the award until that later date.

How we see it

The above situation is analogous to those in 6.3.3 and 6.3.4 above in that, whilst the absolute number of shares awarded will not be known until the vesting date, the basis on which that number will be determined is established in advance in a manner sufficiently clear and objective as to allow an ongoing estimate by the entity and by the counterparty of the number of awards expected to vest. Accordingly, in our view, grant date is the date on which the terms and conditions are determined sufficiently clearly and agreed by the entity and the counterparty, subject to the matters discussed at 6.3.2 above.

FRS 102 does not address the valuation of such awards and IFRS 2 does not address it directly. Intuitively, it might seem obvious that an award which promises (subject to vesting conditions) shares to the value of £10,000 must have a grant date fair value of £10,000, adjusted for the time value of money, together with market conditions and non-vesting conditions. However, matters are not so clear-cut, as shown in Illustration 6-2:

Illustration 6-2: Award of shares to a fixed monetary value

At the beginning of year 1, the reporting entity grants:

- To Employee A an award of 1,000 shares subject to remaining in employment for three years.
- And
- To Employee B £10,000 subject to remaining in employment for three years, to be paid in as many shares as are (at the end of year 3) worth £10,000.

Both awards vest, and the share price at the end of year 3 is £10, so that both employees receive 1,000 shares.

Applying Section 26, the charge for A's award is clearly $1000 \times$ the fair value as at the beginning of year 1 of a share deliverable in three years' time. What is the charge for B's award?

How we see it

In our view, the fair value of the equity instruments granted for B's award would be the £10,000 adjusted for the time value of money, as the value employee B will receive is fixed at £10,000 and is independent of the share price. This amount, determined at grant date, would be recognised as an expense over the vesting period, which in this case is a three-year service condition for employee B.

Although Section 26 does not directly address the valuation of awards of equity instruments equivalent to a fixed monetary value, the standard does require the grant date fair value of the equity instruments awarded to be recognised, which for a fixed monetary award would be the fixed monetary amount to be received adjusted for the time value of money.

6.3.6 Awards with multiple service and performance periods

Entities frequently make awards that cover more than one reporting period, but with different performance conditions for each period, rather than a single cumulative target for the whole vesting period. In such cases, the grant date may depend on the precision with which the terms of the award are communicated to employees, as demonstrated by Illustration 6-3 below.

Illustration 6-3: Awards with multiple service and performance periods

Scenario 1

At the beginning of year 1, an entity enters into a share-based payment arrangement with an employee. The employee is informed that the maximum potential award is 40,000 shares, 10,000 of which will vest at the end of year 1, and 10,000 more at the end of each of years 2 to 4. Vesting of each of the four tranches of 10,000 shares is conditional on:

- (a) The employee having been in continuous service until the end of each relevant year.

And

- (b) Revenue targets for each of those four years, as communicated to the employee at the beginning of year 1, having been attained.

In this case, the terms of the award are clearly understood by both parties at the beginning of year 1, and this is therefore the grant date under FRS 102 (subject to issues such as any requirement for later formal approval – see 6.3 above). The cost of the award can be recognised using a 'graded' vesting approach, or using a simpler alternative – see 7.2.2 below.

Scenario 2

At the beginning of year 1, an entity enters into a share-based payment arrangement with an employee. The employee is informed that the maximum potential award is 40,000 shares, 10,000 of which will vest at the end of year 1, and 10,000 more at the end of each of years 2 to 4. Vesting of each tranche of 10,000 shares is conditional on:

- (a) The employee having been in continuous service until the end of each relevant year.

And

- (b) Budgeted revenue targets for each of those four years, to be communicated to the employee once management establish the budget at the beginning of each relevant year in respect of that year only, having been attained.

In this case, in our view, at the beginning of year 1 there is a clear shared understanding only of the terms of the first tranche of 10,000 shares that will potentially vest at the end of year 1. There is no clear understanding of the terms of the tranches potentially vesting at the end of years 2 to 4 because their vesting depends on attaining budgeted revenue targets for those years which have not yet been set. The revenue targets remain subjective until management establish the budget for the relevant year and communicate the target to employees.

Accordingly, each of the four tranches of 10,000 shares has a separate grant date (and, therefore, a separate measurement date), i.e., the beginning of each of years 1, 2, 3 and 4, and a vesting period of one year from the relevant grant date.

In this type of situation, the entity would also need to consider whether, in the absence of a grant date, the employee was nonetheless rendering services in advance of the grant date. However, if targets are unquantified and do not depend on a formula, for example, then it is likely to be difficult to estimate an expense in advance of the grant date (see 6.3.2 above).

A variation on the above two scenarios which is seen quite frequently in practice is an award where the target is quantified for the first year and the targets for subsequent years depend on a formula-based increase in the year 1 target. The formula is set at the same time as the year 1 target.

Whether the accounting treatment for scenario 1 above or scenario 2 above is the more appropriate in such a situation is, in our view, a matter of judgement depending on the precise terms of the arrangement (see 6.3.3 above).

How we see it

To summarise the above, where an award is made over more than one reporting period but with different performance conditions, rather than a single cumulative target, grant date will depend on the precision with which the terms of the award are communicated to employees. If the terms are clearly understood by both parties at the start of the award for all periods (i.e., scenario 1 above), grant date is established. If the performance conditions are set at a later date for subsequent periods, grant date is established when the terms are understood by both parties, which would result in different grant dates for each tranche (i.e., scenario 2 above). The entity would also need to consider whether, in the absence of a grant date, the employee was nonetheless rendering services in advance of the grant date.

6.3.7 Awards subject to modification by entity after original grant date

Some employee share awards are drafted in terms that give the entity discretion to modify the detailed terms of the scheme after grant date. Some have questioned whether this effectively means that the date originally determined as the 'grant date' is not in fact the grant date as defined in FRS 102, on the grounds that the entity's right to modify means that the terms are not in fact understood by both parties in advance.

How we see it

The above, in our view, is very often not an appropriate analysis. If it were, it could mean that significant numbers of share-based awards to employees (in the UK) would be required to be measured at vesting date, which clearly is not intended under the grant date model in Section 26.

The assessment of whether or not an intervention by the entity after grant date constitutes a modification is often difficult. Some situations commonly encountered in practice are considered in the sections below.

6.3.7.A Significant equity restructuring or transactions

Many schemes contain provisions designed to ensure that the value of awards is maintained following a major capital restructuring (such as a share split or share consolidation – see 8.7 below) or a major transaction with shareholders as a whole (such as a major share buyback or the payment of a special dividend). These provisions will either specify the adjustments to be made in a particular situation or, alternatively, may allow the entity to make such discretionary adjustments as it sees fit in order to maintain the value of awards. In some cases, the exercise of such discretionary powers may be relatively mechanistic (e.g., the adjustment of the number of shares subject to options following a share split). In other cases, more subjectivity will be involved (e.g., in determining whether a particular dividend is a 'special' dividend for the purposes of the scheme).

In our view, where the scheme rules specify the adjustments to be made or where there is a legal requirement to make adjustments in order to remedy any dilution that would otherwise arise, the implementation of such adjustments would not result in the recognition of any incremental fair value. This assumes that the adjustment would simply operate on an automatic basis to put the holders of awards back to the position that they would have been in had there not been a restructuring and hence there would be no difference in the fair value of the awards before and after the restructuring (or other specified event).

However, where there is no such explicit requirement in the scheme rules or under relevant legislation, we believe that there must be a presumption that the exercise of the entity's discretionary right to modify is a 'modification' as outlined in FRS 102. In such a situation, the fair values before and after the modification may differ and any incremental fair value is required to be expensed over the remaining vesting period (see 8.3 below).

How we see it

In summary, as noted above, no incremental fair value would arise where the adjustment would simply operate on an automatic basis to put the holders of awards back to the position that they would have been in had there not been a restructuring, if the scheme rules or relevant legislation require an adjustment to remedy any dilution. Where there is no explicit requirement in the scheme rules or relevant legislation the exercise of the entity's discretionary right to modify is a 'modification' as defined in FRS 102.

6.3.7.B Interpretation of general terms

More problematic might be the exercise of any discretion by the entity to interpret the more general terms of a scheme in deciding whether performance targets have been met and therefore whether, and to what extent, an award should vest. In this case, there might be more of an argument that the entity's intervention constitutes a modification.

If such an intervention were not regarded as a modification, then the results might be different depending on the nature of the award and the conditions attached to it. Where an award is subject to a market condition, or to a non-vesting condition, an expense might well have to be recognised in any event, if all the non-market vesting conditions (e.g., service) were satisfied, see 7.3 and 7.4 below.

However, suppose that an award had been based on a non-market performance condition, such as a profit target, which was met, but only due to a gain of an unusual, non-recurring nature. The Board of Directors concludes that this must be ignored, with the effect that the award does not vest. If this is regarded as the exercise of a pre-existing right to ensure that the award vests only if 'normal' profit reaches a given level, then there has been no modification. On this analysis, the award has not vested, and any expense previously recognised would be reversed. If, however, the Board's intervention is regarded as a modification, it would have no impact on the accounting treatment in this case, as the effect would not be beneficial to the employee and so the modification would be ignored under the general requirements of FRS 102 relating to modifications (see 8.3.2 below).

6.3.7.C Discretion to make further awards

Some schemes may contain terms that give the entity the power to increase an award in circumstances where the recipient is considered to have delivered exceptional performance, or some such similar wording.

How we see it

In our view, unless the criteria for judging such exceptional performance are so clear as to be, in effect, performance conditions, the presumption is that any award made pursuant to such a clause is granted, and therefore measured, when it is made.

There may be circumstances where an award described as 'discretionary' may not truly be so, since the entity has created an expectation amounting to an obligation to make the award. However, we believe that it would be somewhat contradictory to argue that such expectations had been created in the case of an award stated to be for (undefined) exceptional performance only.

6.3.8 'Good leaver' arrangements

It is common for awards to contain a so-called 'good leaver' clause. A 'good leaver' clause is one which makes provision for an employee who leaves before the end of the full vesting period of an award nevertheless to receive some or all of the award on leaving (see 6.3.8.A below).

In other cases, the original terms of an award will either make no reference to 'good leavers' or will not be sufficiently specific to allow the accounting treatment on cessation of employment to be an automatic outcome of the original terms of the scheme. In such cases, and in situations where awards are made to leavers on a fully discretionary basis, the accounting approach differs from that required where the original terms are clear about 'good leaver' classification and entitlement (see 6.3.8.B below).

We refer throughout this section on 'good leavers' to an employee leaving employment, but similar considerations apply when an individual automatically becomes entitled to an award before the end of the original vesting period due to other reasons specified in the terms of the agreement, e.g., attaining a certain age or achieving a specified length of service, even if the individual remains in employment after the relevant date. In these situations, the date of full entitlement is the date on which any services, and therefore expense recognition, cease for the purposes of Section 26.

Arrangements for a good leaver to receive all, or part, of an award on leaving employment must be distinguished from a situation where an employee leaves with no award and where forfeiture accounting is likely to apply (see 8.4.1.A below).

6.3.8.A Provision for 'good leavers' made in original terms of award

In some cases, the types of persons who are 'good leavers' may be explicitly defined in the original terms of the arrangement (common examples being persons who die or reach normal retirement age before the end of the full vesting period, or who work for a business unit that is sold or closed during the vesting period). In other cases, the entity may have the discretion to determine on a case-by-case basis whether a person can be treated as a 'good leaver'.

In addition, some schemes may specify the entitlement of a 'good leaver' on leaving (e.g., that the leaver receive a portion of the award pro-rata to the extent that the performance conditions have been met as at the date of leaving), whereas others leave the determination of the award to the entity at the time that the employee leaves.

Whichever situation applies, any expense relating to an award to a good leaver must be fully recognised by the leaving date (or date of unconditional entitlement, if earlier than the usual vesting date) because, at that point, the good leaver ceases to provide any services to the entity for the award and any remaining conditions attached to the award will be treated as non-vesting rather than vesting conditions (see 4.2 above).

How we see it

In our view, an award which vests before the end of the original vesting period due to the operation of a 'good leaver' clause is measured at the original grant date only where, under the rules of the scheme as understood by both parties at the original grant date, the award is made:

- To a person clearly identified as a 'good leaver'
- And
- In an amount clearly quantified or quantifiable

Where, as outlined above, the rules of the scheme make clear the categories of 'good leaver' and their entitlement, the entity must assess at grant date how many good leavers there are likely to be and to what extent the service period for these particular individuals is expected to be shorter than the full vesting period. The grant date fair value of the estimated awards to good leavers must be separately determined, where significant, and the expense relating to good leavers recognised over the expected period between grant date and leaving employment (or date of unconditional entitlement). In this situation the entity would re-estimate the number of good leavers and adjust the cumulative expense at each reporting date. This would be a change of estimate rather than a modification of the award as it would all be in accordance with the original terms and would require no discretionary decisions on the part of the entity. We would not generally expect an entity to have significant numbers of good leavers under such an arrangement.

6.3.8.B Discretionary awards to 'good leavers'

Awards where the arrangements for leavers are clear as at the original grant date of the award are discussed at 6.3.8.A above. However, it is often the case that the entity determines only at, or near, the time that the employee leaves either that the employee is a 'good leaver' or the amount of the award. In such cases, grant date or modification date (see further below) must be taken as the later of the date on which such determination is made, or the date on which the award is notified to the employee. This is because the employee had no clear understanding at the original grant date of an automatic entitlement to equity instruments other than through full vesting of the award at the end of the full service period.

How we see it

In our view, an entity is required to assess the appropriate accounting treatment for discretionary awards to 'good leavers' based on the particular facts and circumstances and the extent to which the discretionary award is linked to the original award.

The discretionary award at the time of leaving is considered to be either a modification of an original award in the employee's favour (for example, where vesting conditions are waived to allow an individual to keep an award) or the forfeiture of the original award and the granting of a completely new award on a discretionary basis (see 8.3 and 8.5 below).

In some cases, a good leaver will be allowed, on a discretionary basis, to keep existing awards that remain subject to performance conditions established at the original grant date. In this situation, any conditions that were previously treated as vesting conditions will become non-vesting conditions following the removal of the service requirement (see 4.1 and 4.2 above). This will be the case whether the discretionary arrangement is accounted for as the forfeiture of the old award plus a new grant or as a modification of the original award.

The non-vesting conditions will need to be reflected in the measurement of the fair value of the award as at the date of modification or new grant (although the non-vesting conditions alone will not result in any incremental fair value). Any fair value that is unrecognised as at the date of the good leaver ceasing employment will need to be expensed immediately as there is no further service period over which to recognise the expense.

There is further discussion of modifications at 8.3 below and of replacement and *ex gratia* awards granted on termination of employment at 8.5 below.

6.3.8.C Automatic full or pro rata entitlement on cessation of employment

In some cases, entities establish schemes where a significant number of the participants will potentially leave employment before the end of the full vesting period and will be allowed to keep a *pro rata* share of the award.

Such arrangements are encountered relatively infrequently and mostly outside the UK. Accordingly, a detailed discussion of the accounting treatment is beyond the scope of this publication. There is further detail available in EY's publication International GAAP®.

6.3.9 Awards over a fixed pool of shares (including 'last man standing' arrangements)

An award over a fixed pool of shares is sometimes granted to a small group of, typically senior employees. Such awards might involve an initial allocation of shares to each individual but also provide for the redistribution of each employee's shares to the other participants should any individual leave employment before the end of the vesting period. This is often referred to as a 'last man standing' arrangement.

The accounting requirements for such an arrangement are unclear and discussion of the various approaches seen in practice is beyond the scope of this publication. In the absence of specific guidance, several interpretations are possible, and these are discussed in EY's publication International GAAP®.

6.4 Transactions with non-employees

In accounting for equity-settled transactions with non-employees, the starting point is that the value of the goods or services received provides the more reliable indication of the fair value of the transaction. The fair value to be used is that at the date on which the goods are obtained or the services rendered. [FRS 102.26.3, FRS 102.26.7, FRS 102.26.8J]. This implies that, where the goods or services are received on a number of dates over a period, the fair value at each date must be used, although in the case of a relatively short period there may be no great fluctuation in fair value.

If the entity rebuts the presumption that the goods or services provide the more reliable indication of fair value, it may use as a surrogate measure the fair value of the equity instruments granted, but as at the date when the goods or services are received, not the original grant date. However, where the goods or services are received over a relatively short period and the share price does not change significantly, an average share price can be used in calculating the fair value of equity instruments granted.

6.4.1 Effect of change of status from employee to non-employee (or vice versa)

Neither FRS 102 nor IFRS 2 gives specific guidance on how to account for an award when the status of the counterparty changes from employee to non-employee (or *vice versa*) but, in all other respects, the award remains unchanged.

How we see it

We believe, the accounting following the change of status will depend on the entity's assessment of whether or not the counterparty is performing the same or similar services before and after the change of status. If it is concluded that the counterparty is providing the same or similar services before and after the change of status, the measurement approach remains unchanged. However, if the services provided are substantially different, the accounting following the change of status will be determined by the counterparty's new status.

A change of status is rare in practice. A detailed discussion is beyond the scope of this publication, but the matter is addressed in EY's publication International GAAP®.

6.5 Determining the fair value of equity instruments

As discussed at 6.2 and 6.4 above, FRS 102 requires the following equity-settled transactions to be measured by reference to the fair value of the equity instruments issued rather than that of the goods or services received:

- All transactions with employees.
- And
- Transactions with non-employees where, in rare cases, the entity rebuts the presumption that the fair value of goods or services provided is more reliably measurable.

There will also be situations where the identifiable consideration received (if any) from non-employees appears to be less than the fair value of consideration given. In such cases, an entity will need to determine the fair value of the equity instruments (see 3.2.3 above).

For all transactions measured by reference to the fair value of the equity instruments granted, Section 26 requires fair value to be measured at the 'measurement date', i.e., grant date in the case of transactions with employees and service date in the case of transactions with non-employees. [FRS 102.26.8]. Fair value must be based on market prices if available. [FRS 102.26.10, FRS 102.26.11]. In the absence of market prices or other entity-specific market data, a valuation method must be used to estimate what the market price would have been on the measurement date in an arm's length transaction between knowledgeable and willing parties. The technique used must be a generally recognised valuation methodology for valuing equity instruments that is appropriate to the circumstances of the entity and uses market data to the greatest extent possible. [FRS 102.26.10, FRS 102.26.11].

Paragraphs 10 to 11 of Section 26 outline requirements on valuation and are discussed at 9 below, supplemented by guidance from the appendices and implementation guidance to IFRS 2. As noted elsewhere in this chapter, the 'fair value' of equity instruments under Section 26 takes account of some, but not all, conditions attached to an award rather than being a 'true' fair value (see 7.3 and 7.4 below on the treatment of market and non-vesting conditions).

7 Equity-settled transactions – allocation of expense

7.1 Overview

Equity-settled transactions, particularly those with employees, raise particular accounting problems since they are often subject to vesting conditions (see 4.1 above) that can be satisfied only over an extended vesting period.

An award of equity instruments that vests immediately is presumed, in the absence of evidence to the contrary, to relate to services that have already been rendered, and is therefore expensed in full at grant date. [FRS 102.26.5]. This may lead to the immediate recognition of an expense for an award to which the employee may not be legally entitled for some time, as demonstrated in Illustration 7-1.

Illustration 7-1: Award with non-vesting condition only

An entity grants a director share options, exercisable after three years provided the director does not compete with the reporting entity for a period of at least three years. The 'non-compete' clause is considered to be a non-vesting condition (see 4.2 above and 7.4 below). As this is the only condition to which the award is subject, the award has no vesting conditions and therefore vests immediately. The fair value of the award at the date of grant, including the effect of the 'non-compete' clause, is determined to be £150,000.

Accordingly, the entity immediately recognises a cost of £150,000.

This cost can never be reversed, even if the director goes to work for a competitor and loses the award. This is discussed more fully at 7.4 below.

Where equity instruments are granted subject to vesting conditions (as in many cases they will be, particularly where payments to employees are concerned), FRS 102 creates a presumption that they are a payment for services to be received in the future, during the 'vesting period', with the transaction being recognised during that period, as demonstrated in Illustration 7-2. [FRS 102.26.6].

Illustration 7-2: Award with service condition only

An entity grants a director share options on condition that the director remain in employment for three years. The requirement to remain in employment is a service condition, and therefore a vesting condition, which will take three years to fulfil. The fair value of the award at the date of grant, ignoring the effect of the vesting condition, is determined to be £300,000. The entity will record a cost of £100,000 a year in profit or loss for three years, with a corresponding increase in equity.

In practice, the calculations required by FRS 102 are unlikely to be as simple as that in Illustration 7-2. In particular:

- The final number of awards that vest cannot be known until the vesting date (because employees may leave before the vesting date, or because relevant performance conditions may not be met).
- And
- The length of the vesting period may not be known in advance (since vesting may depend on satisfaction of a performance condition with no, or a variable, time-limit on its attainment).

In order to deal with such issues, FRS 102 requires a continuous re-estimation process as summarised at 7.1.1 below.

7.1.1 The continuous estimation process of Section 26

The overall objective is that, at the end of the vesting period, the cumulative cost recognised in profit or loss (or, where applicable, included in the carrying amount of an asset), must represent the product of the following two items:

- The number of equity instruments that have vested, or would have vested, but for the failure to satisfy a market condition (see 7.3 below) or a non-vesting condition (see 7.4 below).
- The fair value (excluding the effect of any non-market vesting conditions, but including the effect of any market conditions or non-vesting conditions) of those equity instruments at the date of grant.

It is essential to appreciate that the 'grant date' measurement model in FRS 102 seeks to capture the value of the contingent right to shares promised at grant date, to the extent that the promise becomes (or is deemed to become (see 7.1.2 below)) an entitlement of the counterparty, rather than the value of any shares finally delivered. Therefore, if an option vests, but is not exercised because it would not be in the counterparty's economic interest to do so, FRS 102 still requires a cost for the award to be recognised.

In order to achieve this outcome, FRS 102 requires the following process to be applied:

- (a) At grant date, the fair value of the award (excluding the effect of any service and non-market performance vesting conditions, but including the effect of any market conditions or non-vesting conditions) is determined. [FRS 102.26.7, FRS 102.26.8, FRS 102.26.9].
- (b) At each subsequent reporting date until vesting, the entity calculates a best estimate of the cumulative charge to profit or loss at that date, being the product of:
 - (i) The grant date fair value of the award determined in (a) above.
 - (ii) The current best estimate of the number of awards that will vest (see 7.1.2 below). [FRS 102.26.9].
 - (iii) The expired portion of the vesting period.
- (c) The charge (or credit) to profit or loss for the period is the cumulative amount calculated in (b) above less the amounts already charged in previous periods. There is a corresponding credit (or debit) to equity. [FRS 102.26.3].
- (d) Once the awards have vested, no further accounting adjustments are made to the cost of the award, except in respect of certain modifications to the award (see 8 below).
- (e) If a vested award is not exercised, an entity may (but need not) make a transfer between reserves (see 7.1.3 below).

The overall effect of this process is that a cost is recognised for every award that is granted, except when it is forfeited for failure to meet a vesting condition (see 7.1.2 below). [FRS 102.26.9].

7.1.2 Vesting and forfeiture

In normal English usage, and in many share scheme documents, an award is described as 'vested' when all the conditions needed to earn it have been met, and as 'forfeited' where it lapses before vesting because one or more of the conditions has not been met.

IFRS 2 uses the term 'forfeiture' in a much more restricted sense to refer to an award that does not vest in IFRS 2 terms. FRS 102 takes a similar approach although it does not specifically refer to 'forfeiture' of an award. Essentially the approach is as follows:

- Where an award is subject only to vesting conditions other than market conditions, failure to satisfy any one of the conditions is treated as a forfeiture (and any cumulative expense recognised to date is reversed).
- Where an award is subject to both:
 - Vesting conditions other than market conditions
 - Market conditions and/or non-vesting conditions
 Failure to satisfy any one of the vesting conditions other than market conditions is treated as a forfeiture. Otherwise (i.e., where all the vesting conditions other than market conditions are satisfied), the award is deemed to vest even if the market conditions and/or non-vesting conditions have not been satisfied.
- Where an award is subject only to non-vesting conditions, it is always deemed to vest.

Where an award has been modified (see 8.3 below) so that different vesting conditions apply to the original and modified elements of an award, forfeiture will not apply to the original award if the service and non-market performance conditions attached to that element have been met. This will be the case even if the service and non-market performance conditions attached to the modified award have not been met and so the modified award is considered to have been forfeited (resulting in the reversal of any incremental expense relating to the modification). Illustration 8-6 and Illustration 8-7 at 8.3 below demonstrate this point.

As a result of the interaction of the various types of conditions, the reference in the summary at 7.1.1 above to the 'best estimate of the number of awards that will vest' really means the best estimate of the number of awards for which it is expected that all non-market vesting conditions will be met.

In practice, however, it is not always clear how that best estimate is to be determined, and in particular what future events may and may not be factored into the estimate. This is discussed further at 7.2 to 7.4 and 8.6 below.

7.1.3 Accounting after vesting

FRS 102 does not address specifically the treatment of share-based payment transactions once they have vested but it seems appropriate to adopt the approach required by IFRS 2.

Once an equity-settled transaction has vested (or, in the case of a transaction subject to one or more market or non-vesting conditions, has been treated as vested (see 7.1.2 above)), no further accounting entries are made to reverse the cost already charged, even if the instruments that are the subject of the transaction are subsequently forfeited or, in the case of options, are not exercised. However, the entity may make a transfer between different components of equity. [IFRS 2.23]. For example, an entity's accounting policy might be to credit all amounts recorded for share-based transactions to a separate reserve such as 'Shares to be issued'. Where an award lapses after vesting, it would then be appropriate to transfer an amount equivalent to the cumulative cost for the lapsed award from 'Shares to be issued' to another component of equity, usually the profit and loss reserve.

This prohibition against 'truing up' (i.e., reversing the cost of vested awards that lapse) is controversial, since it has the effect that a cost is still recognised for options that are never exercised, typically because they are 'underwater' (i.e., the current share price is lower than the option exercise price), so that it is not in the holder's interest to exercise the option.

7.2 Vesting conditions other than market conditions

7.2.1 Awards with service conditions and non-market vesting conditions

7.2.1.A Awards with service conditions

Most share-based payment transactions with employees are subject to explicit or implied service conditions. Illustration 7-3 and Illustration 7-4 below demonstrate the application of the allocation principles discussed at 7.1 above to awards subject only to service conditions which are based on the implementation guidance to IFRS 2. [IFRS 2.IG11].

Illustration 7-3: Award with no change in the estimate of number of awards vesting

An entity grants 100 share options to each of its 500 employees. Vesting is conditional upon the employees working for the entity over the next three years. The entity estimates that the fair value of each share option is £15. The entity's best estimate at each reporting date is that 100 (i.e., 20%) of the original 500 employees will leave during the three-year period and therefore forfeit their rights to the share options.

If everything turns out exactly as expected, the entity will recognise the following amounts during the vesting period for services received as consideration for the share options.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period‡ (£)
1	50,000 options × 80%* × £15 × 1/3†	200,000	200,000
2	50,000 options × 80% × £15 × 2/3	400,000	200,000
3	50,000 options × 80% × £15 × 3/3	600,000	200,000

* The entity expects 100 of its 500 of employees to leave and therefore only 80% of the options to vest.

† The vesting period is 3 years, and 1 year of it has expired.

‡ In each case the expense for the period is the difference between the calculated cumulative expense at the beginning and end of the period.

Illustration 7-4: Award with revised estimate of number of awards vesting due to staff turnover

As in Illustration 7-3 above, an entity grants 100 share options to each of its 500 employees. Vesting is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share option is £15.

In this case, however, 20 employees leave during the first year, and the entity's best estimate at the end of year 1 is that a total of 75 (15%) of the original 500 employees will have left before the end of the vesting period. During the second year, a further 22 employees leave, and the entity revises its estimate of total employee departures over the vesting period from 15% to 12% (i.e., 60 of the original 500 employees). During the third year, a further 15 employees leave. Hence, a total of 57 employees (20 + 22 + 15) forfeit their rights to the share options during the three-year period, and a total of 44,300 share options (443 employees × 100 options per employee) finally vest.

The entity will recognise the following amounts during the vesting period for services received as consideration for the share options.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	50,000 options × 85% × £15 × 1/3	212,500	212,500
2	50,000 options × 88% × £15 × 2/3	440,000	227,500
3	44,300 options × £15 × 3/3	664,500	224,500

In Illustration 7-4 above, the number of employees that leave during year 1 and year 2 is not directly relevant to the calculation of cumulative expense in those years, but would naturally be a factor taken into account by the entity in estimating the likely number of awards finally vesting.

7.2.1.B Non-market vesting conditions

It is common for entities to enter into share-based payment arrangements with employees subject to vesting conditions that include performance conditions (see 4.1 above). A performance condition requires a specified period of service to be completed and the achievement of performance targets. Performance targets are either non-market vesting conditions (also referred to as 'non-market performance conditions'), considered further in this section of the chapter, or market conditions (see 7.3 below). A performance target that is a non-market vesting condition is referenced to the entity's own operations (or activities) or the operations or activities of another entity in the same group. A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

Examples of non-market vesting conditions include achieving EPS, sales, profit or some Environmental, Social and Governance (ESG) targets. Examples of ESG targets include targets to reduce Scope 1, Scope 2 and possibly Scope 3 GHG emissions (see 4.1.2 above), health and safety incidents of an entity or targets to increase employee engagement and workforce diversity.

Section 26 requires that an entity not take into account vesting conditions other than market conditions when estimating the fair value of equity instruments granted. Instead, vesting conditions, other than market conditions i.e., non-market vesting conditions, are taken into account by adjusting the number of equity instruments that are expected to vest. [FRS 102.26.9(a)].

In determining the expected number of equity instruments that are expected to vest as a result of a non-market vesting condition, the cumulative charge during the vesting period would be based on the best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome. For example, if an employee was granted 100 share options which vest if the employee remains in service for three years and on achieving a profit-before-tax ('PBT') target, if that employee is still in service at the end of the three years, either 100 options will vest if the PBT target is met or zero options will vest if the PBT target is not met. During the vesting period the entity would need to make an assessment of the number of options that are expected to vest at each reporting date. If the entity assesses at the end of year one the probability that the PBT target would be met is 70% and the service condition will be met, the year one expense would be based on the full 100 options expected to vest at the end of year three, which represents the best estimate of the most likely outcome. In this example, the outcome is binary, the employee will receive either 100 or zero options based on the achievement or not of the PBT target and service condition, they will never receive 70% of the options. Assuming the entity recognised an expense for the award in year one and year two based on the entity's best estimate of the most likely outcome (i.e., the PBT and service condition are expected to be met), but then in year three the service condition is met but the PBT target is not, the entity would reverse in year three any previous expense recognised due to the failure to satisfy the non-market vesting condition.

See the Illustrations in 7.2.3 to 7.2.5 below that set out the accounting when determining the number of equity instruments expected to vest when an award includes a number of possible outcomes linked to non-market vesting conditions.

7.2.2 Equity instruments vesting in instalments ('graded' vesting)

An entity may make share-based payments that vest in instalments (sometimes referred to as 'graded' vesting). For example, an entity might grant an employee 600 options, 100 of which vest if the employee remains in service for one year, a further 200 after two years and the final 300 after three years. In today's more mobile labour markets, such awards are often favoured over awards which vest only on an 'all or nothing' basis after an extended period.

IFRS 2 requires that each instalment be treated as three separate awards, of 100, 200 and 300 options, because each instalment has a different vesting period and therefore, the grant date fair value of each instalment will likely differ (e.g., the length of the vesting period may affect the likely timing of cash flows arising from the exercise of options in determining the fair value). [IFRS 2.IG11]. This may well have the effect that, compared to the expense for an award with a single 'cliff' vesting, the expense for an award vesting in instalments will be for a different amount in total and require accelerated recognition of the expense in earlier periods, as demonstrated in Illustration 7-5 below.

How we see it

We believe that, similar to IFRS 2, graded vesting accounting can apply to share-based payments transactions that vest in instalments. This is on the basis that the definition of 'vest' and 'vesting period' in both IFRS 2 and Section 26 are the same and both contain similar guidance with respect to recognition of an expense when services are provided. However, as Section 26 does not explicitly require the graded vesting accounting approach to be used, we believe that a simpler alternative may be acceptable.

Illustration 7-5: Award vesting in instalments ('graded' vesting)

An entity is considering the implementation of a scheme that awards 600 free shares to each of its employees, with no conditions other than continuous service. Two alternatives are being considered:

- All 600 shares vest in full only at the end of three years.
- 100 shares vest after one year, 200 shares after two years and 300 shares after three years. Any shares received at the end of years 1 and 2 would have vested unconditionally.

The fair value of a share delivered in one year's time is £3; in two years' time £2.80; and in three years' time £2.50.

For an employee that remains with the entity for the full three-year period, the first alternative would be accounted for as follows:

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	600 shares × £2.50 × 1/3	500	500
2	600 shares × £2.50 × 2/3	1,000	500
3	600 shares × £2.50 × 3/3	1,500	500

For the second alternative, the analysis is that the employee has simultaneously received an award of 100 shares vesting over one year, an award of 200 shares vesting over two years and an award of 300 shares vesting over 3 years. This would be accounted for as follows:

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	[100 shares × £3.00] + [200 shares × £2.80 × 1/2] + [300 shares × £2.50 × 1/3]	830	830
2	[100 shares × £3.00] + [200 shares × £2.80 × 2/2] + [300 shares × £2.50 × 2/3]	1,360	530
3	[100 shares × £3.00] + [200 shares × £2.80 × 2/2] + [300 shares × £2.50 × 3/3]	1,610	250

At first sight, such an approach seems to be taking account of vesting conditions other than market conditions in determining the fair value of an award, contrary to the basic principle of paragraph 9 of Section 26 (see 7.1.1 above). However, it is not the vesting conditions that are being taken into account *per se*, but the fact that the varying vesting periods will give rise to different lives for the award (which are generally required to be taken into account - see 8.2 and 9 below).

If graded vesting accounting is applied, provided all conditions are clearly understood at the outset, the accounting treatment demonstrated in Illustration 7-5 would apply even if the vesting of shares in each year also depended on a performance condition unique to that year (e.g., that profit in that year must reach a given minimum level), as opposed to a cumulative performance condition (e.g., that profit must have grown by a minimum amount by the end of year 1, 2 or 3). This is because all tranches of the arrangement have the same service commencement date and so for the awards that have a performance condition relating to year 2 or year 3 there is a service condition covering a longer period than the performance condition. In other words, an award that vests at the end of year 3 conditional on profitability in year 3 is also conditional on the employee providing service for three years from the date of grant in order to be eligible to receive the award. This is discussed further at 6.3.6 above.

7.2.3 Transactions with variable vesting periods due to non-market vesting conditions

An award may have a vesting period which is subject to variation. For example, the award might be contingent upon the achievement of a particular performance target (such as achieving a given level of cumulative earnings) within a given maximum period, but vesting immediately once the target has been reached. Alternatively, an award might be contingent on levels of earnings growth over a period, but with vesting occurring more quickly if growth is achieved more quickly. Also, some plans provide for 're-testing', whereby an original target is set for achievement within a given vesting period, but if that target is not met, a new target and/or a different vesting period are substituted.

FRS 102 has no specific requirements in respect of variable vesting periods, it simply refers to revising the number of awards expected to vest if new information indicates that the number of equity instruments expected to vest differs from previous estimates. [FRS 102.26.9(a)]. However, it seems appropriate to follow the requirements of IFRS 2 in this area. Therefore, in such cases, the entity needs to estimate the length of the vesting period at grant date, based on the most likely outcome of the performance condition. Subsequently, it is necessary to continuously re-estimate, not only the number of awards that will finally vest, but also the date of vesting, as shown by Illustration 7-6. [IFRS 2.15(b), IFRS 2.IG12]. This contrasts with the IFRS 2 treatment of awards with market conditions and variable vesting periods, where the initial estimate of the vesting period is prohibited from being revised (see 7.3.4 below).

Illustration 7-6: Award with non-market vesting condition and variable vesting period

At the beginning of year 1, the entity grants 100 shares each to 500 employees, conditional upon the employees remaining in the entity's employment during the vesting period. The shares will vest:

- At the end of year 1 if the entity's earnings increase by more than 18%.
 - At the end of year 2 if the entity's earnings increase by more than an average of 13% per year over the two-year period.
- Or
- At the end of year 3 if the entity's earnings increase by more than an average of 10% per year over the three-year period.

The award is estimated to have a fair value of £30 per share at grant date. It is expected that no dividends will be paid during the whole three-year period.

By the end of the first year, the entity's earnings have increased by 14%, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that an award of 100 shares each will vest for 440 (500 - 30 - 30) employees at the end of year 2.

By the end of the second year, the entity's earnings have increased by only 10% and therefore the shares do not vest at the end of that year. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity's earnings will increase by at least 6%, thereby achieving the average growth of 10% per year necessary for an award after 3 years, so that an award of 100 shares each will vest for 417 (500 - 30 - 28 - 25) employees at the end of year 3.

By the end of the third year, a further 23 employees have left and the entity's earnings have increased by 8%, resulting in an average increase of 10.67% per year. Therefore, 419 (500 - 30 - 28 - 23) employees receive 100 shares at the end of year 3.

The entity will recognise the following amounts during the vesting period for services received as consideration for the shares.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	440 employees × 100 shares × £30 × 1/2*	660,000	660,000
2	417 employees × 100 shares × £30 × 2/3*	834,000	174,000
3	419 employees × 100 shares × £30	1,257,000	423,000
* The entity's best estimate at the end of year 1 is that it is one year through a two-year vesting period and at the end of year 2 that it is two years through a three-year vesting period.			

In Illustration 7-6, which is based on IG Example 2 in the implementation guidance to IFRS 2, it is assumed that the entity will pay no dividends (to any shareholders) throughout the maximum possible three-year vesting period. This has the effect that the fair value of the shares to be awarded is equivalent to their market value at the date of grant.

If dividends were expected to be paid during the vesting period, this would no longer be the case. Employees would be better off if they received shares after two years rather than three, since they would have a right to receive dividends from the end of year two.

One solution might be to use the approach in IG Example 4 in the implementation guidance to IFRS 2 (the substance of which is reproduced as Illustration 7-8 at 7.2.5 below). That Example deals with an award whose exercise price is either £12 or £16, dependent upon various performance conditions. Because vesting conditions other than market conditions are ignored in determining the value of an award, the approach is in effect to treat the award as the simultaneous grant of two awards, whose value, in that case, varies by reference to the different exercise prices.

The same principle could be applied to an award of shares that vests at different times according to the performance conditions, by determining different fair values for the shares (in this case depending on whether they vest after one, two or three years). The cumulative charge during the vesting period would be based on a best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome (which will require some acceleration of expense if the actual vesting period is shorter than the previously estimated vesting period).

Such an approach appears to be taking account of non-market vesting conditions in determining the fair value of an award, contrary to the basic principle of paragraph 9 of Section 26 (see 7.1.1 above). However, it is not the vesting conditions that are being taken into account *per se*, but the fact that the varying vesting periods will give rise to different lives for the award (which are generally required to be taken into account, see 8.2 and 9 below). That said, the impact of the time value of the different lives on the fair value of the award will, in many cases, be insignificant and it will therefore be a matter of judgement as to how precisely an entity switches from one fair value to another.

Economically speaking, the entity in Illustration 7-6 has made a single award, the true fair value of which must be a function of the weighted probabilities of the various outcomes occurring. However, under the accounting model for equity-settled awards, the probability of achieving non-market performance conditions is not taken into account in valuing an award. If this is required to be ignored, the only approach open is to proceed as in Illustration 7-6 above and treat the arrangement as if it consisted of the simultaneous grant of three awards.

Some might object that this methodology is not relevant to the award in Illustration 7-6 above, since it is an award of shares rather than, in the case of Illustration 7-8 below, an award of options. However, an award of shares is no more than an award of options with an exercise price of zero. Moreover, the treatment in the previous paragraph is broadly consistent with the IFRS 2 treatment of an award vesting in instalments (see 7.2.2 above).

In Illustration 7-6 above, the vesting period, although not known, is at least one of a finite number of known possibilities. The vesting period for some awards, however, may be more open-ended, such as is frequently the case for an award that vests on a trade sale or flotation of the business. Such awards are discussed further at 16.4 below.

How we see it

In summary, as noted above, where an equity-settled award has a variable vesting period on achieving a non-market vesting condition, the cumulative charge during the vesting period would be based on a best estimate of which outcome will occur, and the final cumulative charge would be based on the grant date fair value of the actual outcome (which will require some acceleration of expense if the actual vesting period is shorter than the previously estimated vesting period).

7.2.4 Transactions with variable number of equity instruments awarded depending on non-market performance vesting conditions

More common than awards with a variable vesting period are those where the number of equity instruments awarded varies, typically increasing to reflect the margin by which a particular minimum target is exceeded. In accounting for such awards, the entity must continuously revise its estimate of the number of shares to be awarded in line with the requirement to revise the estimate of the number of equity instruments expected to vest if new information indicates that this number differs from previous estimates. [FRS 102.26.9(a)]. This is demonstrated in Illustration 7-7 below (which is based on IG Example 3 in the implementation guidance to IFRS 2).

Illustration 7-7: Award with non-market vesting condition and variable number of equity instruments

At the beginning of year 1, an entity grants an option over a variable number of shares (see below), estimated to have a fair value at grant date of £20 per share under option, to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity's employment, and provided that the volume of sales of a particular product increase by at least an average of 5% per year. If the volume of sales of the product increases by an average of between 5% and 10% per year, each employee will be entitled to exercise 100 share options. If the volume of sales increases by an average of between 10% and 15% each year, each employee will be entitled to exercise 200 share options. If the volume of sales increases by an average of 15% or more, each employee will be entitled to exercise 300 share options.

By the end of the first year, seven employees have left and the entity expects that a total of 20 employees will leave by the end of year 3. Product sales have increased by 12% and the entity expects this rate of increase to continue over the next two years, so that 80 employees will be entitled to exercise 200 options each.

By the end of the second year, a further five employees have left. The entity now expects only three more employees to leave during year 3, and therefore expects a total of 15 employees to have left during the three-year period. Product sales have increased by 18%, resulting in an average of 15% over the two years to date. The entity now expects that sales will average 15% or more over the three-year period, so that 85 employees will be entitled to exercise 300 options each.

By the end of year 3, a further seven employees have left. Hence, 19 employees have left during the three-year period, and 81 employees remain. However, due to trading conditions significantly poorer than expected, sales have increased by a 3-year average of only 12%, so that the 81 remaining employees are entitled to exercise only 200 share options.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	80 employees × 200 options × £20 × 1/3	106,667	106,667
2	85 employees × 300 options × £20 × 2/3	340,000	233,333
3	81 employees × 200 options × £20	324,000	(16,000)

This Illustration reinforces the point that it is quite possible for an equity-settled transaction to give rise to a credit to profit or loss for a particular period during the period to vesting.

Other types of awards seen where variable number of equity instruments are awarded depending on non-market vesting conditions include an employee receiving awards dependent on an individual's performance rating, the higher the rating the more equity-instruments are awarded (see 4.1.2 above). When the vesting of a share-based payment arrangement is based on an individual's performance rating, for there to be a grant date of such an award the framework for determining the performance rating outcome needs to be sufficiently clear and objective to allow both the entity and the employee to make an estimate of the outcome of the award during the vesting period (see 6.3.3 above). Consistent with Illustration 7-7 above, the entity must continuously revise its estimate of the number of equity instruments to be awarded, provided a grant date has been established for the award. However, if the framework for determining the performance rating outcome is not sufficiently clear and objective, the grant date may not occur until a later date, but the entity would need to consider if services are effectively being rendered for an award from a date earlier than the grant date as defined in FRS 102 and the cost of the award recognised over a period starting with that earlier date (see 6.3.2 above).

7.2.5 Transactions with variable exercise price due to non-market vesting conditions

Another mechanism for delivering higher value to the recipient of a share award so as to reflect the margin by which a particular target is exceeded might be to vary the exercise price depending on performance. IFRS 2 requires such an award to be dealt with, in effect, as more than one award and we believe that it is appropriate to adopt a similar approach under FRS 102. The fair value of each award is determined, and the cost during the vesting period based on the best estimate of which award will actually vest, with the final cumulative charge being based on the actual outcome. [IFRS 2.IG12, IFRS 2.IG Example 4].

This is demonstrated in Illustration 7-8 below.

Illustration 7-8: Award with non-market vesting condition and variable exercise price

An entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity's employment for three years. The exercise price is £40. However, the exercise price drops to £30 if the entity's earnings increase by at least an average of 10% per year over the three-year period.

On grant date, the entity estimates that the fair value of the share options, with an exercise price of £30, is £16 per option. If the exercise price is £40, the entity estimates that the share options have a fair value of £12 per option. During year 1, the entity's earnings increased by 12%, and the entity expects that earnings will continue to increase at this rate over the next two years. The entity therefore expects that the earnings target will be achieved, and hence the share options will have an exercise price of £30.

During year 2, the entity's earnings increased by 13%, and the entity continues to expect that the earnings target will be achieved. During year 3, the entity's earnings increased by only 3%, and therefore the earnings target was not achieved. The executive completes three years' service and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested share options have an exercise price of £40.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	10,000 options × £16 × 1/3	53,333	53,333
2	10,000 options × £16 × 2/3	106,667	53,334
3	10,000 options × £12	120,000	13,333

At first sight this may seem a rather surprising approach. In reality, the entity in Illustration 7-8 made a single award, the fair value of which must lie between £12 and £16, as a function of the weighted probabilities of either outcome occurring. Economically speaking, this is indeed the case. However, under the accounting model for equity-settled share-based payments in IFRS 2 and FRS 102, the probability of achieving non-market performance conditions is not taken into account in valuing an award. If this is required to be ignored, the only approach open is to proceed with the 'two award' analysis as above.

7.3 Market conditions

7.3.1 What is a 'market condition'?

The Glossary to FRS 102 defines the term 'market vesting condition' which for ease, has been referred to as either 'market condition' or 'market vesting condition' throughout this chapter. The following definitions in FRS 102 Appendix I are relevant:

Extract from FRS 102

Appendix I**Glossary****intrinsic value**

The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares. For example, a share option with an exercise price of CU15, on a share with a fair value of CU20, has an intrinsic value of CU5.

market vesting condition

A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group) relative to an index of market prices of equity instruments of other entities.

A market vesting condition requires the counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit.

In order for a market condition to be treated as a performance vesting condition rather than as a non-vesting condition, there must also be an implicit or explicit service condition (see 4.2 above).

A performance condition based on the share price and one based on the intrinsic value of the option are effectively the same, since the values of each will obviously move in parallel.

Section 26 includes a specified increase in the entity's share price as an example of a market condition. [FRS 102.26.9]. A market condition often seen in practice, although more common in a listed entity and not specifically mentioned in FRS 102, is a condition based on total shareholder return (TSR). TSR is a measure of the increase or decrease in a given sum invested in an entity over a period on the assumption that all dividends received in the period had been used to purchase further shares in the entity. The market price of the entity's shares is an input to the calculation.

However, a condition linked to a purely internal financial performance measure such as profit or earnings per share is not a market condition. Such measures will affect the share price or value, but are not directly linked to it, and hence are not market conditions.

A condition linked solely to a general market index is not a market condition, but a non-vesting condition (see 4.2 above and 7.4 below), because the reporting entity's own share price is not relevant to the satisfaction of the condition.

However, if the condition were that the entity's own share price had to outperform a general index of shares, that condition would be a market condition because the reporting entity's own share price is then relevant to the satisfaction of the condition.

7.3.2 Summary of accounting treatment

The key feature of the accounting treatment of an equity-settled transaction subject to a market condition is that the market condition is taken into account in valuing the award at the date of grant, 'with no subsequent adjustment to the estimated fair value, irrespective of the outcome of the market condition or condition that is not a vesting condition, provided that all other vesting conditions are satisfied'.

[FRS 102.26.9(b)]. In other words, an award is treated as vesting irrespective of whether the market condition is satisfied, provided that all other service and non-market performance conditions are satisfied. The requirements relating to market conditions can have rather controversial consequences, as demonstrated by Illustration 7-9.

Illustration 7-9: Award with market condition

An entity grants an employee an option to buy a share on condition of remaining in employment for three years and the share price at the end of that period being at least £7. At the end of the vesting period, the share price is £6.80. The share price condition is factored into the initial valuation of the option, and the option is considered to vest provided that the employee remains for three years, irrespective of whether the share price does in fact reach £7.

Therefore, an award is sometimes treated as vesting (and a cost is recognised for that award) when it does not actually vest in the natural sense of the word. See also Illustration 7-11 at 7.3.4 below.

This treatment is clearly significantly different from that for transactions involving a non-market vesting condition, where no cost would be recognised where the conditions were not met. As discussed at 7.2 above, the methodology prescribed for transactions with a vesting condition other than a market condition is to determine the fair value of the option ignoring the condition and then to multiply that fair value by the estimated (and ultimately the actual) number of awards expected to vest based on the likelihood of that non-market vesting condition being met.

In any event, it appears that it may be possible to soften the impact of the rules for market conditions relatively easily by introducing a non-market vesting condition closely correlated to the market condition. For instance, the option in Illustration 7-9 above could be modified so that exercise was dependent not only upon the £7 target share price and continuous employment, but also on a target growth in earnings per share. Whilst there would not be a perfect correlation between earnings per share and the share price, it would be expected that they would move roughly in parallel, particularly if the entity has historically had a fairly consistent price/earnings ratio. Thus, if the share price target were not met, it would be highly likely that the earnings per share target would not be met either. This would allow the entity to show no cumulative cost for the option, since only one (i.e., not all) of the non-market related vesting conditions would have been met.

Similarly, entities in sectors where the share price is closely related to net asset value (e.g., property companies and investment trusts) could incorporate a net asset value target as a non-market performance condition that would be highly likely to be satisfied only if the market condition was satisfied (i.e., two separate conditions exist, one based on the market price/value of the shares and the other based on the net asset value).

The matrices below illustrate the interaction of market conditions and vesting conditions other than market conditions. Matrix 1 summarises the possible outcomes for an award with the following two vesting conditions:

- The employee remaining in service for three years (service condition).
- The entity's share price increasing by 10% over the vesting period (share price target).

Matrix 1

	Service condition met?	Share price target (market condition) met?	Section 26 expense?
1	Yes	Yes	Yes
2	Yes	No	Yes
3	No	Yes	No
4	No	No	No

It will be seen that, to all intents and purposes, the 'Share price target (market condition) met?' column is redundant, as this is not relevant to whether or not the award is treated as vesting for accounting purposes. The effect of this is that the entity would recognise an expense for outcome 2, even though no awards truly vest.

Matrix 2 summarises the possible outcomes for an award with the same conditions as in Matrix 1, plus a requirement for earnings per share to grow by a general inflation index plus 10% over the period ('EPS target').

Matrix 2

	Service condition met?	Share price target (market condition) met?	EPS target (non-market condition) met?	Section 26 expense?
1	Yes	Yes	Yes	Yes
2	Yes	No	Yes	Yes
3	Yes	Yes	No	No
4	Yes	No	No	No
5	No	Yes	Yes	No
6	No	No	Yes	No
7	No	Yes	No	No
8	No	No	No	No

Again, it will be seen that, to all intents and purposes, the 'Share price target (market condition) met?' column is redundant, as this is not relevant to whether or not the award is treated as vesting. The effect of this is that the entity would recognise an expense for outcome 2, even though no awards truly vest. However, no expense would be recognised for outcome 4, which is, except for the introduction of the EPS target, equivalent to outcome 2 in Matrix 1, for which an expense is recognised. This illustrates that the introduction of a non-market vesting condition closely related to a market condition may mitigate the impact of the accounting requirements.

Examples of the application of the accounting treatment for transactions involving market conditions are given at 7.3.3 and 7.3.5 below.

7.3.3 Transactions with market conditions and known vesting periods

Following on from the discussion at 7.3.2 above, the accounting for these transactions is essentially the same as that for transactions without market conditions but with a known vesting period (including 'graded' vesting, see 7.2.2 above), except that adjustments are made to reflect the changing probability of the achievement of the non-market vesting conditions only, as demonstrated by Illustration 7-10 below (based partly on IG Example 5 in the implementation guidance to IFRS 2). [FRS 102.26.9].

Illustration 7-10: Award with market condition and fixed vesting period

At the beginning of year 1, an entity grants to 100 employees 1,000 share options each, conditional upon the employees remaining in the entity's employment until the end of year 3. However, the share options cannot be exercised unless the share price has increased from £50 at the beginning of year 1 to more than £65 at the end of year 3.

If the share price is above £65 at the end of year 3, the share options can be exercised at any time during the next seven years, i.e., by the end of year 10. The entity applies an option pricing model which takes into account the possibility that the share price will exceed £65 at the end of year 3 (and hence the share options vest and become exercisable) and the possibility that the share price will not exceed £65 at the end of year 3 (and hence the options will be treated as having vested under Section 26 but will never be exercisable, as explained below). It estimates the fair value of the share options with this market condition to be £24 per option.

FRS 102 requires the entity to recognise the services received from a counterparty who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied. It makes no difference whether the share price target is achieved, since the possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date. However, the options are subject to another condition (i.e., continuous employment) and the cost recognised is required to be adjusted to reflect the ongoing best estimate of employee retention.

By the end of the first year, seven employees have left and the entity expects that a total of 20 employees will leave by the end of year 3, so that 80 employees will have satisfied all conditions other than the market condition (i.e., continuous employment).

By the end of the second year, a further five employees have left. The entity now expects only three more employees will leave during year 3, and therefore expects that a total of 15 employees will have left during the three-year period, so that 85 employees will have satisfied all conditions other than the market condition.

By the end of year 3, a further seven employees have left. Hence, 19 employees have left during the three-year period, and 81 employees remain. However, the share price is only £60, so that the options cannot be exercised. Nevertheless, as all conditions other than the market condition have been satisfied, a cumulative cost is recorded as if the options had fully vested in 81 employees.

The entity will recognise the following amounts during the vesting period for services received as consideration for the options (which in economic reality do not vest).

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	80 employees $\times$ 1,000 options $\times$ £24 $\times$ 1/3	640,000	640,000
2	85 employees $\times$ 1,000 options $\times$ £24 $\times$ 2/3	1,360,000	720,000
3	81 employees $\times$ 1,000 options $\times$ £24	1,944,000	584,000

7.3.4 Transactions with variable vesting periods due to market conditions

Where a transaction has a variable vesting period due to a market condition, a best estimate of the most likely vesting period will have been used in determining the fair value of the transaction at the date of grant. IFRS 2 requires the expense for that transaction to be recognised over an estimated expected vesting period consistent with the assumptions used in the valuation, without any subsequent revision.

[IFRS 2.15(b), IFRS 2.IG14]. FRS 102 does not specify the accounting treatment in this situation but it seems consistent with the general requirement in paragraph 9 of Section 26 that there is “no subsequent adjustment to the estimated fair value, irrespective of the outcome of the market vesting condition”.

This may mean, for example, that if the actual vesting period for an employee share option award turns out to be longer than that anticipated for the purposes of the initial valuation, a cost is nevertheless recorded in respect of all employees who reach the end of the anticipated vesting period, even if they do not reach the end of the actual vesting period, as shown by Illustration 7-11 below, which is based on IG Example 6 in the implementation guidance in IFRS 2.

Illustration 7-11: Award with market condition and variable vesting period

At the beginning of year 1, an entity grants 10,000 share options with a ten-year life to each of ten senior executives. The share options will vest and become exercisable immediately if and when the entity's share price increases from £50 to £70, provided that the executive remains in service until the share price target is achieved.

The entity applies an option pricing model which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The entity estimates that the fair value of the share options at grant date is £25 per option. From the option pricing model, the entity determines that the most likely vesting period is five years. The entity also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 share options (10,000 share options × 8 executives) will vest at the end of year 5.

Throughout years 1 to 4, the entity continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

IFRS 2 and FRS 102 require the entity to recognise the services received over the expected vesting period, as estimated at grant date, and also require the entity not to revise that estimate. Therefore, the entity recognises the services received from the executives over years 1-5. Hence, the transaction amount is ultimately based on 70,000 share options (10,000 share options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years.

The entity will recognise the following amounts during the initial expected five-year vesting period for services received as consideration for the options.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	8 employees × 10,000 options × £25 × 1/5	400,000	400,000
2	8 employees × 10,000 options × £25 × 2/5	800,000	400,000
3	8 employees × 10,000 options × £25 × 3/5	1,200,000	400,000
4	8 employees × 10,000 options × £25 × 4/5	1,600,000	400,000
5	7 employees × 10,000 options × £25	1,750,000	150,000

IFRS 2 does not specifically address the converse situation, namely where the award actually vests before the end of the anticipated vesting period.

How we see it

In our view, where the award vests before the end of the anticipated vesting period, any expense not yet recognised at the point of vesting is immediately accelerated. We consider that this treatment is most consistent with the overall requirement of FRS 102 to recognise an expense for share-based payment transactions "as the services are received". It is difficult to regard any services being received for an award after it has vested.

Moreover, the prohibition in IFRS 2 on adjusting the vesting period as originally determined refers to "the estimate of the expected vesting period". In our view, the acceleration of vesting that we propose on applying FRS 102 is not the revision of an estimated period, but the substitution of an estimate for a known vesting period.

Suppose in Illustration 7-11 above, the award had in fact vested at the end of year 4. We believe that the expense for such an award must be allocated as follows:

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	8 employees × 10,000 options × £25 × 1/5	400,000	400,000
2	8 employees × 10,000 options × £25 × 2/5	800,000	400,000
3	8 employees × 10,000 options × £25 × 3/5	1,200,000	400,000
4	8 employees × 10,000 options × £25 × 4/4	2,000,000	800,000

7.3.5 Transactions with multiple outcomes depending on market conditions

In practice, it is very common for an award subject to market conditions to give varying levels of reward that increase depending on the extent to which a 'base line' market performance target has been exceeded. Such an award is demonstrated in Illustration 7-12 below.

Illustration 7-12: Award with market conditions and multiple outcomes

At the beginning of year 1, the reporting entity grants an employee an award of shares that will vest on the third anniversary of grant if the employee is still in employment. The number of shares depends on the share price achieved at the end of the three-year period. The employee will receive:

- No shares if the share price is below £10.00
- 100 shares if the share price is in the range £10.00 - £14.99
- 150 shares if the share price is in the range £15.00 - £19.99
- 180 shares if the share price is £20.00 or above

In effect the entity has made three awards, which need to be valued as follows:

- (a) 100 shares if the employee remains in service for three years and the share price is greater than £10.00
- (b) 50 (150 - 100) shares if the employee remains in service for three years and the share price is greater than £15.00
- And
- (c) 30 (180 - 150) shares if the employee remains in service for three years and the share price is £20.00 or more

Each award would be valued, ignoring the impact of the three-year service condition but taking account of the share price target. This would result in each tranche of the award being subject to an increasing level of discount to reflect the relative probability of the share price target for each tranche of the award being met. All three awards would then be expensed over the three-year service period, and forfeited only if the awards lapsed as a result of the employee leaving during that period.

It can be seen that the (perhaps somewhat counterintuitive) impact of this is that an equity-settled share-based payment where the number of shares increases in line with increases in the entity's share price may nevertheless have a fixed grant date value irrespective of the number of shares finally awarded.

7.3.6 Transactions with independent market conditions, non-market vesting conditions or non-vesting conditions

7.3.6.A Independent market and non-market vesting conditions

The discussion at 7.3.2 above addressed the accounting treatment of awards with multiple conditions that must all be satisfied, i.e., a market condition and a non-market vesting condition. However, entities might also make awards with multiple conditions, only one of which need be satisfied, i.e., the awards vest on satisfaction of either a market condition or a non-market vesting condition. Neither FRS 102 nor IFRS 2 provides any explicit guidance on the treatment of such awards and the requirements are far from clear, as demonstrated by Illustration 7-13 below.

Illustration 7-13: Award with independent market conditions and non-market vesting conditions

An entity grants an employee 100 share options that vest after three years if the employee is still in employment and the entity achieves either:

- An increase in its share price over three years of at least 15%.
- Or
- Cumulative profits over three years of at least £200 million.

The fair value of the award, ignoring vesting conditions, is £300,000. The fair value of the award, taking account of the share price condition, but not the other conditions, is £210,000.

In our view, the entity has, in effect, simultaneously issued two awards, call them 'A' and 'B', which vest as follows:

A On achievement of three years' service plus minimum share price increase.

And

B On achievement of three years' service plus minimum earnings growth.

If the conditions for both awards are simultaneously satisfied, one or other effectively lapses.

It is clear that award A, if issued separately, would require the entity to recognise an expense of £210,000 if the employee were still in service at the end of the three-year period. It therefore seems clear that, if the employee does remain in service, there must be a charge of £210,000 irrespective of whether the award actually vests. It would be anomalous for the entity to avoid recording a charge that would have been recognised if the entity had made award A in isolation simply by packaging it with award B.

If in fact the award vested because the earnings condition, but not the market condition, had been satisfied, it would then be appropriate to recognise a total expense of £300,000.

During the vesting period, we believe that the entity is required to make an assessment at each reporting date of the basis on which the award is expected to vest. It must assess whether, as at that date, the award is expected to vest by virtue of the earnings condition, but not the share price condition, being satisfied. Assume (for example) that the entity assesses at the end of year 1 that the award is likely to vest by virtue of the share price condition, and at the end of year 2 that it is likely to vest by virtue of the earnings condition, and that the award actually does not vest, but the employee remains in service. This would give rise to annual expense as follows:

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	$210,000 \times 1/3$	70,000	70,000
2	$300,000 \times 2/3$	200,000	130,000
3	$210,000 \times 3/3$	210,000	10,000

We believe that ongoing reassessment during the vesting period is most consistent with the general accounting approach to awards with a number of possible outcomes.

As for other awards, the accounting treatment would also require an assessment of whether the employee was actually going to remain in service.

A further question that arises is how the award must be accounted for if both conditions are satisfied. It would clearly be inappropriate to recognise an expense of £510,000 (the sum of the separate fair values of the award) - this would be double-counting, because the employee receives only one package of 100 options. However, should the total expense be taken as £210,000 or £300,000? In our view, it is more appropriate to recognise a cost of £300,000 since the non-market vesting condition has been satisfied.

How we see it

As noted above, the entity has simultaneously issued two awards which vest on achievement of three years' service plus; minimum share price increase or minimum earnings growth. If the conditions for both awards are simultaneously satisfied, one or the other effectively lapses, we believe the higher of both expenses is recognised. We also believe that ongoing reassessment during the vesting period is most consistent with the general approach of FRS 102 to awards with a number of possible outcomes.

7.3.6.B Independent market conditions and non-vesting conditions

Arrangements are also seen where a share-based payment transaction vests on the satisfaction of either a market condition or a non-vesting condition.

The fact that there are two alternative conditions on which the award might vest means that, unless the two conditions are perfectly correlated, the grant date fair value of such an award will be higher than that of an award where there is only one possible basis on which the award might vest. Irrespective of whether the market and/or non-vesting conditions are met, the entity will recognise the grant date fair value provided all other service and non-market vesting conditions are met (i.e., the expense recognition is consistent with that of any award with market and/or non-vesting conditions).

How we see it

In our view, an entity granting an award on the basis of a service condition (and any other non-market vesting conditions) plus either a market condition or a non-vesting condition is required to measure the fair value of the award at grant date taking into account the probability that either the market condition or the non-vesting condition will be met.

7.3.7 Awards with a condition linked to flotation price

Awards in an unlisted entity may be granted with a condition linked to the achievement of a specific price when the entity floats.

How we see it

On flotation there is a market and a market price for the entity's equity instruments and the achievement of a specific price on flotation would, in our view, be a market condition when accompanied by a corresponding service requirement (see 16.4 below).

7.4 Conditions that are not vesting conditions ('Non-vesting conditions')

We believe that the terms "conditions that are not vesting conditions", which is the term referred to in FRS 102, and "non-vesting conditions", which is the term referred to in IFRS 2, are similar (see 2.3.1 above) and we will refer to the term as non-vesting conditions in this section. FRS 102 does not specify the accounting treatment for non-vesting conditions other than to state that "... conditions that are not vesting conditions shall be taken into account when estimating the fair value of the equity instruments granted at the measurement date, with no subsequent adjustment to the estimated fair value, irrespective of the outcome of the ... condition that is not a vesting condition, provided that all other vesting conditions are satisfied". [FRS 102.26.9(b)].

The accounting treatment for awards with non-vesting conditions has some similarities to that for awards with market conditions in that:

- The fair value of the award at grant date is reduced to reflect the impact of the condition.
- And
- An expense is recognised for the award irrespective of whether the non-vesting condition is met, provided that all vesting conditions (other than market conditions) are met.

However, in some situations under IFRS 2 and in the absence of specific guidance, FRS 102, the accounting for non-vesting conditions differs from that for market conditions as regards the timing of the recognition of expense if the non-vesting condition is not satisfied (see 7.4.3 below).

7.4.1 Awards with no conditions other than non-vesting conditions

Any award that has only non-vesting conditions (e.g., an option award to an employee that may be exercised on a trade sale or IPO of the entity, irrespective of whether the employee is still in employment at that time) must be expensed in full at grant date. This is discussed further at 4.2 above and at 16.4 below, and demonstrated in Illustration 7-1 at 7.1 above.

7.4.2 Awards with non-vesting conditions and variable vesting periods

Neither FRS 102 nor IFRS 2 explicitly addresses the determination of the vesting period for an award with a non-vesting condition but a variable vesting period (e.g., an award which delivers 100 shares when the price of gold reaches a given level, but without limit as to when that level must be achieved, so long as the employee is still in employment when the target is reached).

How we see it

However, given the close similarity between the required treatment for awards with non-vesting conditions and that for awards with market conditions, we believe that entities must follow the guidance in the standard for awards with market conditions and variable vesting periods (see 7.3.4 above).

7.4.3 Failure to meet non-vesting conditions

As noted above, the accounting under IFRS 2, and in the absence of specific guidance, FRS 102, for non-vesting conditions sometimes differs from that for market conditions in the timing of the recognition of expense if the non-vesting condition is not satisfied. The treatment depends on the nature of the non-vesting condition, as follows:

- If a non-vesting condition within the control of the counterparty (e.g., making monthly savings in an SAYE scheme) is not satisfied during the vesting period, the failure to satisfy the condition is treated as a cancellation (see 8.4 below), with immediate recognition of any expense for the award not previously recognised. *[IFRS 2.28A, IFRS 2.IG24].*
- If a non-vesting condition within the control of the entity (e.g., continuing to operate the scheme) is not satisfied during the vesting period, the failure to satisfy the condition is treated as a cancellation (see 8.4 below), with immediate recognition of any expense for the award not previously recognised. *[IFRS 2.28A, IFRS 2.IG24].*
- If a non-vesting condition within the control of neither the counterparty nor the entity (e.g., a financial market index reaching a minimum level) is not satisfied, there is no change to the accounting and the expense continues to be recognised over the vesting period, unless the award is otherwise treated as forfeited.

How we see it

The reference to the vesting period, when a non-vesting condition is not met that is not within the control of either party, would include any deemed vesting period calculated as described in 7.4.2 above.

If an award is forfeited due to a failure to satisfy a non-vesting condition after the end of the vesting period (e.g., a requirement for an employee not to work for a competitor for a two year period after vesting), no adjustment is made to the expense previously recognised, consistent with the general provisions for accounting for awards in the post-vesting period (see 7.1.3 above). This would be the case even if shares previously issued to the employee were required to be returned to the entity.

8 Equity-settled transactions – modification, cancellation and settlement

8.1 Background

It is quite common for equity instruments to be modified or cancelled before or after vesting. Typically, this is done where the conditions for an award have become so onerous as to be virtually unachievable, or (in the case of an option) where the share price has fallen so far below the exercise price of an option that it is unlikely that the option will ever be 'in the money' to the holder during its life. An entity may take the view that such equity awards are so unattainable as to have little or no motivational effect, and accordingly replace them with less onerous alternatives. Conversely, and more rarely, an entity may make the terms of a share award more onerous (possibly because of shareholder concern that targets are insufficiently demanding). In addition, an entity may 'settle' an award, i.e., cancel it in return for cash or other consideration.

The provisions in FRS 102 relating to modification, cancellation and settlement are derived from those in IFRS 2 and, where necessary, we have drawn on the guidance in IFRS 2 to supplement and explain the FRS 102 requirements. The provisions in both standards (like the summary of them below) are framed in terms of share-based payment transactions with employees. IFRS 2 and FRS 102 indicates that the provisions are equally applicable to transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted (see 6.4 above). [FRS 102.26.12]. For transactions with parties other than employees, however, all references to 'grant date' must be taken as references to the date on which the third party supplied goods or rendered service.

In the discussion below, any reference to a 'cancellation' is to any cancellation, whether instigated by the entity or the counterparty. As well as more obvious situations where an award is cancelled by either the entity or the counterparty, cancellations include:

- A failure by the entity to satisfy a non-vesting condition within the control of the entity.
And
- A failure by the counterparty to satisfy a non-vesting condition within the control of the counterparty (see 7.4.3 above).

The basic principles of the rules for modification, cancellation and settlement, which are discussed in more detail at 8.3 and 8.4 below, can be summarised as follows:

- As a minimum, the entity must recognise the amount that would have been recognised for the award if it remained in place on its original terms.
- If the value of an award to an employee is reduced (e.g., by reducing the number of equity instruments subject to the award or, in the case of an option, by increasing the exercise price), there is no reduction in the cost recognised in profit or loss.
- However, if the value of an award to an employee is increased (e.g., by increasing the number of equity instruments subject to the award or, in the case of an option, by reducing the exercise price), the incremental fair value must be recognised as a cost. The incremental fair value is the difference between the fair value of the original award and that of the modified award, both measured at the date of modification. [FRS 102.26.12].

8.1.1 Determining the date of the modification

Determining the date of the modification is an important step in applying the rules for modification accounting. It is at that date that the entity must obtain a fair value not only for the modified award, but also for the original award updated to the date of modification, in order to determine any incremental fair value to be recognised. [FRS 102.26.12(a), IFRS 2.27].

How should an entity determine the date of the modification?

Neither FRS 102 nor IFRS 2 contains explicit guidance on determining the date of the modification, unlike determination of grant date. Grant date is defined as, "The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained."

[FRS 102 Appendix I].

To determine the date of modification, we would expect an entity to first consider some of the existing principles in the standard on determining grant date. Not all these principles may be applicable in determining the date of the modification because grant date has already been established and the employees have either already provided or are currently providing services in return for the share-based payment award. The grant date principles that can be applied in establishing the date of modification include; there to be a shared understanding of the modified terms and conditions and the relevant approval for the modified award being obtained.

There may be instances where judgement is required in determining the date of the modification when other facts and circumstances indicate that the date of modification is different than the date employees are formally notified of a modification, especially when an entity has obtained relevant board approvals prior to employees being notified. Some of the factors to consider in addition to the grant date principles are as follows:

- A modification that is beneficial to employees approved by the board, for example removal of a non-market vesting condition or reducing the exercise price, where there is no subsequent further approval required (for example, by shareholders) and the communication to employees is shortly after that approval date, may indicate the date of the modification arises at the date of board approval. A factor that may further help to support the board approval date as the date of the modification is if there was some form of communication prior to the approval of a change in terms that created a valid expectation by the employees prior to the board approval that the award would be modified. Another factor to support the board approval date for the modification is that the communication to employees shortly after the board approval is considered an administrative task. If there was a substantive delay in communicating the amended award to employees, it is important to understand why there was such a delay and this could be a factor in determining that the date of the modification is when there is a shared understanding of the terms by both parties i.e., at the later date.
- Where an entity is permitted to amend certain terms and conditions of the original award that do not require approval by the employees, the date of modification is likely to be the date of board approval for the modified terms, provided the approval creates rights and obligations for both parties (the employee and entity). See discussion above in 6.3.7, where an entity has discretion to modify the details of an award after grant date. If a modification requires the approval by employees or requires further services to be provided (for example, in a situation where the vesting period is extended), the date of modification is likely to be once a shared understanding of the terms has been reached.

These are some of the factors to consider in addition to the grant date principles; there may be others, and an entity will need to consider all facts and circumstances to establish the date of modification.

How we see it

There is no accounting policy choice to determine the date of modification, and we would expect an entity to first consider some of the principles in the standard on determining grant date, such as there being a shared understanding of the modified terms and conditions, and the relevant approval for the modified award being obtained.

A mere intent by the entity's management to change the conditions of the award is not sufficient to determine a modification date as an intent would not create rights and obligations under the share-based payment arrangement. There is no basis in FRS 102 for accounting for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date (see 8.6 below).

However, there could be instances where judgement is required in determining the date of the modification when other facts and circumstances indicate that the date of modification is different than the date employees are formally notified of a modification.

8.2 Valuation requirements when an award is modified, cancelled or settled

These provisions have the important practical consequence that, when an award is modified, cancelled or settled, the entity must obtain a fair value not only for the modified award, but also for the original award, updated to the date of modification. If the award had not been modified, there would have been no need to obtain a valuation for the original award after the date of grant.

Any modification of a performance condition clearly has an impact on the 'real' value of an award, but it may have no direct effect on the value of the award for accounting purposes. As discussed at 7.2 to 7.4 above, this is because market conditions and non-vesting conditions are taken into account in valuing an award whereas non-market vesting conditions are not. Accordingly, by implication, a change to a non-market performance condition will not necessarily affect the expense recognised for the award.

For example, if an award is contingent upon sales of a given number of units and the number of units required to be sold is decreased, the 'real' value of the award is clearly increased. However, as the performance condition is a non-market condition, and therefore not relevant to the original determination of the value of the award, there is no incremental fair value required to be accounted for. However, if the change in the condition results in an increase in the estimated number of awards expected to vest, the change of estimate will however give rise to an accounting charge (see 7.1 to 7.4 above).

If an award is modified by changing the service period, the situation is more complex. A service condition does not of itself change the fair value of the award, but a change in service period may indirectly change the life of the award, which is relevant to its value (see 9 below). Similar considerations apply where performance conditions are modified in such a way as to alter the anticipated vesting date.

The valuation requirements relating to cancelled and settled awards are considered further at 8.4 below.

8.3 Modification

When an award is modified, the entity must as a minimum recognise the cost of the original award as if it had not been modified (i.e., based on the original grant date fair value, spread over the original vesting period, and subject to the original vesting conditions). [FRS 102.26.12(b)].

In addition, a further cost must be recognised for any modifications that increase the fair value of the award. If the modification occurs during the vesting period, this additional cost is spread over the period from the date of modification until the vesting date of the modified award, which might not be the same as that of the original award. [FRS 102.26.12(a)]. Although not explicitly stated in Section 26, but nevertheless consistent with its requirements, where a modification is made after the original vesting period has expired, and is subject to no further vesting conditions, any incremental fair value must be recognised immediately.

Whether a modification increases or decreases the fair value of an award is determined as at the date of modification, as demonstrated by Illustration 8-1. [FRS 102.26.12].

Illustration 8-1: Does a modification increase or decrease the value of an award?

At the beginning of year 1 an entity granted two executives, A and B, a number of options with a fair value of £100 each.

At the beginning of year 2, A's options are modified such that they have a fair value of £85, their current fair value being £80. This is treated as an increase in fair value of £5 (even though the modified award is worth less than the original award when first granted). Therefore, an additional £5 of expense would be recognised in respect of A's options.

At the beginning of year 3, B's options are modified such that they have a fair value of £120, their current fair value being £125. This is treated as a reduction in fair value of £5 (even though the modified award is worth more than the original award when first granted). However, there is no change to the expense recognised for B's options as the entity must recognise, as a minimum, the original grant date fair value of the options (i.e., £100).

This treatment ensures that movements in the fair value of the original award are not reflected in the entity's profit or loss, consistent with the accounting treatment of other equity instruments.

Appendix B and the implementation guidance to IFRS 2 provides further detailed guidance on these requirements as set out in the following sections.

8.3.1 Modifications that increase the value of an award

8.3.1.A Increase in fair value of equity instruments granted

If the modification increases the fair value of the equity instruments granted, (e.g., by reducing the exercise price or changing the exercise period), the incremental fair value, measured at the date of modification, must be recognised over the period from the date of modification to the date of vesting for the modified instruments, as demonstrated in Illustration 8-2 below (which is based on IG Example 7 in the implementation guidance to IFRS 2). [FRS 102.26.12(a), IFRS 2.B.43(a)].

Illustration 8-2: Award modified by repricing

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is £15.

By the end of year 1, the entity's share price has dropped, and the entity reprices its share options. The repriced share options vest at the end of year 3. The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e., before taking into account the repricing) is £5 and that the fair value of each repriced share option is £8.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, so that there will be 390 employees at the end of year 3 (500 - 40 - 70).

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, so that there will be 395 employees at the end of year 3 (500 - 40 - 35 - 30).

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three-year vesting period, so that, for the remaining 397 employees, the original share options vest at the end of year 3.

FRS 102 and IFRS 2 requires the entity to recognise:

- The cost of the original award at grant date (£15 per option) over a three-year vesting period beginning at the start of year 1.
- Plus, the incremental fair value of the repriced options at the repricing date (£3 per option, being the £8 fair value of each repriced option less the £5 fair value of the original option) over a two-year vesting period beginning at the date of repricing (end of year 1).

This would be calculated as follows.

Year	Calculation of cumulative expense		Cumulative expense (£)	Expense for period (£)
	Original award (a)	Modified award (b)	(a+b)	
1	390 employees × 100 options × £15 × 1/3		195,000	195,000
2	395 employees × 100 options × £15 × 2/3	395 employees × 100 options × £3 × 1/2	454,250	259,250
3	397 employees × 100 options × £15	397 employees × 100 options × £3	714,600	260,350

In effect, the original award and the incremental value of the modified award are treated as if they were two separate awards.

A similar treatment to that in Illustration 8-2 above is adopted where the fair value of an award subject to a market condition has its value increased by the removal or mitigation of the market condition.

[IFRS 2.B.43(c)]. Where a vesting condition other than a market condition is changed, the treatment set out at 8.3.1.C below is adopted. The standards do not specifically address the situation where the fair value of an award is increased by the removal or mitigation of a non-vesting condition.

How we see it

In our view, it seems appropriate to account for the increase in fair value by the removal or mitigation of a non-vesting condition in the same way as for a modification caused by the removal or mitigation of a market condition, i.e., as in Illustration 8-2 above.

8.3.1.B Increase in number of equity instruments granted

Paragraph 12 of Section 26 on modification of awards begins by referring solely to modifications to the conditions on which equity instruments were granted rather than the number of equity instruments granted. However, in discussing the related accounting treatment, paragraph 12 goes on to refer both to the fair value of an award and to the number of equity instruments granted. If the modification increases the number of equity instruments granted, the fair value of the additional instruments, measured at the date of modification, must be recognised over the period from the date of modification to the date of vesting for the modified instruments. [FRS 102.26.12(a)]. Although not explicitly stated, it follows that if there is no further vesting period for the modified instruments, the incremental cost must be recognised immediately.

It is often the case, however, that a change in the number of equity instruments granted is combined with other modifications to the award, such situations are considered further at 8.3.2 and 8.3.4 below.

8.3.1.C Removal or mitigation of non-market related vesting conditions

Where a vesting condition, other than a market condition, is modified in a manner that is beneficial to the employee, the modified vesting condition is required to be taken into account when applying the general requirements of FRS 102 as discussed at 7.1 to 7.4 above. In other words, the entity would continuously estimate the number of awards likely to vest and/or the vesting period. This is consistent with the general principle that vesting conditions, other than market conditions, are not taken into account in the valuation of awards, but are reflected by recognising a cost for those instruments that ultimately vest on achievement of those conditions. See also the discussion at 8.2 above.

Neither FRS 102 nor IFRS 2 provide an example that addresses this point specifically, but we assume that the intended approach is as in Illustration 8-3 below. In this Illustration, the entity modifies an award in a way that is beneficial to the employee even though the modification does not result in any incremental fair value. The effect of the modification is therefore recognised by basing the expense on the original grant date fair value of the awards and an assessment of the extent to which the modified vesting conditions will be met.

Illustration 8-3: Modification of non-market vesting condition in employee's favour

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, with exercise conditional upon the employee remaining in the entity's employment for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is £15 per option at the date of grant.

At the end of year 1, the entity estimates that a total of 48,000 units will be sold and accordingly records no cost for the award in year one.

During year 2, there is such a severe downturn in trading conditions that the entity believes that the sales target is too demanding to have any motivational effect, and reduces the target to 30,000 units, which it believes is achievable. It also expects 14 members of the sales team to remain in employment throughout the three-year performance period. It therefore records an expense in year 2 of £140,000 ($£15 \times 14 \text{ employees} \times 1,000 \text{ options} \times 2/3$). This cost is based on the originally assessed value of the award (i.e., £15) since the performance condition was never factored into the original valuation, such that any change in performance condition likewise has no effect on the valuation and does not result in any incremental fair value.

By the end of year 3, the entity has sold 35,000 units, and the share options vest as the modified performance condition has been met. Twelve members of the sales team have remained in service for the three-year period. The entity would therefore recognise a total cost of £180,000 ($12 \text{ employees} \times 1,000 \text{ options} \times £15$), giving an additional cost in year 3 of £40,000 (total charge £180,000, less £140,000 charged in year 2).

How we see it

Where a vesting condition, other than a market condition, is modified in a manner that is beneficial to the employee, the modified vesting condition is taken into account when applying the general requirements of FRS 102, and the entity would continuously estimate the number of awards likely to vest and/or the vesting period.

The difference between the accounting consequences for different methods of enhancing an award could cause confusion in some cases. For example, it may sometimes not be clear whether an award has been modified by increasing the number of equity instruments or by lowering the performance targets, as demonstrated in Illustration 8-4.

Illustration 8-4: Increase in number of equity instruments or modification of vesting conditions?

An entity grants a performance-related award which provides for different numbers of options to vest after 3 years, depending on different performance targets as follows:

Profit growth	Number of options
5%-10%	100
10%-15%	200
over 15%	300

During the vesting period, the entity concludes that the criteria are too demanding and modifies them as follows:

Profit growth	Number of options
5%-10%	200
over 10%	300

This raises the issue of whether the entity has changed:

(a) The performance conditions for the vesting of 200 or 300 options.

Or

(b) The number of equity instruments awarded for achieving growth of 5%-10% or growth of over 10%.

In our view, the reality is that the change is to the performance conditions for the vesting of 200 or 300 options, and must therefore be dealt with as in 8.3.1.C above rather than 8.3.1.B above. Suppose, however, that the conditions had been modified as follows:

Profit growth	Number of options
5%-10%	200
10%-15%	300
over 15%	400

In this case, there has clearly been an increase in the number of equity instruments subject to an award for a growth increase of over 15%, which would have to be accounted for as such (i.e., under 8.3.1.B above rather than 8.3.1.C above). In such a case, it might seem more appropriate to deal with the changes to the lower bands as changes to the number of shares awarded rather than changes to the performance conditions.

How we see it

The removal of the 'over 15%' performance condition is seen as a change in performance condition, whereas the increase in options for each profit growth target is seen as an increase in the number of equity instruments granted.

8.3.2 Modifications that decrease the value of an award

This type of modification does not occur very often, as the effect would be somewhat demotivating and, in some cases, contrary to local labour regulations. However, there have been occasional examples of an award being made more onerous, usually in response to criticism by shareholders that the original terms were insufficiently demanding.

The general requirement of FRS 102 and of IFRS 2 (as outlined at 8.3 above) is that, where an award is made more onerous (and therefore less valuable), the financial statements must still recognise the cost of the original award. This rule is in part an anti-avoidance measure since, without it, an entity could reverse the cost of an out-of-the-money award by modifying it so that it was unlikely to vest (for example, by adding unattainable non-market performance conditions) rather than cancelling the award and triggering an acceleration of expense as discussed at 8.4 below.

8.3.2.A Decrease in fair value of equity instruments granted

If the modification decreases the fair value of the equity instruments granted (e.g., by increasing the exercise price or reducing the exercise period), the decrease in value is effectively ignored and the entity continues to recognise a cost for services as if the awards had not been modified. [FRS 102.26.12(b), IFRS 2.B.44(a)]. This approach also applies to reductions in the fair value of an award by the addition of a market condition or by making an existing market condition more onerous. [IFRS 2.B.44(c)].

How we see it

IFRS 2 notes the approach to apply to modifications of awards for market conditions that are not beneficial to employees (e.g., the decrease in fair value is effectively ignored) but has no specific guidance on how the above approach applies to non-vesting conditions. We assume that reductions in the fair value resulting from the addition or amendment of a non-vesting condition are similarly ignored. We believe this approach equally applies under FRS 102.

Illustration 8-5 demonstrates the accounting for an award that is modified by replacing a non-market performance condition with a market condition:

Illustration 8-5: Award modified by replacing a non-market performance condition with a market condition

At the beginning of year 1, an entity grants 1,000 share options to each of its 10 employees, with exercise conditional upon the employee remaining in the entity's employment for three years, and an earnings per share (EPS) target (non-market performance condition) being met over the three-year period. The fair value of the share options is £15 per option at the date of grant.

At the end of year 1, the entity estimates that all the employees will remain in service until the end of year 3 and that the EPS target will be met. It therefore records a cost of £50,000 for the award in year 1 ($£15 \times 10 \text{ employees} \times 1,000 \text{ options} \times 1/3$).

During year 2, the entity reassesses the arrangement and replaces the EPS target with a share price target (market condition) that must be achieved by the end of year 3. At the date of modification, the fair value of the option with the market condition is £12 and the fair value of the original option is £17. Therefore, the fair value of the award has decreased as a result of the modification but, under Section 26, this decrease is not accounted for and the entity must continue to use the original grant date fair value. An expense must be recognised based on this grant date fair value unless the award does not vest due to failure to meet a service or non-market performance condition specified at the original grant date. At the original grant date, the conditions were a service condition and a non-market performance condition. With the removal of the non-market performance condition, the only condition that has been in place since grant date is the service condition.

At the end of year 2 the entity estimates that nine employees will fulfil the service condition by the end of year 3. It therefore records a cumulative expense in year 2 of £90,000 ($£15 \times 9 \text{ employees} \times 1,000 \text{ options} \times 2/3$) and an expense for the year of £40,000 ($£90,000 - £50,000$).

At the end of year 3 the share price target has not been met but eight employees have met the service condition. The entity therefore recognises a cumulative expense of £120,000 ($£15 \times 8 \text{ employees} \times 1,000 \text{ options}$) and an expense for the year of £30,000 ($£120,000 - £90,000$).

In the above illustration, the expense reversal only relates to those employees who have forfeited their options by failing to fulfil the employment condition. There is no reversal of expense for those employees who met the service condition but whose options did not vest (in real terms) because the market condition was not met. In FRS 102 terms the options of those eight employees vested because all non-market conditions were met and so the entity must recognise the grant date fair value for those awards. This is the case even though the original grant date fair value did not take account of the effect of the market condition (unlike an award with a market condition specified from grant date). This outcome is the result of the different treatment of market and non-market conditions within Section 26, and the requirement to recognise an expense for an award with a market condition provided all other conditions have been met (see further discussion at 7.3.2 above).

8.3.2.B Decrease in number of equity instruments granted

If the modification reduces the number of equity instruments granted, IFRS 2 requires the reduction to be treated as a cancellation of that portion of the award (see 8.4 below). [FRS 102.26.12(b), IFRS 2.B.44(b)]. Essentially this has the effect that any previously unrecognised cost of the cancelled instruments is immediately recognised in full, whereas the cost of an award whose value is reduced by other means continues to be spread in full over the remaining vesting period.

In situations where a decrease in the number of equity instruments is combined with other modifications so that the total fair value of the award remains the same or increases, it is unclear whether the approach required is one based on the value of the award as a whole or, as in the previous paragraph, one based on each equity instrument as the unit of account. This is considered further at 8.3.4 below.

8.3.2.C Additional or more onerous non-market related vesting conditions

Where a non-market vesting condition is modified in a manner that is not beneficial to the employee, again it is ignored and a cost recognised as if the original award had not been modified, as shown by Illustration 8-6 (which is based on IG Example 8 in the implementation guidance to IFRS 2). [FRS 102.26.12(b), IFRS 2.B.44(c), IFRS 2.IG15, IFRS 2.IG Example 8].

Illustration 8-6: Award modified by changing non-market performance conditions

At the beginning of year 1, the entity grants 1,000 share options to each member of its sales team, conditional upon the employee remaining in the entity's employment for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the share options is £15 per option at the date of grant. During year 2, the entity believes that the sales target is insufficiently demanding and increases it to 100,000 units. By the end of year 3, the entity has sold 55,000 units, and the modified share options are forfeited. Twelve members of the sales team have remained in service for the three-year period.

On the basis that the original target would have been met, and twelve employees would have been eligible for awards, the entity would recognise a total cost of £180,000 (12 employees × 1,000 options × £15) in accordance with the minimum cost requirements of paragraph 12 of Section 26. The cumulative cost in years 1 and 2 would, as in the Examples above, reflect the entity's best estimate of the original 50,000 unit sales target being achieved at the end of year 3. If, conversely, sales of only 49,000 units had been achieved, any cost booked for the award in years 1 and 2 would have been reversed in year 3, since the original target of 50,000 units would not have been met.

It is noted in IG Example 8 that the same accounting result would have occurred if the entity had increased the service requirement rather than modifying the performance target. Because such a modification would make it less likely that the options would vest, which would not be beneficial to the employees, the entity would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service for the original three-year vesting period. Other modifications to vesting periods are discussed below.

8.3.3 Modifications with altered vesting period

Where an award is modified so that its value increases, FRS 102 and IFRS 2 require the entity to continue to recognise an expense for the grant date fair value of the unmodified award over its original vesting period, even where the vesting period of the modified award is longer (see 8.3.1 above). This appears to have the effect that an expense may be recognised for awards that do not actually vest, as demonstrated by Illustration 8-7 (which is based on Illustration 8-2 above).

Illustration 8-7: Award modified by reducing the exercise price and extending the vesting period

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees, with vesting conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is £15.

By the end of year 1, the entity's share price has dropped, and the entity reprices its share options. The repriced share options vest at the end of year 4. The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (i.e., before taking into account the repricing) is £5 and that the fair value of each repriced share option is £7.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, and a further 25 employees during year 4, such that there will be 390 employees at the end of year 3 (500 - 40 - 70) and 365 (500 - 40 - 70 - 25) at the end of year 4.

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3 and 30 more in year 4, such that there will be 395 employees at the end of year 3 (500 - 40 - 35 - 30) and 365 (500 - 40 - 35 - 30 - 30) at the end of year 4.

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three-year vesting period, so that, for the remaining 397 employees, the original share options would have vested at the end of year 3. The entity now estimates that only a further 20 employees will leave during year 4, leaving 377 at the end of year 4. In fact, 25 employees leave, so that 372 satisfy the criteria for the modified options at the end of year 4.

In our view the entity is required to recognise:

- The cost of the original award at grant date (£15 per option) over a three-year vesting period beginning at the start of year 1, based on the ongoing best estimate of, and ultimately the actual, number of employees at the end of the original three-year vesting period.

The incremental fair value of the repriced options at repricing date (£2 per option, being the £7 fair value of each repriced option less the £5 fair value of the original option) over a three year vesting period beginning at the date of repricing (end of year one), but based on the ongoing best estimate of, and ultimately the actual, number of employees at the end of the modified four-year vesting period.

This would be calculated as follows:

Year	Calculation of cumulative expense		Cumulative expense (£)	Expense for period (£)
	Original award	Modified award		
1	390 employees × 100 options × £15 × 1/3		195,000	195,000
2	395 employees × 100 options × £15 × 2/3	365 employees × 100 options × £2 × 1/3	419,333	224,333
3	397 employees × 100 options × £15	377 employees × 100 options × £2 × 2/3	645,767	226,434
4	397 employees × 100 options × £15	372 employees × 100 options × £2	669,900	24,133

How we see it

It may seem strange that a cost is being recognised for the original award in respect of the 25 employees who leave during year 4, who are never entitled to anything. However, in our view, this is consistent with:

- The overall requirement of FRS 102 and IFRS 2 that the minimum cost of a modified award is the cost that would have been recognised if the award had not been modified.
- IG Example 8 in IFRS 2 (the substance of which is reproduced in Illustration 8-6 above) where an expense is clearly required to be recognised to the extent that the original performance conditions would have been met if the award had not been modified.

As noted in Illustration 8-6 and 8-7 above, the rule in FRS 102 and IFRS 2 requiring recognition of a minimum expense for a modified award (i.e., as if the original award had remained in place) applies irrespective of whether the effect of the modification is that an award becomes less valuable to the employee (as in Illustration 8-6) or more valuable to the employee (as in Illustration 8-7).

Where a modified vesting period is shorter than the original vesting period, a question arises as to when all the expense relating to both the original and modified elements of the award must be recognised.

How we see it

In our view, the expense is recognised by the end of the modified vesting period as no services will be rendered beyond that point. In this type of modification, which is distinct from a change of estimate where there is a variable vesting period (see 7.2.3 above), we believe that an entity has an accounting policy choice between retrospective and prospective adjustment of the vesting period as at the modification date.

8.3.4 Modifications that reduce the number of equity instruments granted but maintain or increase the value of an award

As discussed at 8.3.2.B above, IFRS 2 requires cancellation accounting to be applied to a reduction in the number of equity instruments when a modification reduces both the number of equity instruments granted and the total fair value of the award. [IFRS 2.B.44(b)]. FRS 102 is silent on the accounting treatment of such arrangements, and we therefore suggest that entities follow the IFRS 2 requirements. The IFRS 2 approach is consistent with the fact that part of the award has been removed without compensation to the employee. However, a modification of this kind is rarely seen in practice because of the demotivating effect and, in some jurisdictions, a requirement to pay compensation to the counterparty. An entity is more likely to modify an award so that the overall fair value remains the same, or increases, even if the number of equity instruments is reduced. These types of modification, sometimes known as 'value for value' exchanges or 'give and take' modifications, are considered below.

Where an entity reduces the number of equity instruments but also makes other changes so that the total fair value of the modified award remains the same as, or exceeds, that of the original award as at the modification date, it is unclear whether the unit of account for accounting purposes must be an individual equity instrument or the award as a whole. Illustration 8-8 and Illustration 8-9 below show the two situations and the two approaches.

Illustration 8-8: Modification where number of equity instruments is reduced but total fair value of award is unchanged

At the beginning of year 1, an entity granted an employee 200 share options with a grant date fair value of £9 and a vesting period of three years. During years 1 and 2, the entity recognises a cumulative expense of £1,200 ($200 \times £9 \times 2/3$). At the end of year 2 the exercise price of the options is significantly higher than the market price and the options have a fair value of £5 per option. On this date, the entity modifies the award and exchanges the 200 underwater options for 100 'at the money' options with a fair value of £10 each. The total fair value of the new awards of £1,000 ($100 \times £10$) equals the total fair value of the awards exchanged ($200 \times £5$), as measured at the modification date.

View 1 is that the unit of account is an individual option. Taking this approach, the decrease in the number of options from 200 to 100 will be accounted for as a cancellation with an acceleration at the modification date of any un-expensed element of the grant date fair value of 100 options (i.e., recognition of an additional amount of £300 ($100 \times £9 \times 1/3$)). The grant date fair value of the remaining 100 options continues to be recognised over the remainder of the vesting period together with their incremental fair value following the modification. Therefore, in year 3, there would be an expense of £300 (for the remaining grant date fair value) plus £500 ($100 \times (£10 - £5)$) for the incremental fair value of 100 options. In total, therefore, an expense of £2,300 is recognised.

View 2 is that the total number of options exchanged is the more appropriate unit of account. In this case, the cancellation of the original options and the grant of replacement options are accounted for as one modification. There would therefore be no acceleration of expense in respect of the reduction in the number of options from 200 to 100 and the grant date fair value of the original award would continue to be recognised over the vesting period. In this case, the total expense recognised would be £1,800 ($200 \times £9$).

Illustration 8-9: Modification where number of equity instruments is reduced but total fair value is increased

At the beginning of year 1, an entity granted to its employees 1,000 share options with an exercise price equal to the market price of the shares at grant date. There is a two-year vesting period and the grant date fair value is £10 per option. The entity's share price has declined significantly so that the share price is currently significantly less than the exercise price. At the end of year 1, the entity decides to reduce the exercise price of the options and, as part of the modification, it also reduces the number of options from 1,000 to 800. At the date of modification, the fair value of the original options is £7 per option and that of the modified options £11 per option.

View 1 is that the unit of account is an individual option. Taking this approach, the decrease in the number of options from 1,000 to 800 will be accounted for as a cancellation of 200 options with an acceleration at the modification date of any remaining grant date fair value relating to those 200 options. The total expense recognised in year 1 is £6,000 ($(800 \times £10 \times 1/2) + (200 \times £10)$). The grant date fair value of the remaining 800 options continues to be recognised over the remainder of the vesting period together with the incremental fair value of those awards as measured at the modification date. In total the entity will recognise an expense of £13,200 (original grant date fair value of £10,000 ($1,000 \times £10$) plus incremental fair value of £3,200 ($800 \times (£11 - 7)$)).

View 2 is that the unit of account is the total number of options as there are linked modifications forming one package. In this case, the incremental fair value is calculated as the difference between the total fair value before and after the modification. In total the entity will recognise an expense of £11,800 (original grant date fair value of £10,000 ($1,000 \times £10$) plus incremental fair value on modification of £1,800 ($(800 \times £11) - (1,000 \times £7)$)).

How we see it

Given the lack of clarity, we believe that an entity could make an accounting policy choice as to whether it considers the unit of account to be an individual equity instrument or an award as a whole. However, once made, that accounting policy choice is applied consistently to all modifications that reduce the number of equity instruments but maintain or increase the overall fair value of an award. Whichever policy is chosen, the general requirements of FRS 102 will still need to be applied to determine whether the amendments to the arrangement are such that it is appropriate to treat the changes as a modification rather than as a completely new award (see 8.4.2 and 8.4.4 below).

8.3.5 Modification of award from equity-settled to cash-settled (and vice versa)

Occasionally an award that was equity-settled when originally granted is modified to become cash-settled, or an originally cash-settled award is modified to become equity-settled. FRS 102 provides no explicit guidance on such modifications. IFRS 2 provides no explicit guidance on modifications from equity-settled to cash-settled but does provide specific guidance on modifications of awards from cash-settled to equity-settled. In the absence of specific guidance on such modifications in FRS 102, it is possible to arrive at a reasonable approach by analogy to various provisions of FRS 102 and IFRS 2 in respect of:

FRS 102

- The modification of equity-settled awards during the vesting period (see 8.3 above)
- And
- The settlement of equity-settled awards in cash (see 8.4 below).

IFRS 2

- The addition of a cash-settlement alternative to an equity-settled award after grant date (as demonstrated in IG Example 9 in the implementation guidance to IFRS 2)
- And
- The settlement in equity of awards where the entity has a choice of settlement, but which have been accounted for as cash-settled during the vesting period (see 11.1.1.A below).

A detailed discussion of this topic is beyond the scope of this publication, but the subject is addressed more fully in EY's publication International GAAP®.

8.4 Cancellation and settlement

The accounting for cancellation and settlement of an award, in paragraphs 13 and 13A of Section 26, is consistent with the basic requirement of IFRS 2 (as set out in (a) and (b) below). However, Section 26 does not address the treatment of replacement awards following a cancellation and in the absence of specific guidance in FRS 102, we consider it appropriate to follow the full guidance in IFRS 2, as outlined below, for replacement of an award.

Where an award is cancelled or settled (i.e., cancelled with some form of compensation), other than by forfeiture for failure to satisfy the vesting conditions, IFRS 2 requires the following approach:

- (a) If the cancellation or settlement occurs during the vesting period, it is treated as an acceleration of vesting, and the entity recognises immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period. *[FRS 102.26.13, IFRS 2.28(a)]*.
- (b) Where the entity pays compensation for a cancelled award:
 - (i) Any compensation paid up to the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as a deduction from equity, as being equivalent to the redemption of an equity instrument. *[FRS 102.26.13A, IFRS 2.28, IFRS 2.29]*.
 - (ii) Any compensation paid in excess of the fair value of the award at cancellation or settlement date (whether before or after vesting) is accounted for as an expense in profit or loss. *[FRS 102.26.13A, IFRS 2.28(b), IFRS 2.29]*.
 - (iii) If the share-based payment arrangement includes liability components, the fair value of the liability is remeasured at the date of cancellation or settlement. Any payment made to settle the liability component is accounted for as an extinguishment of the liability. *[IFRS 2.28(b), IFRS 2.29]*.
- (c) If the entity grants new equity instruments during the vesting period and, on the date that they are granted, identifies them as replacing the cancelled or settled instruments, the entity is required to account for the new equity instruments as if they were a modification of the cancelled or settled award. Otherwise, it accounts for the new instruments as an entirely new award. *[IFRS 2.28, IFRS 2.29]*.

It is noted that the calculation of any additional expense in (b) above depends on the fair value of the award at the date of cancellation or settlement, not on the cumulative expense already charged. This has the important practical consequence that, when an entity pays compensation on cancellation or settlement of an award, it must obtain a fair value for the original award, updated to the date of cancellation or settlement. If the award had not been cancelled or settled, there would have been no need to obtain a valuation for the original award after the date of grant.

These requirements raise some further detailed issues of interpretation on a number of areas, as follows:

- The distinction between 'cancellation' and 'forfeiture' (see 8.4.1 below)
 - The distinction between 'cancellation' and 'modification' (see 8.4.2 below)
 - The calculation of the expense on cancellation (see 8.4.3 below)
- And
- Replacement awards (see 8.4.4 and 8.5 below).

8.4.1 Distinction between cancellation and forfeiture

Although not specifically stated, we believe that, similar to IFRS 2, the guidance provided in Section 26.13A on cancellations and settlement does not relate to grants cancelled by forfeiture when the vesting conditions are not satisfied. The significance of this is that the terms of many share-based awards provide that they are, or can be, 'cancelled', in a legal sense, on forfeiture. IFRS 2 clarifies that, where an award is forfeited (within the meaning of that term in IFRS 2 – see 7.1.2 above), the entity must apply the accounting treatment for a forfeiture (i.e., reversal of expense previously recognised), even if the award is legally cancelled as a consequence of the forfeiture. FRS 102 does not have such an explicit distinction but we presume that a similar treatment is intended.

8.4.1.A Termination of employment by entity

In some cases, it might not always be immediately clear whether cancellation or forfeiture has occurred, particularly where options lapse as the result of a termination of employment by the entity. For example, an entity might grant options to an employee at the beginning of year 1 on condition of his remaining in employment until the end of year 2. During year 1, however, economic conditions require the entity to make a number of its personnel, including that employee, redundant, as a result of which his options lapse. Is this lapse a forfeiture or a cancellation for accounting purposes?

The uncertainty arises because it could be argued either that the employee will be unable to deliver the services required in order for the options to vest (suggesting a forfeiture) or that the options lapse as a direct result of the employer's actions (suggesting a cancellation).

The definition of 'service condition' addresses this uncertainty. The definition includes the following guidance:

"...If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. ...". [FRS 102 Appendix I].

Therefore, Section 26 requires the failure to satisfy a service condition as the result of any termination of employment to be accounted for as a forfeiture rather than as a cancellation. For example, a situation where the entity terminates the employment contract is required to be accounted for as a forfeiture.

8.4.1.B Surrender of award by employee

It is sometimes the case that an employee, often a member of senior management, will decide or be encouraged by the entity, to surrender awards during the vesting period. The question arises as to whether the surrendered awards are to be treated as a cancellation or forfeiture for accounting purposes. FRS 102 and IFRS 2 allow forfeiture accounting, and the consequent reversal of any cumulative expense, only in situations where vesting conditions are not satisfied. A situation where the counterparty voluntarily surrenders an award, and therefore the opportunity to meet the vesting conditions, is a decision within the control of the counterparty rather than a failure to satisfy a vesting condition and must be accounted for as a cancellation rather than as a forfeiture.

How we see it

We do not believe that the intention of the guidance in Section 26 was to allow an employee to 'fail' to meet a service condition by voluntarily surrendering an award. Such an action therefore continues to be treated as a cancellation rather than as a forfeiture.

8.4.2 Distinction between cancellation and modification

One general issue raised by the approach to modification and cancellation in FRS 102 and IFRS 2 is where the boundary lies between 'modification' of an award in the entity's favour and outright cancellation of the award. As a matter of legal form, the difference is obvious. However, if an entity were to modify an award in such a way that there was no realistic chance of it ever vesting (for example, by introducing a requirement that the share price increase 1,000,000 times by vesting date), some might argue that this amounts to a *de facto* cancellation of the award. The significance of the distinction is that, whereas the cost of a 'modified' award continues to be recognised on a periodic basis over the vesting period (see 8.3 above), the remaining cost of a cancelled award is recognised immediately.

8.4.3 Calculation of the expense on cancellation

The basic accounting treatment for a cancellation and settlement is demonstrated in Illustration 8-10 below.

Illustration 8-10: Cancellation and settlement - basic accounting treatment

At the start of year 1, an entity grants an executive 30,000 options on condition that she remains in employment for three years. Each option is determined to have a fair value of £10.

At the end of year 1, the executive is still in employment and the entity charges an expense of £100,000 ($30,000 \times £10 \times 1/3$). At the end of year 2, the executive is still in employment. However, the entity's share price has suffered a decline which the entity does not expect to have reversed by the end of year 3, such that the options, while still 'in the money' now have a fair value of only £6.

The entity cancels the options at the end of year 2 and in compensation pays the executive £6.50 per option cancelled, a total payment of £195,000 ($30,000 \text{ options} \times £6.50$).

FRS 102 and IFRS 2 first require the entity to record a cost as if the options had vested immediately. The total cumulative cost for the award must be £300,000 ($30,000 \text{ options} \times £10$). £100,000 was recognised in year 1, so that an additional cost of £200,000 is recognised.

As regards the compensation payment, the fair value of the awards cancelled is £180,000 ($30,000 \text{ options} \times £6.00$). Accordingly, £180,000 of the payment is accounted for as a deduction from equity, with the remaining payment in excess of fair value, £15,000, applying paragraphs 13 and 13A of Section 26.

The net effect of this is that an award that ultimately results in a cash payment to the executive of only £195,000 (i.e., £6.50 per option) has resulted in a total charge to profit or loss of £315,000 (i.e., £10.50 per option, representing £10 grant date fair value + £6.50 compensation payment - £6.00 cancellation date fair value).

Illustration 8-10 shows the basic calculation of the required cancellation 'charge'. In more complex situations, however, the amount of the 'charge' may not be so clear-cut, due to an ambiguity in the drafting of paragraph 28(a) of IFRS 2 and paragraph 13 of Section 26, which state that an entity:

"shall account for the cancellation or settlement ... as an acceleration of vesting and therefore shall recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period." [FRS 102.26.13, IFRS 2.28(a)].

There is something of a contradiction within this requirement as demonstrated by Illustration 8-11.

Illustration 8-11: Cancellation and settlement – best estimate of cancellation expense

At the beginning of year 1, entity A granted 150 employees an award of free shares, with a grant date fair value of £5, conditional upon continuous service and performance targets over a 3-year period from grant date. The number of shares awarded varies according to the extent to which targets (all non-market vesting conditions) have been met and could result in each employee still in service at the end of year 3 receiving a minimum of 600, and a maximum of 1,000 shares.

Halfway through year 2 (i.e., 18 months after grant date), A is acquired by B, following which A cancels all of its share awards. At the time of the cancellation, 130 of the original 150 employees were still in employment. At that time, it was A's best estimate that, had the award run to its full term, 120 employees would have received 900 shares each. Accordingly, the cumulative expense recognised by A for the award as at the date of takeover would, under the normal estimation processes discussed at 7.1 to 7.4 above, be £270,000 (900 shares × 120 employees × £5 × 18/36).

How must A account for the cancellation of this award?

The opening phrase of paragraph 28(a) of IFRS 2 (echoed in paragraph 13 of Section 26, "the entity shall account for the cancellation ...as an acceleration of vesting" - suggests that A must recognise a cost for all 130 employees in service at the date of cancellation. However, the following phrase, "[the entity] shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period", suggests that the charge must be based on only 120 employees, the best estimate, as at the date of cancellation of the number of employees in whom shares will finally vest.

How we see it

In our view, either reading is possible. Recognise the cancellation cost, either based on the employees in service at the date of cancellation or based on the best estimate of the number of employees at the date of cancellation to whom the shares would vest.

There is then the issue of the number of shares per employee that is required to be taken into account in the cancellation charge. Is this the 1,000 shares per employee (the maximum amount that could vest) or 900 shares per employee (the amount expected by the entity at the date of cancellation actually to vest)?

How we see it

In our view, it is unclear whether the intention was that the cancellation charge is to be based on the number of shares considered likely, as at the date of cancellation, to vest for each employee (900 shares in this example) or whether it be based on the maximum number of shares (1,000 shares in this example). Given the lack of clarity, in our view an entity must make an accounting policy choice.

In extreme cases, the entity's best estimate, as at the date of cancellation, might be that no awards are likely to vest. In this situation, no cancellation expense would be recognised. However, there would need to be evidence that this was not just a rather convenient assessment made as at the date of cancellation. Typically, the previous accounting periods would also have reflected a cumulative expense of zero on the assumption that the awards would never vest.

An effect of these requirements is that they create an accounting arbitrage between an award that is 'out of the money' but not cancelled (the cost of which continues to be spread over the remaining period to vesting) and one which is formally cancelled (the cost of which is recognised immediately). Entities might well prefer to opt for cancellation so as to create a 'one-off' charge to earnings rather than continue to show, particularly during difficult trading periods, significant periodic costs for options that no longer have any real value. However, such early cancellation of an award precludes any chance of the cost of the award being reversed through forfeiture during, or at the end of, the vesting period if the original vesting conditions are not met.

8.4.4 Replacement awards

FRS 102 contains no specific requirements or guidance in relation to replacement awards and so we consider it appropriate to draw on those in IFRS 2. The remainder of this section therefore reflects the IFRS 2 requirements. Whilst the requirements relating to accounting for replacement awards are generally clear under IFRS 2, there are nevertheless some issues of interpretation.

As set out at 8.4 above, a new award that meets the criteria in paragraph 28(c) of IFRS 2 to be treated as a replacement of a cancelled or settled award is accounted for as a modification of the original award and any incremental value arising from the granting of the replacement award is recognised over the vesting period of that replacement award. Where the criteria are not met, the new equity instruments are accounted for as a new grant (in addition to accounting for the cancellation or settlement of the original arrangement). The requirements are discussed in more detail below.

8.4.4.A Designation of award as replacement award

Whether or not an award is a 'replacement' award (and therefore recognised at only its incremental, rather than its full, fair value) is determined by whether the entity designates it as such on the date that it is granted.

Entities need to ensure that designation occurs on grant date as defined by IFRS 2 (and FRS 102) (see 6.3 above). For example, if an entity cancels an award on 15 March and notifies an employee in writing on the same day of its intention to ask the remuneration committee to grant replacement options at its meeting in two months on 15 May, such notification (although formal and in writing) may not strictly meet the requirement for designation on grant date (i.e., 15 May).

How we see it

In our view, what is important is that the entity establishes a clear link between the cancellation of the old award and the granting of a replacement award even if there is later formal approval of the replacement award following the communication of its terms to the counterparty at the same time as the cancellation of the old award.

An entity does not have a free choice to designate any newly granted awards as replacement awards. In our view, however, such designation cannot credibly be made unless there is evidence of some connection between the cancelled and replacement awards. This might be that the cancelled and replacement awards involve the same counterparties, or that the cancellation and replacement are part of the same arrangement.

8.4.4.B Incremental fair value of replacement award

Where an award is designated as a replacement award, any incremental fair value must be recognised over the vesting period of the replacement award. The incremental fair value is the difference between the fair value of the replacement award and the 'net fair value' of the cancelled or settled award, both measured at the date on which the replacement award is granted. The net fair value of the cancelled or settled award is the fair value of the award, immediately before cancellation, less any compensation payment that is accounted for as a deduction from equity. [IFRS 2.28(c)]. Thus the 'net fair value' of the original award can never be less than zero (since any compensation payment in excess of the fair value of the cancelled award would be accounted for in profit or loss, not in equity – see Illustration 8-10 at 8.4.3 above).

There is some confusion within IFRS 2 as to whether a different accounting treatment is intended to result from, on the one hand, modifying an award and, on the other hand, cancelling it and replacing it with a new award on the same terms as the modified award. This is explored in Illustration 8-12 below, which is based on the same fact pattern as Illustration 8-2 at 8.3.1.A above.

Illustration 8-12: Replacement awards – is there an accounting arbitrage between modification and accounting for cancellation and a new grant?

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is £15.

By the end of year 1, the entity's share price has dropped. The entity cancels the existing options and issues options which it identifies as replacement options, which also vest at the end of year 3. The entity estimates that, at the date of cancellation, the fair value of each of the original share options granted is £5 and that the fair value of each replacement share option is £8.

40 employees leave during year 1. The entity estimates that a further 70 employees will leave during years 2 and 3, so that there will be 390 employees at the end of year 3 ($500 - 40 - 70$).

During year 2, a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, so that there will be 395 employees at the end of year 3 ($500 - 40 - 35 - 30$).

During year 3, 28 employees leave, and hence a total of 103 employees ceased employment during the original three-year vesting period, so that, for the remaining 397 employees, the replacement share options vest at the end of year 3.

Paragraph BC233 of IFRS 2 suggests that the intention of the IASB was that the arrangement should be accounted for in the same way as the modification in Illustration 8-2 above.

However, it is not clear that this intention is actually reflected in the drafting of paragraph 28 of IFRS 2 which seems to require the cancellation of the existing award to be treated as an acceleration of vesting, explicitly and without qualification, and any 'new equity instruments' granted to be accounted for in the same way as a modification of the original grant of equity instruments. It does not require this treatment for the cancellation of the 'original instruments', because this has already been addressed as an acceleration of vesting.

The application of, firstly, the main text of IFRS 2 and, secondly, the Basis for Conclusions to IFRS 2 to the entity in Illustration 8-12 is set out below.

The main text in IFRS 2 appears to require the entity to recognise:

- The entire cost of the original options at the end of year 1 (since cancellation has the effect that they are treated as vesting at that date), based on the 390 employees expected at that date to be in employment at the end of the vesting period. This is not the only possible interpretation of the requirement of paragraph 28(a), see the broader discussion in Illustration 8-11 at 8.4.3 above.
- For the options replacing the 390 cancelled awards, the incremental fair value of the replacement options at repricing date (£3 per option, being the £8 fair value of each replacement option less the £5 fair value of each cancelled option) over a two year vesting period beginning at the date of cancellation (end of year 1), based on the (at first estimated and then actual) number of employees at the end of year 3 (i.e., the final number could be less than the estimate of 390).
- For any additional replacement options (i.e., replacement options awarded in excess of the 390×100 options that were expected to vest at cancellation date), the full incremental fair value at repricing date (being the £8 fair value of each replacement option) over a two-year vesting period beginning at the repricing date (end of year 1). The expense is based on the (at first estimated and then actual) number of employees in excess of 390 at the end of year 3.

This would be calculated as follows:

Year	Calculation of cumulative expense		Cumulative expense (£)	Expense for period (£)
	Original award	Replacement award		
1	390 employees $\times$ 100 options $\times$ £15	-	585,000	585,000
2	390 employees $\times$ 100 options $\times$ £15	390 employees $\times$ 100 options $\times$ £3 $\times$ 1/2 5 employees $\times$ 100 options $\times$ £8 $\times$ 1/2	645,500	60,500
3	390 employees $\times$ 100 options $\times$ £15	390 employees $\times$ 100 options $\times$ £3 7 employees $\times$ 100 options $\times$ £8	707,600	62,100

By contrast, the accounting treatment implied by the Basis for Conclusions is as follows (see Illustration 8-2 above):

Year	Calculation of cumulative expense		Cumulative expense (£)	Expense for period (£)
	Original award (a)	Modified award (b)	(a+b)	
1	390 employees $\times$ 100 options $\times$ £15 $\times$ 1/3	-	195,000	195,000
2	395 employees $\times$ 100 options $\times$ £15 $\times$ 2/3	395 employees $\times$ 100 options $\times$ £3 $\times$ 1/2	454,250	259,250
3	397 employees $\times$ 100 options $\times$ £15	397 employees $\times$ 100 options $\times$ £3	714,600	260,350

In the above illustration, both the periodic allocation of expense and the total expense differ under each interpretation. This is because, under the first interpretation, the cost of the original award is accelerated at the end of year 1 for all 390 employees expected at that date to be in employment at the end of the vesting period, whereas under the second interpretation a cost is recognised for the 397 employees whose awards finally vest. The difference between the two total charges of £7,000 (£714,600 - £707,600) represents $397 - 390 = 7$ employees @ £1,000 (100 options × £10 (£15 + £3 - £8)) each = £7,000.

How we see it

In practice, the second (modification accounting) approach above tends to be seen more frequently. However, we believe that either interpretation is valid, and an entity adopts one or the other consistently as a matter of accounting policy.

In Illustration 8-12 above, we base the cancellation calculations on 390 employees (the number expected to be employed at the end of the vesting period as estimated at the cancellation date) rather than on 460 employees (the number in employment at the cancellation date). As discussed in Illustration 8-11 at 8.4.3 above, either approach may be adopted but the selected approach must be applied consistently.

The discussion above relates to situations in which awards are cancelled and replaced for reasons other than expected, or actual, failure by the counterparty to meet a service condition. Changes to awards in contemplation, or as a consequence, of cessation of employment are considered at 6.3.8.B above and at 8.5 and 8.6 below.

8.4.4.C Replacement of vested awards

The rules for replacement awards summarised in paragraph (c) at 8.4 above apply “if a grant of equity instruments is cancelled or settled during the vesting period ...”. [IFRS 2.28]. FRS 102 does not explicitly state that its requirements relate solely to awards cancelled or settled during the vesting period, but this seems to be implied by the references to “an acceleration of vesting” and “the remainder of the vesting period”. [FRS 102.26.13]. However, if the original award has already vested when a replacement award is granted, there is no question of accelerating the cost of the cancelled award, as it has already been recognised during the vesting period. The issue is rather the treatment of the new award itself. Whilst neither IFRS 2 nor FRS 102 explicitly addresses this point, it appears that such a replacement award is treated in the same way as a completely new award. In other words, its full fair value is recognised immediately or, if there are any vesting conditions for the replacement award, over its vesting period.

By contrast, the rules in IFRS 2 for modification of awards (discussed in 8.3 above) apply whether the award has vested or not. Paragraphs 26 and 27 of IFRS 2 (modifications) are not restricted to events “during the vesting period” in contrast to paragraph 28 (cancellation and settlement, including replacement awards), which is restricted to events “during the vesting period”. [IFRS 2.26, IFRS 2.27, IFRS 2.28]. In FRS 102, any such distinction is less clear because the paragraph on modifications is written in the context of a modification of vesting conditions and, whilst it refers explicitly to the accounting treatment of modifications during the vesting period, it is silent on the modification of vested awards. [FRS 102.26.12].

How we see it

In the absence of explicit guidance, we believe that it is appropriate to follow the accounting approach of IFRS 2. This has the effect that the accounting cost of modifying an already vested award (i.e., the incremental fair value of the modified award) may, at first sight, appear to be lower than the cost of cancelling and replacing it, which requires the full fair value of the new award to be expensed. However, the full fair value of the new replacement award will be reduced by the fair value of the cancelled award that the employee has surrendered as part of the consideration for the new award. This analysis will, in many cases, produce an accounting outcome similar to that of the modification of an unvested award.

8.5 Replacement and *ex gratia* awards on termination of employment

When an employee's employment is terminated during the vesting period of an award of shares or options, the award will typically lapse in consequence. It is common in such situations, particularly where the employee was part of the senior management, for the entity to make an alternative award, or to allow the employee to retain existing awards, as part of the package of benefits agreed with the employee on termination of employment.

Generally, such an award is an *ex gratia* award, in other words, it is a voluntary award to which the outgoing employee had no legal entitlement under the terms of the original award. However, a number of plan rules set out, in a 'good leaver' clause (see 6.3.8 above), the terms on which any *ex gratia* award may be made, usually by applying a formula to determine, or limit, how much of the original award can be considered to have vested.

In many cases the award will be made on a fully vested basis, i.e., the employee has full entitlement without further conditions needing to be fulfilled. In other cases, however, an employee will be allowed to retain awards that remain subject to the fulfilment of the original conditions (other than future service).

Whichever form the award takes, in accounting terms it will be treated as vesting at the date of termination of employment because any remaining conditions will be accounted for as non-vesting conditions in the absence of an explicit or implied service condition (see 4.2 above).

It has not always been clear whether the termination of employment must be accounted for as a forfeiture or as a cancellation. However, as discussed at 8.4.1.A above, if an employee is unable to satisfy a service condition for any reason, this is required to be accounted for under FRS 102 and IFRS 2 as a forfeiture rather than as a cancellation.

IFRS 2 does not specifically address the accounting for any replacement or *ex gratia* awards granted on termination of employment. It perhaps follows from the treatment of the termination of employment as a forfeiture to:

- Reverse any expense relating to the forfeited award.
- And
- Recognise the *ex gratia* award as a completely new award granted at the date of termination of employment.

However, the guidance is not clear and there might be situations where entities consider it more appropriate to apply modification accounting (recognising the original grant date fair value of the award that would otherwise be forfeited on its original terms (because the service condition would not be met) plus the incremental value of the modified terms).

How we see it

In the absence of clarity, we believe that judgement will be required based on the specific facts and circumstances and the extent to which the changes to the arrangements are considered to be a waiver of existing conditions in connection with the cessation of employment rather than the introduction of a discretionary replacement arrangement on completely new terms.

8.6 Entity's plans for future modification or replacement of award - impact on estimation process at reporting date

As discussed at 7.1.1 and 7.1.2 above, FRS 102 requires an entity to determine a cumulative charge at each reporting date by reference to an estimate of the number of awards that will vest (within the specific meaning of that term in FRS 102). The process of estimation at each reporting date must take into account any new information that indicates a change to previous estimates.

In addition to the normal difficulties inherent in any estimation process, it is not entirely clear which anticipated future events must be taken into account in the estimation process and which must not, as demonstrated by Illustration 8-13 below.

Illustration 8-13: Estimation of number of awards expected to vest - treatment of anticipated future events

At the beginning of year 1, an entity granted an award of 1,000 shares to each of its 600 employees at a particular manufacturing unit. The award vests on completion of three years' service. As at the end of year 1, the entity firmly intends to close the unit, and terminate the employment of employees, as part of a rationalisation programme. This closure would occur part way through year 2. The entity has not, however, announced its intentions or taken any other steps so as to allow provision for the closure under Section 21 Provisions and Contingencies.

Under the original terms of the award, the award would lapse on termination of employment. However, the entity intends to compensate employees made redundant by changing the terms of their award so as to allow full vesting on termination of employment.

What is the 'best estimate', as at the end of year 1, of the number of awards expected to vest? Specifically, must the entity:

- (a) Ignore the intended closure altogether, on the grounds that there is no other recognition of it in the financial statements?
- (b) Take account of the impact of the intended closure on vesting of the current award, but ignore the intended modification to the terms of the award to allow vesting?
- Or
- (c) Take account of both the intended closure and the intended modification of the award?

In our view, there is no basis in FRS 102 for accounting for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date, not those that might be in issue in the future. Accordingly, we do not consider approach (c) above to be appropriate if any change to the issued awards was simply an intention.

Equally, we struggle to support approach (a) above. FRS 102 requires the entity to use an estimate of the number of awards expected to vest and its best available estimate as at the end of year 1 must be that the unit will be closed, and the employees' employment terminated, in year 2. This view is supported by the fact that, unlike other areas of accounting such as impairment and provisions, accounting for share-based payment transactions does not explicitly prohibit an entity from taking account of the consequences of reorganisations and similar transactions to which it is not yet committed.

Accordingly, we believe that approach (b) must be followed.

The entity's best estimate, at the end of year 1, must be that none of the awards currently in place will vest (because all the employees will be made redundant and so will not meet the service condition before the end of the vesting period). It therefore applies forfeiture accounting at the end of year 1 and reverses any cost previously recorded for the award.

When the terms of the award are changed (see 8.1.1 above) in year 2 to allow full vesting on redundancy, the entity will either recognise the full cost of the new award (as all cost relating to the original award has been reversed) or will treat the revised arrangement as a modification of the original award that is beneficial to the employee. In effect, the modification approach is based on a view that the original award is not now going to lapse because it will be modified before employment ceases and the forfeiture crystallises. In our view, in the absence of clarity in the standard, the entity is required to assess the more appropriate approach based on the particular facts and circumstances.

Either approach will have what many may see as the less than ideal result that the entity will recognise a credit in profit or loss in year 1 and an expense in year 2, even though there has been no change in management's best estimate of the overall outcome. This follows from the analysis, discussed above, that we do not believe that the entity can account, in year 1, for the award on the basis of what its terms may be in year 2.

The best estimate is made as at each reporting date. A change in estimate made in a later period in response to subsequent events, affects the accounting expense from that later period only (i.e., there is no restatement of earlier periods presented).

How we see it

In summary, as noted above, we believe there is no basis to account for an anticipated future change to the terms of an award. The entity must account for those awards in issue at the reporting date, not those that might be in issue in the future. The best estimate of the awards expected to vest at the end of the reporting date is based on the awards currently in place, in other words, at the end of year 1 none of the awards in place will vest. When the terms of the award are changed, it is then based on facts and circumstances, whether the change is accounted for as a new award or treat the revised arrangement as a modification of the original award.

8.7 Share splits and consolidations

It is relatively common for an entity to divide its existing equity share capital into a larger number of shares (share splits) or to consolidate its existing share capital into a smaller number of shares (share consolidations). The impact of such splits and consolidations is not specifically addressed in either FRS 102 or IFRS 2.

Suppose that an employee has options over 100 shares in the reporting entity, with an exercise price of £1. The entity undertakes a '1 for 2' share consolidation, i.e., the number of shares in issue is halved such that, all other things being equal, the value of one share in the entity after the consolidation is twice that of one share before the consolidation.

IFRS 2 is required to be applied to modifications to an award arising from equity restructurings (FRS 102 is silent on this). [IFRS 2.BC24]. In many cases, a share scheme will provide for automatic adjustment so that, following the consolidation, the employee holds options over only 50 shares with an exercise price of £2. As discussed at 6.3.7.A above, all things being equal, it would be expected that the modified award would have the same fair value as the original award and so there would be no incremental expense to be accounted for.

However, it may be that the scheme has no such provision for automatic adjustment, such that the employee still holds options over 100 shares. The clear economic effect is that the award has been modified, since its value has been doubled. It could be argued that, on a literal reading of IFRS 2, no modification has occurred, since the employee holds options over 100 shares at the same exercise price before and after the consolidation.

How we see it

In our view, whilst it seems appropriate to have regard to the substance of the transaction, and treat it as giving rise to a modification, it can be argued that FRS 102 and IFRS 2 as drafted does not require such a treatment. In the absence of clear guidance, the accounting policy adopted must be applied consistently.

Sometimes, the terms of an award give the entity discretion to make modifications at a future date in response to more complex changes to the share structure, such as those arising from bonus issues, share buybacks and rights issues where the effect on existing options may not be so clear-cut. These are discussed further at 6.3.7.A above.

9 Equity-settled transactions – valuation

9.1 Introduction

As noted at 6.1 above, an equity-settled share-based payment transaction is valued either at the fair value of the goods or services received using the general requirements of FRS 102 for the determination of fair value or at the fair value of the equity instruments granted using the specific requirements set out in Section 26. FRS 102 defines fair value as: *[FRS 102.26.1C]*

Extract from FRS 102

Defined term

fair value	fair value is the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

The timing of the fair value measurement, and whether it is based on the goods or services or on the equity instruments, is driven by a number of factors including the relative reliability of measurement and the identity of the counterparty (see 6 above).

In this section we consider the specific requirements in Section 26 for the valuation of shares, share options and equity-settled share appreciation rights. No distinction is drawn between awards to employees and to non-employees and the requirements must therefore be applied to the measurement of employee awards at grant date and non-employee awards at service date.

9.2 Shares

Section 26 requires the fair value of shares (and the related goods or services received) to be determined using the following three-tier measurement hierarchy:

- (a) If an observable market price is available for the equity instruments granted, use that price.
- (b) If an observable market price is not available, measure the fair value of equity instruments granted using entity-specific observable market data such as:
 - (i) A recent transaction in the entity's shares.
 - (ii) A recent independent fair valuation of the entity or its principal assets.
- (c) If an observable market price is not available and obtaining a reliable measurement of fair value under (b) is impracticable, indirectly measure the fair value of the shares using a valuation method that uses market data to the greatest extent practicable to estimate what the price of those equity instruments would be on the grant date in an arm's length transaction between knowledgeable, willing parties. The entity's directors must use their judgement to apply a generally accepted valuation methodology for valuing equity instruments that is appropriate to the circumstances of the entity. *[FRS 102.26.10]*.

FRS 102 defines a requirement as 'impracticable' when the entity cannot apply it after making every reasonable effort to do so. *[FRS 102 Appendix I]*.

It seems unlikely that the market price referred to in (a), or the entity-specific observable market data referred to in (b), will be available for the measurement of the vast majority of share-based awards granted by unlisted entities. Most entities will therefore be required to apply the approach required by (c) and use an appropriate valuation methodology.

The selection of an appropriate methodology for valuing the equity of an unlisted entity is beyond the scope of this publication but, in many cases of awards of free shares (which are akin to options with a zero strike price), it is likely that an approach similar to that used for valuing share options will be adopted (see 9.3 below).

FRS 102 states that all market conditions and non-vesting conditions must be taken into account when estimating the fair value of the shares or share options at the measurement date (see further discussion at 7.3 and 7.4 above on market conditions and non-vesting conditions). *[FRS 102.26.9]*. Apart from this, there is no mention of adjusting the market price, or estimated market price, of an entity's shares to take into account the terms and conditions on which they were granted (which would, typically, reduce the value). Many conditions and restrictions attached to awards will be covered by the requirements of paragraph 9. However, this guidance does not specifically address the common situation where the counterparty is not entitled to receive dividends during the vesting period.

Under the requirements of IFRS 2, no adjustment is required to the estimated grant date fair value of shares if the employees are entitled to receive dividends, or dividend equivalents paid in cash, during the vesting period (as they are in no different a position in this respect than if they already held shares). However, where employees are not entitled to receive dividends during the vesting period, IFRS 2 requires the valuation to be reduced by the present value of dividends expected to be paid during the vesting period. [IFRS 2.B31, IFRS2.B33, IFRS 2.B34].

The accounting treatment of awards which give the right to receive dividends during the vesting period is discussed further at 16.3 below.

If an entity is taking approach (c) above in determining a fair value for the equity instruments, then it seems appropriate to adjust for all the terms and conditions on which the shares have been awarded (other than those vesting conditions which are not taken into account in the determination of fair value).

Where an entity is using approaches (a) or (b), it might appear that it is required to use an unadjusted market price or other observable price without adjusting for the specific terms and conditions of the share-based payment. However, that seems to be at variance with the requirements of paragraph 9 to take certain conditions into account.

How we see it

In our view, it will generally be more appropriate to adjust the fair value for the terms and conditions on which the right to the equity instrument is granted if the instrument granted is not precisely that for which the market price, or other observable price, is available.

9.3 Share options and equity-settled share appreciation rights

A share option is defined in FRS 102 as “a contract that gives the holder the right, but not the obligation, to subscribe to the entity’s shares at a fixed or determinable price for a specific period of time”.

[FRS 102 Appendix I].

A share appreciation right (SAR) is not specifically defined in FRS 102 but is a grant where the counterparty will become entitled either to shares (or, more commonly, to a future cash payment) based on the increase in the entity’s share price or value from a specified level over a period of time (see further discussion at 10 below on cash-settled awards).

Section 26 requires the fair value of share options and equity-settled share appreciation rights (and the related goods or services received) to be determined using the following three-tier measurement hierarchy:

- (a) If an observable market price is available for the equity instruments granted, use that price.
- (b) If an observable market price is not available, measure the fair value of share options and share appreciation rights granted using entity-specific observable market data such as for a recent transaction in the share options.
- (c) If an observable market price is not available and obtaining a reliable measurement of fair value under (b) is impracticable, indirectly measure the fair value of share options or share appreciation rights using an alternative valuation methodology such as an option pricing model. The inputs for an option pricing model (such as the weighted average share price, exercise price, expected volatility, option life, expected dividends and the risk-free interest rate) are to use market data to the greatest extent possible. Paragraph 10 of Section 26 (see 9.2 above) provides guidance on determining the fair value of the shares used in determining the weighted average share price. The entity derives an estimate of expected volatility consistent with the valuation methodology used to determine the fair value of the shares. [FRS 102.26.11].

Section 26 does not mandate the use of an option pricing model, however, in practice, it is likely that use of a pricing model will often be a practical basis for determining the fair value of share options and appreciation rights.

The treatment of vesting and non-vesting conditions in the determination of the fair value of share options must be considered in the same way as for the fair value of shares (see 9.2 above) as paragraph 9 of Section 26 refers to both shares and share options.

A discussion of valuation methodology is beyond the scope of this publication. Whilst not addressing the subject of valuation in detail, EY’s publication International GAAP® draws on the guidance in Appendix B to IFRS 2 relating to the valuation of share-based payments and addresses some aspects of the pricing of options, particularly with respect to employee awards.

10 Cash-settled transactions

Throughout the discussion in this section, 'cash' must be read as including 'other assets' in accordance with the definition of a cash-settled share-based payment transaction (see 3.1 above).

10.1 Scope of requirements

Section 26 notes that cash-settled share-based payment transactions include:

- Share appreciation rights (SARs), where employees are entitled to a future cash payment (rather than an equity instrument) based on the increase in an entity's share price from a specified level over a specified period of time.
- A right to a future cash payment through a grant of shares (including shares to be issued upon the exercise of share options) that are redeemable, either mandatorily (e.g., upon cessation of employment) or at the employee's option. [FRS 102.26.2].

Another type of cash-settled arrangement frequently encountered in practice is a grant of phantom options, where employees are entitled to a cash payment equivalent to the gain that would have been made by exercising options at a notional price over a notional number of shares and then selling the shares at the date of exercise.

As is clear from the inclusion of certain types of redeemable share as a specific example of a cash-settled share-based payment arrangement, FRS 102 looks beyond the simple issue of whether an award entitles an employee to receive instruments that are in form shares or options to the terms of those instruments. The fact that certain redeemable shares would be treated as a cash-settled, not an equity-settled, award is consistent with the fact that a share with these terms would be regarded as a financial liability rather than an equity instrument of the issuer (based on Section 22).

In some cases, the boundary between equity-settled and cash-settled schemes may appear somewhat blurred, so that further analysis may be required to determine whether a particular arrangement is equity-settled or cash-settled. Some examples of such arrangements are discussed at 10.2 below.

10.2 What constitutes a cash-settled award?

There are a number of possible circumstances in which, on, or shortly after, settlement of an equity-settled award either:

- The entity incurs a cash outflow equivalent to that which would arise on cash-settlement (e.g., because it purchases its own shares to deliver to counterparties).
- Or
- The counterparty receives cash equivalent to the amount that would arise on cash-settlement (e.g., because the shares are sold for cash on behalf of the counterparty).

Such situations raise the question of whether such schemes are in fact truly equity-settled or cash-settled.

Examples of relatively common mechanisms for delivering the cash-equivalent of an equity-settled award to employees are discussed below. It emerges from the analysis below that, the accounting for share-based payment transactions is driven by questions of form rather than substance. To put it rather crudely, what matters is often not so much whether the entity has made a cash payment for the fair value of the award, but rather the name of the payee.

The significance of this is that the analysis affects the profit or loss charge for the award, as demonstrated by Illustration 10-1 below.

Illustration 10-1: Equity-settled award satisfied by purchase of own shares

An entity awards an employee a free share with a fair value at grant date of £5 which has a fair value of £8 at vesting. At vesting the entity acquires one of its own shares from an existing shareholder for £8 for delivery to the employee. If the scheme were treated as cash-settled, there would be a charge to profit or loss of £8 (the fair value at vesting date, see 10.3 below). If it were treated as equity-settled (as required in this case by FRS 102), profit or loss would show a charge of only £5 (the fair value at grant date), with a further net charge of £3 in equity, comprising the £8 paid for the share accounted for as a treasury share or own share less the £5 credit to equity (being the credit entry corresponding to the £5 charge to profit or loss - see 5.2 above).

The analyses below all rely on a precise construction of the definition of a cash-settled share-based payment transaction, i.e., one “in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares and share options) of the entity or another group entity” (emphasis added). [FRS 102 Appendix I]. Thus, if the entity is not actually required, legally or constructively, to pay cash to the counterparty, there is no cash-settled transaction under FRS 102, even though the arrangement may give rise to an external cash flow and, possibly, another form of recognised liability.

Some have raised the question of whether the entity must recognise some form of liability to repurchase own equity in situations where the entity has a stated policy of settling equity-settled transactions using previously purchased treasury or own shares.

How we see it

In our view, the normal provisions of accounting for financial instruments apply and there would be no question of recognising a liability to repurchase own equity on the basis merely of a declared intention. It is only when the entity enters into a forward contract or a call option with a third party that some accounting recognition of a future share purchase may be required.

An entity might sometimes purchase a number of its own shares shortly after issuing a similar number of shares in settlement of an equity-settled transaction. This raises the question of whether such a scheme would be considered as in substance cash-settled. In our view, further enquiry into the detailed circumstances of the purchase is required in order to determine the appropriate analysis.

Broadly speaking, so long as there is no obligation (explicit or implicit) for the entity to settle in cash with the counterparty, such purchase arrangements will not require a scheme to be treated as cash-settled under Section 26. However, in our view, there might be situations in which post-settlement share purchases are indicative of an obligation to the counterparty, such that treatment as a cash-settled scheme would be appropriate.

For example, if the entity were to create an expectation by employees that any shares awarded can always be liquidated immediately, because the entity will ensure that there is a market for the shares, it could well be appropriate to account for such a scheme as cash-settled. This will often be the case with awards granted to the employees of an unlisted company. The treatment of schemes in which the entity has a choice of settlement, but has created an expectation of cash-settlement, provides a relevant analogy (see 11.1.3 below).

A more extreme example of such a situation would be where the entity has arranged for the shares delivered to the counterparty to be sold on the counterparty's behalf but has at the same time entered into a contract to purchase those shares. In that situation, in our view, the substance is that:

- The entity has created an expectation by the counterparty of a right to receive cash.
- And
- The intermediate purchaser or broker is no more than an agent paying that cash to the counterparty on behalf of the entity.

Accordingly, it would be appropriate to account for such an arrangement as a cash-settled award.

Similar issues arise in the application of ‘drag along’ and ‘tag along’ rights in the context of an exit event and these are discussed at 16.4.6 below.

How we see it

In summary, where an entity might sometimes make a market purchase of its own shares shortly after issuing a similar number of shares in settlement of an equity-settled transaction, detailed analysis is required to determine the appropriate classification of the share-based payment award.

If an entity were to create an expectation by employees that shares can be liquidated quickly by the entity ensuring there is a market for the shares, our view is that it could be appropriate to account for the award as cash-settled.

Where the entity arranges a broker to purchase some or all shares from the counterparty on the counterparty's behalf and the entity then purchases those shares from the broker, it would be appropriate to account for the purchase arrangement of those shares as a cash-settled share-based payment transaction.

10.3 Required accounting for cash-settled share-based payment transactions

10.3.1 Basic accounting treatment

For a cash-settled share-based payment transaction, Section 26 requires an entity to measure the goods or services acquired and the corresponding liability incurred at the fair value of the liability. Until that liability is settled, the entity is required to remeasure the fair value at each reporting date and at the date of settlement. Any changes in fair value arising from this process of remeasurement must be recognised in profit or loss for the period. [FRS 102.26.14].

It is clear that the ultimate cost of a cash-settled transaction must be the actual cash paid to the counterparty, which will be the fair value at settlement date, but the liability is recognised and measured as follows:

- At each reporting date between grant and settlement the fair value of the award is determined in accordance with the requirements of Section 26.
- During the vesting period, the liability recognised at each reporting date is the Section 26 fair value of the award at that date multiplied by the expired portion of the vesting period.
- From the end of the vesting period until settlement, the liability recognised is the full fair value of the liability at the reporting date.

Where the cost of services received in a cash-settled transaction is recognised in the carrying amount of an asset (e.g., inventory) in the entity's statement of financial position, the carrying amount of the asset must not be adjusted for changes in the fair value of the liability.

The fair value of the liability must be measured by reference to the fair value of the cash-settled share-based payment transaction. For example, share appreciation rights are measured by reference to the fair value of the underlying equity instruments measured in accordance with paragraphs 10 and 11 of Section 26. [FRS 102.26.14A].

The term 'fair value' is defined in paragraph 1C of Section 26 and differs from the definition of fair value in FRS 102 Appendix I. Fair value is defined in Section 26 as, "the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction." [FRS 102.26.1C]. As discussed in 9.3 above, whilst Section 26 does not mandate the use of an option pricing model, in practice, it is likely that use of a pricing model will often be a practical basis for determining fair value. The use of a pricing model is consistent with the requirement in IFRS 2 that fair value be determined by applying an option pricing model, taking into account the terms and conditions on which the cash-settled transaction was granted, and the extent to which the employees have rendered service to date.

10.3.2 Application of the accounting treatment

The treatment required by Section 26 for cash-settled transactions is demonstrated by Illustration 10-2 which is based on IG Example 12 in the implementation guidance to IFRS 2.

Illustration 10-2: Cash-settled transaction with service condition

An entity grants 100 cash-settled share appreciation rights (SARs) to each of its 500 employees, on condition that the employees remain in its employment for the next three years. The SARs can be exercised on the third, fourth and fifth anniversary of the grant date.

During year 1, 35 employees leave. The entity estimates that a further 60 will leave during years 2 and 3 (i.e., the award will vest in 405 employees).

During year 2, 40 employees leave, and the entity estimates that a further 25 will leave during year 3 (i.e., the award will vest in 400 employees).

During year 3, 22 employees leave, so that the award vests in 403 employees. At the end of year 3, 150 employees exercise their SARs (leaving 253 employees still to exercise).

Another 140 employees exercise their SARs at the end of year 4, leaving 113 employees still to exercise, who do so at the end of year 5.

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below. The intrinsic values of the SARs at the date of exercise (which equal the cash paid out) at the end of years 3, 4 and 5 are also shown below.

Year	Fair value	Intrinsic value
	£	£
1	14.40	
2	15.50	
3	18.20	15.00
4	21.40	20.00
5		25.00

The entity will recognise the cost of this award as follows:

Year	Calculation of liability	Calculation of cash paid	Liability (£)	Cash paid (£)	Expense for period (£)*
1	405 employees × 100 SARs × £14.40 × 1/3		194,400	-	194,400
2	400 employees × 100 SARs × £15.50 × 2/3		413,333	-	218,933
3	253 employees × 100 SARs × £18.20	150 employees × 100 SARs × £15.00	460,460	225,000	272,127
4	113 employees × 100 SARs × £21.40	140 employees × 100 SARs × £20.00	241,820	280,000	61,360
5	-	113 employees × 100 SARs × £25.00	-	282,500	40,680

* Liability at end of period + cash paid in period - liability at start of period

The accounting treatment for cash-settled transactions is therefore (despite some similarities in the methodology) significantly different from that for equity-settled transactions. An important practical issue is that, for a cash-settled transaction, the entity must determine the fair value at each reporting date rather than at grant date (and at the date of any subsequent modification or settlement) as would be the case for equity-settled transactions.

As Illustration 10-2 shows, it is not necessary to determine the fair value of a cash-settled transaction at grant date in order to determine the share-based payment expense.

We discuss in more detail below the following aspects of the accounting treatment of cash-settled transactions:

- Determining the vesting period (see 10.3.2.A below)
- Periodic allocation of cost (see 10.3.2.B below)
- Treatment of non-market vesting conditions (see 10.3.2.C below)

- Treatment of market conditions and non-vesting conditions (see 10.3.2.D below)
And
- Treatment of modification, cancellation and settlement (see 10.3.2.E below)

10.3.2.A Determining the vesting period

The rules for determining vesting periods are the same as those applicable to equity-settled transactions, as discussed at 7.1 to 7.4 above. Where an award vests immediately, there is a presumption that, in the absence of evidence to the contrary, the award is in respect of services that have already been rendered and must therefore be expensed in full at grant date. [FRS 102.26.5].

Where cash-settled awards are made subject to vesting conditions (as in many cases they will be, particularly where payments to employees are concerned), there is a presumption that the awards are a payment for services to be received in the future, during the 'vesting period', with the transaction being recognised during that period, as demonstrated in Illustration 10-2 above.

10.3.2.B Periodic allocation of cost

The required treatment for cash-settled transactions is simply to measure the fair value of the liability at each reporting date. [FRS 102.26.14]. This might suggest that the full fair value, and not just a time-apportioned part of it, must be recognised at each reporting date, as would be the case for any liability that is a financial instrument measured at fair value.

However, paragraph 14 needs to be read with paragraph 6 which states that if the counterparty is required to complete a specified period of service, the entity "shall account for those services as they are rendered during the vesting period, with a corresponding increase in ... liabilities". This indicates that a spreading approach is to be adopted. [FRS 102.26.6].

For cash-settled awards vesting in instalments (sometimes referred to as 'graded' vesting), we believe that the requirements of IFRS 2 illustrated in IG11 of IFRS 2, whereby each instalment is treated as a separate award, can be followed similarly as to equity-settled awards (see 7.2.2 above). This results in multiple separate awards having been granted with different vesting periods. As for all cash-settled share-based payment transactions the fair value for each instalment will be determined at each reporting date and at the date of settlement. On a cumulative basis, the amount ultimately recognised for goods or services received as consideration for the cash-settled awards will be equal to the cash that is paid. [FRS 102.26.6, FRS 102.26.14C].

How we see it

We believe, for cash-settled share-based payment transactions vesting in instalments, the requirement of IFRS 2 illustrated in IG11 of IFRS 2 can be followed with the associated cost recognised over the different vesting periods. However, as Section 26 does not explicitly require the graded vesting accounting approach to be used, we believe that a simpler alternative may be acceptable.

10.3.2.C Non-market vesting conditions

FRS 102 makes clear that:

- Vesting conditions (other than market conditions) must not be taken into account in estimating the fair value of a cash-settled share-based payment. Instead, as for equity-settled share-based payment transactions, such conditions must be taken into account by adjusting the number of awards included in the measurement of the liability arising from the cash-settled share-based payment transaction. [FRS 102.26.14B].
- The amount recognised for the goods or services received during the vesting period must be based on the entity's best estimate of the number of awards expected to vest. This estimate must be revised, if necessary, if subsequent information indicates that the number of awards expected to vest differs from previous estimates. On the vesting date, the entity must revise the estimate to equal the number of awards that ultimately vested. [FRS 102.26.14B].
- On a cumulative basis, the amount ultimately recognised for goods or services received as consideration for the cash-settled share-based payment will be equal to the cash that is paid. [FRS 102.26.14C].

10.3.2.D Market conditions and non-vesting conditions

Section 26 clarifies that market conditions and non-vesting conditions must be taken into account in estimating the fair value of the cash-settled share-based payment at each reporting date and at the date of settlement. There will be no ultimate cost for an award subject to a market condition or non-vesting condition that is not satisfied as any liability would be reversed. [FRS 102.26.14(b)].

This differs from the accounting model for equity-settled transactions with market conditions or non-vesting conditions, which can result in a cost being recognised for awards subject to those conditions even when they are not satisfied (see 7.3 and 7.4 above).

10.3.2.E Modification, cancellation and settlement

FRS 102 provides no specific guidance on modification, cancellation and settlement of cash-settled awards. However, as cash-settled awards are accounted for using a full fair value model no such guidance is needed. It is clear that:

- Where an award is modified, the liability recognised at and after the point of modification will be based on its new fair value, with the effect of any movement in the liability recognised immediately.
- Where an award is cancelled the liability will be derecognised, with a credit immediately recognised in profit or loss.
- Where an award is settled, the liability will be derecognised, and any gain or loss on settlement immediately recognised in profit or loss.

How we see it

As noted above, FRS 102 provides no specific guidance on modification, cancellation and settlement of cash-settled awards. In our view, as cash-settled awards are accounted for using a full fair value model no such guidance is needed, the accounting set out above would apply.

10.4 Modification of award from equity-settled to cash-settled or from cash-settled to equity-settled

As noted at 8.3.5 above, a detailed discussion of this topic is beyond the scope of this publication but is addressed more fully in EY's publication International GAAP®.

11 Transactions with equity and cash alternatives

Some share-based payment transactions (particularly those with employees) provide either the entity or the counterparty with the choice of settling the transaction either in shares (or other equity instruments) or in cash (or other assets). [FRS 102.26.15].

More detailed guidance is provided as to how that general principle must be applied to transactions:

- Where the entity has choice of settlement (see 11.1 below).
- Where the counterparty has choice of settlement (see 11.2 below).

A common type of arrangement seen in practice is the 'matching' award or deferred bonus arrangement where an employee is offered a share award or a cash alternative to 'match' a share award or a cash bonus earned during an initial period. This type of arrangement is discussed further at 16.1 below.

Some share-based payment transactions rather than providing either the entity or the counterparty with a choice between settlement in equity or in cash, offer no choice but instead require an arrangement that will generally be equity-settled to be settled in cash in certain specific and limited circumstances (awards with contingent cash settlement). There will also be situations where there is contingent settlement in equity of an award that is otherwise cash-settled. These types of arrangement are considered in more detail at 11.3 below.

Some awards offer an equity alternative and a cash alternative where the cash alternative is not based on the price or value of the equity instruments. These arrangements are considered at 11.4 below.

11.1 Transactions where the entity has choice of settlement in equity or in cash

Section 26 requires that an entity with a choice of settling a transaction in cash (or other assets) or by transferring equity instruments, must account for the transaction as a wholly equity-settled share-based payment transaction (in accordance with paragraphs 7 to 13A of Section 26) unless:

- (a) The choice of settlement in equity instruments has no commercial substance (e.g., because the entity is legally prohibited from issuing shares).

Or

- (b) The entity has a past practice or a stated policy of settling in cash or generally settles in cash whenever the counterparty asks for cash settlement.

If (a) or (b) applies, the transaction must be accounted for as wholly cash-settled in accordance with paragraph 14 of Section 26 (see 10 above). [FRS 102.26.15A].

An important practical effect of the above criteria is that some schemes that may appear at first sight to be equity-settled may in fact have to be treated as cash-settled. For example, if an entity has consistently adopted a policy of granting *ex gratia* cash compensation to all those deemed to be 'good' leavers (or all 'good' leavers of certain seniority) in respect of partially vested share options, such a scheme may well be treated as cash-settled for the purposes of FRS 102 to the extent to which there are expected to be such 'good' leavers during the vesting period. 'Good leaver' arrangements are also discussed at 6.3.8 above.

11.1.1 Accounting at date of settlement for awards where there is a choice of equity- or cash-settlement

FRS 102 contains guidance on how to account as at the date of settlement for an award that has been accounted for as equity-settled, but which is settled in cash (see 11.1.1.B below). However, it contains no guidance on how to account as at the date of settlement, for an award that has been accounted for as cash-settled, but which is settled in equity. We suggest the following approach (see 11.1.1.A below) based on the requirements of IFRS 2.

11.1.1.A Settlement of an award treated as cash-settled during vesting period

IFRS 2 gives no specific guidance as to the accounting treatment on settlement where an entity has accounted for an award as cash-settled, but it is settled in equity. However, it is clear from other provisions of IFRS 2, including the general rules on settlement and the provisions relating to settlement of an award where the counterparty has the choice of settlement method, that:

- The liability must be remeasured to fair value through the income statement at settlement date.
- If cash settlement occurs, the cash paid is applied to reduce the liability.
- If equity settlement occurs, the liability is transferred into equity.

11.1.1.B Settlement of an award treated as equity-settled during vesting period

When a transaction that has been accounted for as equity-settled, Section 26 specifies the following approach:

(a) On settlement:

- (i) If the transaction is cash-settled, the cash is accounted for as a deduction from equity, subject to (b) below.
- (ii) If the transaction is equity-settled, there is a transfer from one component of equity to another (if necessary).

And

(b) If the cash payment exceeds the fair value of the equity instruments that would otherwise have been issued as at the date of settlement, the entity recognises an additional expense for the excess value given. [FRS 102.26.13A].

This is demonstrated in Illustration 11-1 below.

Illustration 11-1: Settlement of transaction treated as equity-settled where fair value of cash settlement exceeds fair value of equity settlement

An entity has accounted for a share-based payment transaction where there is a choice of settlement as an equity-settled transaction and has recognised a cumulative expense of £1,000 based on the fair value at grant date.

At settlement date the fair value of the equity-settlement option is £1,700 and that of the cash-settlement option £2,000. If the entity settles in equity, no further accounting entry is required. However, there may be a transfer within equity of the £1,000 credited to equity during the vesting period.

If the entity settles in cash, the entity must recognise an additional expense of £300 (applying paragraph 13A of Section 26, being the difference between the fair value of the equity-settlement option (£1,700) and that of the cash-settlement option (£2,000)). The accounting entry is:

	£	£
Profit or loss (employee costs)	300	
Equity	1,700	
Cash		2,000

It can be seen in the Illustration above, if the transaction was settled in equity, no additional expense would be recognised on settlement and the cumulative expense would have only been £1,000 based on the fair value at grant date. The accounting treatment is different under IFRS 2 when the entity has a choice of settlement, and the entity chooses to settle in equity instruments. Under IFRS 2, if on the settlement date, the equity instruments issued had a higher fair value than the cash alternative, the difference between the fair value of the equity instruments issued and the amount of the cash that would have been paid, is recognised as an additional expense (see 2.4.2 above). [IFRS2.43(b)].

11.1.2 Change in classification of award after grant date

Neither FRS 102 nor IFRS 2 specifies whether a transaction, where the entity has a choice of settlement in equity or cash, must be assessed as equity-settled or cash-settled only at the inception of the transaction or whether this is assessed at each reporting date until the transaction is settled.

FRS 102 states that a transaction must be treated as equity-settled unless either criterion (a) or criterion (b) in paragraph 15A of Section 26 applies (see 11.1 above). As it is not specified that this assessment takes place only at inception of the award, in our view FRS 102 requires an ongoing assessment of the relevance of these criteria.

FRS 102 also does not specify how to account for a change in classification resulting from a change in the entity's policy or intention. In our view, the most appropriate treatment is to account for such a change as if it were a modification of the manner of settlement of the award (see 10.4 above). Where the entity can choose the manner of settlement, the substance of the situation is the same as a decision to modify the manner of settlement of an award which does not already give the entity a choice. These situations are distinct from those where the manner of settlement depends on the outcome of a contingent event outside the entity's control (see 11.3 below).

How we see it

As noted above, where the entity is able to choose the manner of settlement, we believe an entity continuously reviews at each reporting date whether the entity “has a present obligation to settle in cash”. Where there is a change in classification resulting from a change in the entity’s policy or intention, the most appropriate treatment is to account for such a change as if it were a modification of the manner of settlement of the award (see 10.4 above).

11.1.3 Economic compulsion for cash settlement (including unlisted entity awards with a presumption of cash settlement)

Some awards may nominally give the reporting entity the choice of settling in cash or equity, while in practice giving rise to an economic compulsion to settle only in cash. In addition to the examples mentioned at 11.1 above, this will often be the case where an entity that is a subsidiary or owned by a small number of individuals, such as members of the same family, grants options to employees. In such cases there will normally be a very strong presumption that the entity will settle in cash in order to avoid diluting the existing owners’ interests. Similarly, where the entity is not listed, there is little real benefit for an employee in receiving a share that cannot be realised except when another shareholder wishes to buy it or there is a change in ownership of the business as a whole.

How we see it

In our view, such schemes are generally most appropriately accounted for as cash-settled schemes from inception. In any event, once the scheme has been operating for a while, it is likely that there will be a past practice of cash settlement such that the scheme is required to be treated cash-settled under the general provisions of FRS 102 summarised above.

A similar conclusion is often reached even where the terms of the agreement do not appear to offer the entity a choice of settling the award in cash, but it has established a constructive obligation or a past practice of so doing (see 10.2 above).

11.2 Transactions where the counterparty has choice of settlement in equity or in cash

Where the counterparty has a choice of settlement in either equity instruments or cash, it will generally be the case that the arrangement will be accounted for as a cash-settled share-based payment transaction (see 10 above).

Section 26 requires an entity to account for a transaction where the counterparty has a choice of settlement in cash (or other assets) or by the transfer of equity instruments, as a wholly cash-settled share-based payment transaction (in accordance with paragraph 14), except for when the conditions set out in paragraph 15B of Section 26 are met. [FRS 102.26.15B]. If the choice of settlement in cash (or other assets) has no commercial substance because the cash settlement amount (or value of the other assets) bears no relationship to, and is likely to be lower in value than, the fair value of the equity instruments, the entity must account for the transaction as wholly equity-settled in accordance with paragraphs 7 to 13 of Section 26. [FRS 102.26.15B(a)]. In addition, if the choice of settlement relates only to a net settlement feature and there is an obligation on the entity under tax laws or regulations to withhold an amount for an employee’s tax obligation associated with that share-based payment, the entity must account for the transaction as wholly equity-settled in accordance with paragraphs 7 to 13 of Section 26 (see 15.3.1 below). [FRS 102.26.15B(b)].

In cases where the fair values of the cash and equity alternatives are similar, the approach required by FRS 102 is broadly consistent with the outcome of the approach required by IFRS 2. A split accounting approach, between liabilities and equity, is required by IFRS 2 which mainly has an impact where the fair value of the equity alternative exceeds that of the cash alternative.

FRS 102 only provides guidance when there is change in settlement of an equity-settled share-based payment. The discussions at 11.1.1 and 11.1.2 above may also provide some guidance for transactions where the counterparty has choice of settlement.

11.2.1 Transactions with settlement alternatives of different value

In many share-based payment transactions with a choice of settlement, the value of the share and cash alternatives is equal. The counterparty will have the choice between, say, 1,000 shares or the cash value of 1,000 shares. Under FRS 102, this transaction would be accounted for as a cash-settled transaction.

However, it is not uncommon, particularly in transactions with employees, for the equity-settlement alternative to have more value. For example, an employee might be able to choose at vesting between the cash value of 1,000 shares immediately or 2,000 shares (often subject to further conditions such as a minimum holding period, or a further service period). In such a situation, it will need to be decided whether the arrangement falls within paragraph 15B of Section 26 (see 11.2 above) leading to the entire arrangement being accounted for as an equity-settled transaction.

11.2.2 'Backstop' cash settlement rights

Some schemes may provide cash settlement rights to the holder so as to cover more or less remote contingencies.

If the terms of the award provide the employee with a general right of cash-settlement, FRS 102 requires the award to be treated as cash-settled. This is the case even if the right of cash settlement is extremely unlikely to be exercised (e.g., because it would give rise to adverse tax consequences for the employee as compared with equity settlement). If, however, the right to cash-settlement is exercisable only in specific circumstances, a more detailed analysis may be required (see 11.3 below).

11.3 Awards requiring cash or equity settlement in specific circumstances (awards with contingent cash or contingent equity settlement)

This section is written with a focus on awards with contingent cash settlement. However, similar considerations will apply in a situation where it is the settlement in equity that depends on the outcome of circumstances outside the control of the entity, or both the entity and the counterparty.

Rather than giving either the entity or the counterparty a general right to choose between settlement in equity or in cash, some awards require cash settlement in certain specific and limited circumstances but otherwise will be equity-settled. These arrangements are sometimes referred to as contingent settlement provisions and are driven by the occurrence or non-occurrence of specific outcomes rather than by choice. Questions arise as to whether such an award must be accounted for as equity-settled or cash-settled and whether this must be re-assessed on an ongoing basis during the vesting period.

Neither FRS 102 nor IFRS 2 has specific guidance on the accounting treatment of such arrangements. In advising on the July 2015 amendments to FRS 102, the Accounting Council noted that respondents to the draft amendments to Section 26 pointed out that this is a subject that has recently been discussed in the context of IFRS 2 although no changes have yet been made, or indeed proposed, to the published guidance. The Accounting Council therefore advised that the need for further amendment for situations where settlement in cash depends on the occurrence of an event outside the control of either party to a transaction should be re-considered as part of the next review of FRS 102.²²⁹ No further amendments have been proposed, most likely as a result of no related amendments being proposed to IFRS 2 by the IASB.

In the absence of specific guidance, we consider some possible accounting analyses at 11.3.1 to 11.3.3 below, as follows:

- Two different approaches to the assessment of awards with contingent cash settlement (see 11.3.1 to 11.3.2 below).
Awards that require cash settlement on a change of control (see 11.3.3 below).
- The accounting treatment for changes in the manner of settlement where the award is contingent on future events (see 11.3.4).

²²⁹ FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland, September 2015, paragraph 39 of The Accounting Council's Advice to the FRC to issue Amendments to FRS 102 - Small entities and other minor amendments.

How we see it

In our view, in the absence of specific guidance in FRS 102, the two different approaches set out in sections 11.3.1 and 11.3.2 below could be applied to awards which offer no choice in settlement but instead require cash settlement in certain specific and limited circumstances (i.e., awards with contingent cash settlement). Equally, similar considerations will apply to awards which offer no choice in settlement but instead require equity settlement in certain specific and limited circumstances (i.e., awards with contingent equity settlement).

11.3.1 Approach 1 – Treat as cash-settled if contingency is outside entity's control

One approach might be to observe that the underlying principle that determines whether an award is accounted for as equity-settled or cash-settled appears to be whether the reporting entity can unilaterally avoid cash-settlement (see 11.1 and 11.2 above). Under this approach, any award where the counterparty has a right to cash-settlement is always treated as a liability, irrespective of the probability of cash-settlement, unless there is no commercial substance. By contrast, an award where the choice of settlement rests with the entity is accounted for as a liability only where the entity's own actions have effectively put it in a position where it has no real choice but to settle in cash.

Applying this approach, it is first of all necessary to consider whether the event that requires cash-settlement is one over which the entity has control. If the event, however unlikely, is outside the entity's control, then under this approach the award is required to be treated as cash-settled. However, if the event is within the entity's control, the award must be treated as cash-settled only if the entity has a liability by reference to the criteria summarised in 11.1 above.

How we see it

Whilst, in our view, this is an acceptable accounting approach, it does not seem entirely satisfactory. For example, it is common for an equity-settled share-based payment award to contain a provision to the effect that, if the employee dies in service, the entity will pay to the employee's estate the fair value of the award in cash. The approach above would lead to the conclusion that the award must be classified as cash-settled, on the basis that it is beyond the entity's control whether an employee dies in service. This seems a somewhat far-fetched conclusion and is moreover inconsistent with the accounting treatment that the entity would apply to any other death-in-service benefit.

11.3.2 Approach 2 – Treat as cash-settled if contingency is outside entity's control and probable

Under US GAAP²³⁰ a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control (such as an initial public offering) does not give rise to a liability until it becomes probable that that event will occur.

How we see it

In our view, the above approach based on the probability of a contingent event that is outside the control of both the counterparty and the entity is also acceptable in the absence of specific guidance in FRS 102 (and IFRS 2) and has frequently been used in practice by entities applying IFRS 2.

The impact of Approach 1 and Approach 2 can be demonstrated by reference to an award that requires cash-settlement in the event of a change of control of the entity (see 11.3.3 below).

11.3.3 Application of Approach 1 and Approach 2 to awards requiring cash settlement on a change of control

It is not uncommon for the terms of an award to provide for compulsory cash-settlement by the entity if there is a change of control of the reporting entity. Such a provision ensures that there is no need for any separate negotiations to buy out all employee options, so as to avoid non-controlling (minority) interests arising in the acquired entity when equity-settled awards are settled after the change of control.

²³⁰ ASC 718 - Compensation - Stock Compensation (formerly FAS123(R), Share-Based Payment), FASB, para. 718-10-25-11.

The determination of whether or not a change of control is within the control of the entity is beyond the scope of this publication.

If the facts and circumstances of a particular case indicate that a change of control is within the entity's control, the conclusion under either Approach 1 or Approach 2 above would be that the award must be treated as cash-settled only if the entity has a liability by reference to the criteria summarised at 11.1 above.

If, however, the change of control is not considered to be within the control of the reporting entity, the conclusion will vary depending on whether Approach 1 or Approach 2 is followed. Under Approach 1, an award requiring settlement in cash on a change of control outside the control of the entity would be treated as cash-settled, however unlikely the change of control may be. Under Approach 2 however, an award requiring settlement in cash on a change of control outside the control of the entity would be treated as cash-settled only if a change of control were probable.

A difficulty with Approach 2 is that it introduces rather bizarre inconsistencies in the accounting treatment for awards when the relative probability of their outcome is considered. As noted at 11.2.2 above, an award that gives the counterparty an absolute right to cash-settlement is accounted for as a liability, however unlikely it is that the counterparty will exercise that right (unless the cash settlement option is considered to have no commercial substance). Thus, under this approach, the entity could find itself in the situation where it treats:

- As a liability: an award with an unrestricted right to cash-settlement for the counterparty, where the probability of the counterparty exercising that right is less than 1%.
But
- As equity: an award that requires cash settlement in the event of a change of control which is assessed as having a 49% probability of occurring.

How we see it

In our view, an entity could adopt either of these accounting treatments (Approach 1 or Approach 2) as set out in sections 11.3.1 and 11.3.2 above but must do so consistently and state its policy for accounting for such transactions, if material.

It is noted in the selection of an accounting policy that the IASB had discussions, but did not conclude, on whether an approach based on the 'probable' outcome, as set out here, be applied under IFRS 2 or whether an approach based on the accounting treatment for a compound financial instrument be used. Any further developments in this area could affect the availability of the alternative treatments in future. The detailed discussions are beyond the scope of this publication but are addressed in EY's publication International GAAP®.

There is further discussion at 16.4 below of awards that vest or are exercisable on a flotation or change of control, including the question of whether a cash-settlement obligation rests with the entity itself or with other parties involved in the change of control (see 16.4.6 below).

11.3.4 Accounting for change in manner of settlement where award is contingent on future events outside the control of the entity and the counterparty

When, under Approach 2 above, the manner of settlement of an award changes solely as a consequence of a re-assessment of the probability of a contingent event, there is neither settlement of the award nor modification of its original terms. The terms of the award are such that there have been two potential outcomes, one equity-settled and one cash-settled, running in parallel since grant date. It is as if, in effect, the entity has simultaneously issued two awards, only one of which will vest.

At each reporting date the entity is required to assess which outcome is more likely and account for the award on an equity- or cash-settled basis accordingly.

How we see it

In our view, any adjustments arising from a switch between the cumulative amount for the cash-settled award and the cumulative amount for the equity-settled award is required to be taken to profit or loss in the current period. This is similar to the approach for an award with multiple independent vesting conditions (see 7.3.6 above).

When applying an approach where the two outcomes have both been part of the arrangement from grant date, an entity measures the fair value of the equity-settled award only at the original grant date and there is no remeasurement of the equity-settled award on reassessment of the settlement method. As the cash-settled award would be remeasured on an ongoing basis, a switch in the manner of settlement during the period until the shares vest or the award is settled in cash could give rise to significant volatility in the cumulative expense. At the date of vesting or settlement, however, the cumulative expense will equate to either the grant date fair value of the equity-settled approach or the settlement value of the cash-settled approach depending on whether or not the contingent event has happened.

The situation discussed in this section (i.e., an arrangement with two potential outcomes from grant date because the manner of settlement is not within the control of either the entity or the counterparty) is not the same as an award where the manner of settlement is entirely within the entity's control. Where the entity has such control and therefore a choice of settlement, a change in the manner of settlement is treated as a modification with a potential catch-up adjustment through equity (see 8.3.5 and 10.4 above).

11.4 Cash settlement alternative where the cash sum is not based on share price or value

Some awards may provide a cash-settlement alternative that is not based on the share price. For example, an employee might be offered a choice between 500 shares or £1,000,000 on the vesting of an award.

How we see it

Whilst an award of £1,000,000, if considered in isolation, would obviously not be a share-based payment transaction, in our view it falls within the scope of Section 26 if it is offered as an alternative to a transaction that is within the scope of that Section. FRS 102 has no specific guidance in this area, but we draw on the Basis for Conclusions to IFRS 2 which states that the cash alternative may be fixed or variable and, if variable, may be determinable in a manner that is related, or unrelated, to the price of the entity's shares.

Under the requirements of paragraphs 15B of Section 26, the award will be treated as cash-settled unless the option arrangements do not have commercial substance (see 11.2 above).

12 Replacement share-based payment awards issued in a business combination

12.1 Background

It is relatively common for an entity (A) to acquire another (B) which, at the time of the business combination, has outstanding employee share options or other share-based awards. If no action were taken by A, employees of B would be entitled, once any vesting conditions had been satisfied, to shares in B. This is not a very satisfactory outcome for either party: A now has non-controlling (minority) shareholders in subsidiary B, which was previously wholly-owned, and the employees of B are the owners of unmarketable shares in an effectively wholly-owned subsidiary.

The obvious solution, adopted in the majority of cases, is for some mechanism to be put in place such that the employees of B end up holding shares in the new parent A. This can be achieved, for example, by:

- A granting options over its own shares to the employees of B in exchange for the surrender of the employees' options over the shares of B.
- Or
- Changing the terms of the options so that they are over a special class of shares in B which are mandatorily convertible into shares of A.

It is important that entities understand the nature and reasons for the replacement share-based payment award to determine if and how much of the award relates to the acquisition of control (which forms part of the cost of combination, accounted for under Section 19) and how much relates to the provision of future services (accounted for under Section 26). It is necessary for entities to understand who initiated the arrangement and when the parties entered into the arrangement to help in assessing the nature of the arrangement (see Chapter 22 at 3.6.2.C). [FRS 102.19.11B].

FRS 102 contains no guidance about how such a substitution transaction must be accounted for in the consolidated financial statements of A and this area is beyond the scope of this publication. Under IFRS, the relevant guidance is included in IFRS 3 and the requirements, which are based on accounting for the modification of share-based payments, are addressed in EY's publication International GAAP®.

The treatment in the single entity financial statements of B is discussed at 12.2 below.

12.2 Financial statements of the acquired entity

The replacement of an award based on the acquiree's equity with one based on the acquirer's equity appears, from the perspective of the acquired entity, to be a cancellation and replacement.

How we see it

In our view, this must be accounted for in accordance with the general principles for such transactions (see 8.4 above) but taking into account the specific provisions of Section 26 in respect of group share schemes (see 13 below).

In addition to considerations about whether this is accounted for as a separate cancellation and new grant or as a modification of the original terms, the acquiree needs to take into account its new status as a subsidiary of the acquirer. If the acquiree's employees are now receiving awards granted by the new parent, the new subsidiary might choose to apply the provisions for groups in paragraph 16 of Section 26 (see 13.2.3.A below) rather than the general approach for an entity receiving goods or services but not obliged to settle the award.

13 Group share schemes

In this section we consider various aspects of share-based payment arrangements operated within a group of companies and involving several legal entities. The main areas covered are as follows:

- Typical features of a group share scheme (see 13.1 below)
- A summary of the accounting treatment of group share schemes (see 13.2 below)
- Employee benefit trusts ('EBTs') and similar arrangements (see 13.3 below)
- An example of a group share scheme (based on an equity-settled award satisfied by a purchase of shares) illustrating the accounting by the different entities involved (see 13.4 below)
- An example of a group share scheme (based on an equity-settled award satisfied by a fresh issue of shares) illustrating the accounting by the different entities involved (see 13.5 below)
- An example of a group cash-settled transaction where the award is settled by an entity other than the one receiving goods or services (see 13.6 below)

And

- The accounting treatment when an employee transfers between group entities (see 13.7 below)

Associates and joint arrangements do not meet the definition of group entities but there will sometimes be share-based payment arrangements that involve the investor or venturer and the employees of its associate or joint venture. Such arrangements are beyond the scope of this publication but are addressed in EY's publication International GAAP®.

13.1 Typical features of a group share scheme

In this section we use the term 'share scheme' to encompass any transaction falling within the scope of Section 26, whether accounted for as equity-settled or cash-settled.

It is common practice for a group to operate a single share scheme covering the employees of the parent and/or several subsidiaries, but the precise terms and structures of group share schemes are so varied that it is rare to find two completely identical arrangements. From an accounting perspective, however, group share schemes can generally be reduced to a basic framework, as described below, which will serve as the basis of the following discussion.

A group scheme typically involves transactions by several legal entities:

- The parent, over whose shares awards are granted and which is often responsible for settling the award (either directly or through a trust).
- The subsidiary employing an employee who has been granted an award ('the employing subsidiary').
- In some cases, an EBT that administers the scheme. The accounting treatment of transactions with EBTs is discussed at 13.3 below.

In practice, it might not always be a simple assessment to determine which entity is receiving an employee's services and which entity is responsible for settling the award. For example, the scheme may be directed by a group employee services entity, or an individual might be a director of the parent as well as providing services to other operating entities within the group.

Where an employee services company is involved, it will be necessary to evaluate the precise group arrangements in order to decide whether the entity is, in substance, the employer. It will often be the case that the services company is simply administering the arrangements on behalf of the parent entity.

How we see it

Where an individual provides services to more than one group entity, an assessment will need to be made as to which entity or entities are receiving the individual's services in return for the award (e.g., the employee service company or the entity or entities the service company makes a charge for an individual's services). This will depend on the precise facts and circumstances of a particular situation.

A share-based award is often granted to an employee by the parent, or a group employee services entity, which will in turn have an option exercisable against the EBT for the shares that it may be required to deliver to the employee. Less commonly, the trustees of the EBT make awards to the employees and enter into reciprocal arrangements with the parent.

If the parent takes the view that it will satisfy any awards using existing shares it will often seek to fix the cash cost of the award by arranging for the EBT to purchase, on the day that the award is made, sufficient shares from existing shareholders to satisfy all or part of the award. This will be funded by external borrowings, a loan from the parent, a contribution from the employing subsidiary, or some combination. The cash received from the employee on exercise of the option can be used by the EBT to repay any borrowings.

If the parent takes the view that it will satisfy the options with a fresh issue of shares, these will be issued to the EBT, either:

- (a) At the date on which the employee exercises his option (in which case the EBT will subscribe for the new shares using the cash received from the employee together with any non-refundable contribution made by the employing subsidiary, see below). Such arrangements are generally referred to as 'simultaneous funding'.
 - (b) At some earlier date (in which case the EBT will subscribe for the new shares using external borrowings, a loan from the parent or a contribution from the employing subsidiary, or some combination. The cash received from the employee on exercise of the option may then be used by the EBT to repay any borrowings). Such arrangements are generally referred to as 'pre-funding'.
- Or
- (c) Some shares will be issued before the exercise date as in (b) above, and the balance on the exercise date as in (a) above.

As noted in (a) above, the employing subsidiary often makes a non-refundable contribution to the EBT in connection with the scheme, so as to ensure that employing subsidiaries bear an appropriate share of the overall cost of a group-wide share scheme.

13.2 Accounting treatment of group share schemes – summary

13.2.1 Background

From a financial reporting perspective, it is generally necessary to consider the accounting treatment in:

- The group's consolidated financial statements
 - The parent's separate financial statements
- And
- The employing subsidiary's financial statements

We assume throughout this section on group share schemes that the subsidiary is directly owned by the parent company. In practice, there will often be one or more intermediate holding companies between the ultimate parent and the subsidiary. The intermediate parent company generally will not be the entity granting the award, receiving the goods or services or responsible for settling the award. Therefore, under Section 26, we believe that there is no requirement for the intermediate company to account for the award in its separate financial statements.

The accounting entries to be made in the various financial statements will broadly vary according to:

- Whether the award is satisfied using shares already held or a fresh issue of shares
 - Whether any charge is made to the employing subsidiary for the cost of awards to its employees
 - Whether an EBT is involved. The accounting treatment of transactions undertaken with and by EBTs is discussed in more detail at 13.3 below
- And
- The tax consequences of the award. For the purposes of the discussion and illustrative examples below, tax effects are ignored. A more general discussion of the tax effects of share-based payment transactions is found at 15 below

The sections below largely discuss the application of the basic requirements of Section 26 to share-based payment transactions within a group of entities. However, in addition to the application of those requirements, Section 26 allows an alternative treatment based on the allocation of a group share-based payment expense to group entities on a reasonable basis (see 13.2.3.A below).

How we see it

As noted above, we believe there is no requirement under FRS 102 for the intermediate company to account for the award in its separate or individual financial statements as it generally will not be the entity granting the award, receiving the goods or services or responsible for settling the award.

13.2.2 Scope of Section 26 for group share schemes

By virtue of the definition of a 'share-based payment transaction' (see 3.1 and 3.2.1 above), a group share-based payment transaction is in the scope of Section 26 for:

- The consolidated financial statements of the group (the accounting for which follows the general principles set out in 4 to 11 above)
 - The separate or individual financial statements of the entity in the group that receives goods or services (see 13.2.3 below)
- And
- The separate or individual financial statements of the entity in the group (if different from that receiving the goods or services) that settles the transaction with the counterparty. This entity will typically, but not necessarily, be the parent (see 13.2.4 below)

As discussed at 3 above, the scope paragraphs of Section 26, together with the definitions in Appendix I to FRS 102, indicate whether transactions are to be accounted for as equity-settled or as cash-settled in most group situations including:

- Transactions settled in the equity of the entity, or in the equity of its parent (see 13.2.5 below).
- Cash-settled transactions settled by a group entity other than the entity receiving the goods or services (see 13.2.6 below).

At 3.2.1.A above, we consider seven scenarios commonly found in practice and outline the approach required by Section 26 in the consolidated and separate or individual financial statements of group entities depending on whether the award is settled in cash or shares and which entity grants the award, has the obligation to settle the award and receives the goods or services. These scenarios do not reflect the alternative treatment for group plans in Section 26 (see 13.2.3.A below).

It is common practice in a group share scheme to require each participating entity in the group to pay a charge, either to the parent or to an EBT, in respect of the cost of awards made under the scheme to employees of that entity. This is generally done either as part of the group's cash-management strategy, or in order to obtain tax relief under applicable local legislation. The amount charged could in principle be at the discretion of the group but is often based on either the fair value of the award at grant date or the fair value at vesting, in the case of an award of free shares, or exercise, in the case of an award of options.

Neither FRS 102 nor IFRS 2 directly addresses the accounting treatment of such intragroup management charges and other recharge arrangements, which is discussed further at 13.2.7 below. [IFRS 2.B.46].

Worked examples illustrating how these various principles translate into accounting entries are given at 13.4 to 13.6 below.

13.2.3 Entity receiving goods or services

The entity in a group receiving goods or services in a share-based payment transaction determines whether the transaction must be accounted for as equity-settled or cash settled in its separate or individual financial statements. It does this by assessing the nature of the awards granted and its own rights and obligations.

The entity accounts for the transaction as equity-settled when either the awards granted are the entity's own equity instruments, or the entity has no obligation to settle the share-based payment transaction. Otherwise, the entity accounts for the transaction as cash-settled. Where the transaction is accounted for as equity-settled it is remeasured after grant date only to the extent permitted or required by Section 26 for equity-settled transactions generally, as discussed at 4 to 7 above.

A possible consequence of these requirements is that the amount recognised by the entity may differ from the amount recognised by the consolidated group or by another group entity settling the share-based payment transaction. This is discussed further at 13.6 below.

The cost recognised by the entity receiving goods or services is calculated according to the principles set out above unless the group applies the alternative treatment for group plans in Section 26 (see 13.2.3.A below). The cost under Section 26 is not adjusted for any intragroup recharging arrangements, the accounting for which is discussed at 13.2.7 below.

13.2.3.A Alternative treatment for group plans

As an alternative to the accounting treatment in paragraphs 7 to 15C of Section 26 (see 5 to 11 and 13 of this chapter), in a share-based payment arrangement granted by an entity to the employees of one or more group entities, those group entities are permitted to measure the share-based payment expense on the basis of a reasonable allocation of the group expense calculated in accordance with FRS 102, IFRS 2 or on an equivalent basis. [FRS 102.26.16].

It is worthwhile to note that paragraph 16 of Section 26 explicitly allows an alternative to the 'measurement' of a share-based payment, but not an alternative to the 'recognition' requirements. This is an important distinction in determining whether another GAAP is 'equivalent' as referred to in paragraph 16 of Section 26.

This view is supported by paragraph AG28 of FRS 100, which states that "In deciding whether the share-based payment expense for the group has been calculated on a basis equivalent to FRS 102 or IFRS 2, it is intended that preparers will apply similar considerations to those set out in paragraph AG6. That is, the concept of 'equivalence' referred to in this paragraph of FRS 102 is intended to be aligned to that in, for UK entities, section 401 of the Act and, for Irish entities, section 300 of the Companies Act 2014. Therefore, it is necessary to consider whether the basis on which the group share-based payment expense has been calculated is in accordance with the basic requirements of the measurement basis of FRS 102 or IFRS 2 (such as the requirement to measure the goods or services received on a fair value basis), without requiring strict conformity with each and every aspect of that basis. This assessment should be based on the particular facts, including the similarities to and differences from the requirements of the relevant standard". [FRS 102.26.16].

13.2.4 Entity settling the transaction

As noted at 3.2.1 above, Section 26 sets out the accounting treatment when the entity settling the transaction does not receive the goods or services. An entity settling a share-based payment transaction when another entity in the group receives the goods or services must recognise the transaction as an equity-settled share-based payment transaction only if it is settled in its own equity instruments, otherwise, the transaction is recognised as cash-settled share-based payment. [FRS 102.26.2A].

The above requirements relate only to the credit entry, the classification of the transaction as equity- or cash-settled, and its measurement. They do not specify the debit entry, which is therefore subject to the general requirement of Section 26 (and IFRS 2) that a share-based payment transaction must normally be treated as an expense, unless there is the basis for another treatment (see 4 above).

In our view, the settling entity is not always required to treat the transaction as an expense. Instead:

- Where the settling entity is a parent (direct or indirect) of the entity receiving the goods or services and is accounting for the transaction as equity-settled, it will generally account for the settlement of the award as an addition to the cost of its investment in the employing subsidiary (or of that holding company of the employing subsidiary which is the settling entity's directly-held subsidiary). It may then be necessary to review the carrying value of that investment to ensure that it is not impaired.
- Where the settling entity is a parent (direct or indirect) of the entity receiving the goods or services and is accounting for the transaction as cash-settled (whereas the subsidiary will be accounting for the transaction as equity-settled), in our view it has an accounting policy choice for the treatment of the remeasurement of the cash-settled liability. Either:
 - It accounts for the entire award as part of the contribution to the subsidiary and therefore as an addition to the cost of its investment in the employing subsidiary (or of that holding company of the employing subsidiary which is the settling entity's directly-held subsidiary).
 - Or
 - After the initial capitalisation of the grant date fair value of the liability, it remeasures the liability through profit or loss.

Whichever policy is chosen, it may then be necessary to review the carrying value of the investment to ensure that it is not impaired.

- In other cases (i.e., where the settling entity is a subsidiary (direct or indirect) or fellow subsidiary of the entity receiving the goods or services), it must treat the settlement as a distribution and charge it directly to equity. Whether or not such a settlement is a legal distribution is a matter of law.

How we see it

As noted above, the debit entry depends on the classification of the award, and which entity is settling the award in the group, parent or another entity. If the settling entity is the parent of the entity receiving the goods or services; in an equity-settled transaction, the debit is recognised as an addition to the cost of investment, in a cash-settled transaction, there is an accounting policy choice for the treatment of the remeasurement of the cash-settled liability.

If the settling entity is not the parent (i.e., direct or indirect subsidiary or fellow subsidiary, of the entity receiving the goods or services), the settlement is treated as a distribution and charged directly to equity.

We adopt the approach of full capitalisation by the parent entity in the worked examples set out at 13.4 to 13.6 below.

13.2.5 Transactions settled in equity of the entity or its parent

13.2.5.A Awards settled in equity of subsidiary

Where a subsidiary grants an award to its employees and settles it in its own equity, the subsidiary accounts for the award as equity-settled. *[FRS 102.26.1, FRS 102 Appendix I]*.

The parent accounts for the award as equity-settled in its consolidated financial statements. In its separate financial statements, the parent does not account for the award under FRS 102 because the Parent receives no goods or services, nor does it settle the transaction (see 3.2.1 above). In both cases, the transaction may have implications for other aspects of the financial statements, since its settlement results in the partial disposal of the subsidiary.

Where the parent is responsible for settling the award, it accounts for the transaction as equity-settled in its consolidated financial statements. In its separate financial statements, however, it accounts for the award as cash-settled, since it is settled not in its own equity, but in the equity of the subsidiary (see 3.2.1 and 13.2.4 above). From the perspective of the parent's separate financial statements, the equity of a subsidiary is a financial asset.

13.2.5.B Awards settled in equity of the parent

Where the parent grants an award directly to the employees of a subsidiary and settles it in its own equity, the subsidiary accounts for the award as equity-settled, with a corresponding increase in equity as a contribution from the parent. *[FRS 102.26.1, FRS 102.26.1A]*.

The parent accounts for the award as equity-settled in both its consolidated and separate financial statements (see 3.2.1 above). *[FRS 102.26.2A]*.

Where a subsidiary grants an award of equity in its parent to its employees and settles the award itself, it accounts for the award as cash-settled, since it is settled not in its own equity, but in the equity of its parent. From the perspective of the subsidiary's separate or individual financial statements, the equity of the parent is a financial asset. *[FRS 102.26.1]*.

This requirement potentially represents something of a compliance burden. For the purposes of the parent's consolidated financial statements the fair value of the award needs to be calculated once, at grant date. For the purposes of the subsidiary's financial statements, however, the basic requirements of Section 26 require the award to be accounted for as cash-settled, with the fair value recalculated at each reporting date. In some cases, the rather unclear wording of paragraph 16 of Section 26 might mean that the arrangements are considered to meet the criteria for the alternative accounting treatment for group schemes. If this were the case, the subsidiary could, in effect, account on an equity-settled basis until the point of settlement (see 13.2.3.A above).

However, this approach, which results in equity-settled accounting in the consolidated financial statements and cash-settled accounting in the subsidiary financial statements, applies only when a subsidiary 'grants', and is therefore obliged to settle, such an award. In some jurisdictions, including the UK, it is normal for grants of share awards to be made by the parent, or an employee service company or EBT, rather than by the subsidiary, although the subsidiary may well make recommendations to the grantor of the award as to which of its employees are to benefit.

In those cases, the fact that the subsidiary may communicate the award to the employee does not necessarily mean that the subsidiary itself has granted the award. It may simply be notifying the employee of an award granted by another group entity and which the other group company has the obligation to settle. In that case the subsidiary must apply the normal requirement of Section 26 to account for the award as equity-settled.

13.2.6 Cash-settled transactions not settled by the entity receiving goods or services

The scope section of Section 26 (see 3 above) considers arrangements in which the parent has an obligation to make cash payments to the employees of a subsidiary linked to the price of either:

- The subsidiary's equity instruments.
- Or

- The parent's equity instruments.

In both cases, the subsidiary has no obligation to settle the transaction. Therefore, unless the alternative accounting rules are applied (see below), the subsidiary accounts for the transaction as equity-settled, recognising a corresponding credit in equity as a contribution from its parent. [FRS 102.26.1, FRS 102.26.1A].

The subsidiary subsequently remeasures the cost of the transaction only for any changes resulting from non-market vesting conditions not being met in accordance with the normal provisions of Section 26 discussed at 4 to 7 above. Section 26 does not specifically make the point made in IFRS 2, that this will differ from the measurement of the transaction as cash-settled in the consolidated financial statements of the group. [IFRS 2 B56, IFRS 2.B57].

The parent has an obligation to settle the transaction in cash, paragraph 2A of Section 26 requires the parent to account for the transaction as cash-settled in both its consolidated and separate financial statements as the settling entity. [FRS 102.26.1, FRS 102.26.2A].

The requirement for the subsidiary to measure the transaction as equity-settled is somewhat controversial. The essential rationale for requiring the subsidiary to record the cost of a share-based payment transaction settled by its parent is to reflect that the subsidiary is effectively receiving a capital contribution from its parent.

Using the alternative accounting treatment for group plans set out in Section 26 (see 13.2.3.A above), it appears that the subsidiary in this situation could base its expense either on an equity-settled calculation or on an allocation of the group cash-settled expense.

13.2.7 Intragroup recharges and management charges

As noted at 13.2.2 above, neither FRS 102 nor IFRS 2 deals specifically with the accounting treatment of intragroup recharges and management charges that may be levied on the subsidiary that receives goods or services, the consideration for which is equity or cash of another group entity.

The accounting requirements of FRS 102 for group share schemes derive from requirements in IFRS 2 which evolved, via an Interpretation, from an exposure draft (D17) published in 2005.²³¹ In the absence of more specific guidance, we suggest that the treatment outlined below is applied to recharge arrangements in place between entities applying FRS 102. For entities applying the Companies Act 2006, the accounting treatment under D17 is also addressed in Section 7 of TECH 02/17BL. [TECH 02/17BL.7.53, TECH 02/17BL.7.54, TECH 02/17BL.7.55, TECH 02/17BL.7.56].

D17 proposed that any such payment made by a subsidiary is charged directly to equity, on the basis that it represents a return of the capital contribution recorded as the credit to equity required by IFRS 2 (see 13.2.3 and 13.2.6 above) up to the amount of that contribution, and a distribution thereafter.

How we see it

In our view, whilst IFRS 2 and FRS 102 as currently drafted does not explicitly require the accounting set out in D17 for the subsidiary, this is likely to be the more appropriate analysis for most cases where the amount of the recharge or management charge to a subsidiary is directly related to the value of the share-based payment transaction. Indeed, the only alternative, 'mechanically' speaking, would be to charge the relevant amount to profit or loss. This would result in a double charge (once for the FRS 102 charge, and again for the management charge or recharge) which we consider not only less desirable for most entities, but also less appropriate in cases where the amounts are directly related.

Accordingly, in the Illustrations at 13.4 to 13.6 below, we apply the treatment originally proposed in D17 to any payments made by the subsidiary for participation in the group scheme.

231 D17 - IFRS 2 - Group and Treasury Share Transactions, IASB, 2005, para. IE5.

Many intragroup recharge arrangements are based directly on the value of the underlying share-based payment, typically at grant date, vesting date or exercise date. In other cases, a more general management charge might be levied that reflects not just share-based payments but also a number of other arrangements or services provided to the subsidiary by the parent. Where there is a more general management charge of this kind, we believe that it is more appropriate for the subsidiary to recognise a double charge to profit or loss rather than debiting the management charge to equity as would be the case for a direct recharge.

IFRS 2 and FRS 102 also do not address how the parent must account for a recharge or management charge received. In our view, to the extent that the receipt represents a return of a capital contribution made to the subsidiary, the parent may choose whether to credit:

- The carrying amount of its investment in the subsidiary.
- Or
- Profit or loss (with a corresponding impairment review of the investment).

Even if part of the recharge received is credited to the carrying amount of the investment, any amount received in excess of the capital contribution previously debited to the investment in subsidiary must be accounted for as a distribution from the subsidiary and credited to the income statement of the parent. Where applicable, the illustrative examples at 13.4 to 13.6 below show the entire amount as a credit to the income statement of the parent rather than part of the recharge being treated as a credit to the parent's investment in its subsidiary.

How we see it

In the absence of guidance in IFRS 2 and FRS 102 on accounting by the parent for a recharge or management charge received, in our view, to the extent that the receipt represents a return of a capital contribution made to the subsidiary, the parent could choose whether to credit the carrying amount of its investment in subsidiary (up to the capital contribution previously debited to the carrying amount of its investment) with the excess recognised in profit or loss or the full receipt recognised in profit or loss.

A further issue that arises in practice is the timing of recognition of the recharge by the parties to the arrangement. In the absence of a contractual agreement, the treatment adopted might depend on the precise terms and whether there are contractual arrangements in place, but two approaches generally result in practice:

- To account for the recharge when it is actually levied or paid (which is consistent with accounting for a distribution).
- Or
- To accrue the recharge over the life of the award or the recharge agreement even if, as is commonly the case, the actual recharge is only made at vesting or exercise date.

An entity must choose the more appropriate treatment for its particular circumstances. The first approach is often the more appropriate in a group context where recharge arrangements might be rather informal and therefore not binding until such time as a payment is made. It is also consistent with the overall recognition of the arrangement through equity. The second approach, which is likely to be the more appropriate approach when a liability is considered to exist in advance of the payment date. It is closer in some respects to the accounting treatment of a provision or financial liability, but would reflect changes in the liability through equity rather than profit or loss and would build up the liability over the life of the award rather than recognising it in full when a present obligation has been identified.

Whichever accounting treatment is adopted, any adjustments to the amount to be recognised as a recharge, whether arising from a change in the Section 26 expense or other changes, must be recognised in the current period and previous periods must not be restated.

How we see it

In the absence of guidance in FRS 102 and IFRS 2 on the timing of recognition of the recharge, in our view, an entity chooses the most appropriate treatment for its particular circumstances based on the guidance set out above, i.e., account for the charge when levied/paid or accrue the recharge over the life of the award.

Where applicable, the examples at 13.4 to 13.6 below illustrate the first of the two treatments outlined above and recognise the recharge only when it becomes payable at the date of exercise.

13.3 Employee benefit trusts ('EBTs') and similar arrangements

13.3.1 Background

For some time entities have established trusts and similar arrangements for the benefit of employees. These are known by various names but, for the sake of convenience, in this section we will use the term 'EBT' ('employee benefit trust') to cover all such vehicles by whatever name they are actually known.

The commercial purposes of using such vehicles vary from employer to employer but may include the following:

- An EBT, in order to achieve its purpose, needs to hold shares that have either been issued to it by the entity or been bought by the EBT on the open market.
- In the case of longer-term benefits, the use of an EBT may 'ring fence' the assets set aside for the benefit of employees in case of the insolvency of the entity.
- The use of an EBT may be necessary in order to achieve a favourable tax treatment for the entity or the employees, or both.

The detailed features of an EBT will again vary from entity to entity but typical features often include the following:

- The EBT provides a warehouse for the shares of the sponsoring entity, for example by acquiring and holding shares that are to be sold or transferred to employees in the future. The trustees may purchase the shares with finance provided by the sponsoring entity (by way of cash contributions or loans), or by a third-party bank loan, or by a combination of the two. Loans from the entity are usually interest-free. In other cases, the EBT may subscribe directly for shares issued by the sponsoring entity or acquire shares in the market.
- Where the EBT borrows from a third party, the sponsoring entity will usually guarantee the loan, i.e., it will be responsible for any shortfall if the EBT's assets are insufficient to meet its debt repayment obligations. The entity will also generally make regular contributions to the EBT to enable the EBT to meet its interest payments, i.e., to make good any shortfall between the dividend income of the EBT (if any) and the interest payable. As part of this arrangement the trustees may waive their right to dividends on the shares held by the EBT.
- Shares held by the EBT are distributed to employees through an employee share scheme. There are many different arrangements, these may include:
 - The purchase of shares by employees when exercising their share options under a share option scheme.
 - The purchase of shares by the trustees of an approved profit-sharing scheme for allocation to employees under the rules of the scheme.
 - The transfer of shares to employees under some other incentive scheme.
- The trustees of an EBT may have a legal duty to act at all times in accordance with the interests of the beneficiaries under the EBT. However, most EBTs (particularly those established as a means of remunerating employees) are specifically designed so as to serve the purposes of the sponsoring entity, and to ensure that there will be minimal risk of any conflict arising between the duties of the trustees and the interest of the entity.

13.3.2 Accounting for EBTs

The requirement to treat an EBT as an extension of the entity is included in Section 9 (see Chapter 8 at 4.5). [FRS 102.9.35, FRS 102.9.36, FRS 102.9.37]. This treatment has the following broad consequences for the consolidated and separate financial statements of the reporting entity:

- Until such time as the entity's own shares held by the EBT vest unconditionally in employees (e.g., as the result of the vesting of an award of ordinary shares, or the exercise of a vested option over ordinary shares), any consideration paid for the shares must be deducted in arriving at shareholders' equity.
- Other assets and liabilities (including borrowings) of the EBT must be recognised as assets and liabilities in the financial statements of the sponsoring entity.
- No gain or loss is recognised in profit or loss or other comprehensive income on the purchase, sale, issue or cancellation of the entity's own shares. Consideration paid or received for the purchase or sale of the entity's own shares in an EBT is shown separately from other purchases and sales of the entity's own shares ('true' treasury shares held by the reporting entity) in the statement of changes in equity.

- Any dividend income arising on own shares must be excluded from profit or loss and deducted from the aggregate of dividends paid. Where material, the deduction from the aggregate dividends paid must be disclosed. [FRS 102.9.38(g)].

And

- Finance costs and any administration expenses must be charged as they accrue and not as funding payments are made to the EBT.

The discussion above, and in the remainder of 13 below, focuses on arrangements where the EBT holds unallocated shares of the reporting entity and/or shares that have been allocated to employees in connection with share awards but where the awards have not yet vested unconditionally. There will also be situations in practice in which an EBT reaches the stage where, or is designed so that, it only holds shares to which employees have full entitlement (i.e., the shares are fully vested). In this situation the shares are beneficially owned and controlled by the individual employees but might remain in trust for tax or other reasons in the period following vesting. Where an EBT does not hold any unvested shares and there are no other assets or liabilities in the EBT over which the entity continues to exercise control, there will be nothing left in the EBT to incorporate into the entity's financial statements by extension.

13.3.3 Illustrative Examples - awards satisfied by shares purchased by, or issued to, an EBT

The following Illustrations show the interaction of accounting for the EBT with the requirements of Section 26. Illustration 13-1 shows the treatment where an award is satisfied using shares previously purchased by the EBT. Illustration 13-2 shows the treatment where freshly issued shares are used.

Illustration 13-1: Interaction of accounting for share purchase by EBT and accounting for share-based payment transactions

On 1 January in year 1, the EBT of ABC plc made a market purchase of 100,000 shares of ABC plc at £2.50 per share. These were the only ABC shares held by the EBT at that date.

On 1 May in the same year, ABC granted executives options over between 300,000 and 500,000 shares at £2.70 per share, which will vest at the end of year 1, the number vesting depending on various performance criteria. It is determined that the cost to be recognised in respect of this award under FRS 102 is £0.15 per share.

Four months later, on 1 September, the EBT made a further market purchase of 300,000 shares at £2.65 per share.

At the end of year 1, options vested over 350,000 shares and were exercised immediately.

The accounting entries for the above transactions in the consolidated financial statements of ABC would be as set out below.

	£	£
1 January		
Own shares (equity)	250,000	
Cash		250,000
<i>To record purchase of 100,000 £1 shares at £2.50/share</i>		
1 May – 31 December		
Profit or loss	52,500	
Equity [†]		52,500
<i>To record cost of vested 350,000 options at £0.15/option</i>		
1 September		
Own shares (equity)	795,000	
Cash		795,000
<i>To record purchase of 300,000 £1 shares at £2.65/share</i>		
31 December		
Cash	945,000	
Equity ^{†1}		945,000
<i>Receipt of proceeds on exercise of 350,000 options at £2.70/share</i>		
Equity [†]	914,375	
Own shares (equity) ²		914,375
<i>Release of shares from EBT to employees</i>		

1 This reflects the fact that the entity's resources have increased as a result of a transaction with an owner, which gives rise to no gain or loss and is therefore credited direct to equity.

2 It is necessary to transfer the cost of the shares 'reissued' by the EBT out of own shares, as the deduction for own shares would otherwise be overstated. The total cost of the pool of 400,000 shares immediately before vesting was £1,045,000 (£250,000 purchased on 1 January and £795,000 purchased on 1 September), representing an average cost per share of £2.6125. £2.6125 × 350,000 shares = £914,375.

† These amounts must all be accounted for in the profit and loss reserve or, until the awards are exercised, a separate reserve for share-based payments.

Illustration 13-1 illustrates the importance of keeping the accounting for the cost of the shares completely separate from that for the cost of the share-based payment award. In cash terms, ABC has made a 'profit' of £30,625, since it purchased 350,000 shares with a weighted average cost of £914,375 and issued them to the executives for £945,000. However, this 'profit' is accounted for entirely within equity, whereas a calculated expense of £52,500 is recognised in profit or loss.

Illustration 13-2: Interaction of accounting for fresh issue of shares to EBT and accounting for share-based payment transactions

On 1 January in year 1, the EBT of ABC plc subscribed for 100,000 £1 shares of ABC plc at £2.50 per share, paid for in cash provided by ABC by way of loan to the EBT. In accordance with the Companies Act, these proceeds must be credited to the share capital account up to the par value of the shares issued, with any excess taken to a share premium account. These were the only ABC shares held by the EBT at that date.

On 1 May in the same year, ABC granted executives options over between 300,000 and 500,000 shares at an exercise price of £2.70 per share, which will vest at the end of year 1, the number vesting depending on various performance criteria. It is determined that the fair value to be recognised in respect of this award is £0.15 per share.

Four months later, on 1 September, the EBT subscribed for a further 300,000 shares at £2.65 per share, again paid for in cash provided by ABC by way of loan to the EBT.

At the end of year 1, options vested over 350,000 shares and were exercised immediately.

The accounting entries for the above transactions in the consolidated financial statements of ABC would be as set out below.

	£	£
1 January		
Equity ⁺¹	250,000	
Share capital		100,000
Share premium		150,000
<i>To record issue of 100,000 £1 shares to EBT at £2.50/share</i>		
1 May - 31 December		
Profit or loss	52,500	
Equity [†]		52,500
<i>To record cost of vested 350,000 options at £0.15/option</i>		
1 September		
Equity ⁺¹	795,000	
Share capital		300,000
Share premium		495,000
<i>To record issue of 300,000 £1 shares at £2.65/share</i>		
31 December		
Cash	945,000	
Equity ⁺²		945,000
<i>Receipt of proceeds on exercise of 350,000 options at £2.70/share</i>		

- 1 This entry is required to reconcile the legal requirement to record an issue of shares with the fact that, in reality, there has been no increase in the resources of the reporting entity. All that has happened is that one member of the reporting group (the EBT) has transferred cash to another (the parent entity).
 - 2 This reflects the fact that the entity's resources have increased as a result of a transaction with an owner, which gives rise to no gain or loss and is therefore credited direct to equity.
- † These amounts are required to be accounted for in the profit and loss reserve (subject to note 1 above) or, until the awards are exercised, a separate reserve for share-based payments.

How we see it

In our view, the debit to equity in note 1 on issue of shares, is not strictly accounted for within any 'Own shares reserve' in equity, which must be restricted to shares acquired from third parties, although it is increasingly common in practice to see an entry in 'own shares' to reflect such a holding of shares by an EBT.

13.3.4 Financial statements of the EBT

The EBT may be required to prepare financial statements in accordance with requirements imposed by local law or by its own trust deed. The form and content of such financial statements are beyond the scope of this publication.

13.4 Illustrative example of group share scheme – equity-settled award satisfied by purchase of shares

The discussion in 13.4.1 to 13.4.3 below is based on Illustration 13-3 and addresses the accounting treatment for three distinct aspects of a group share scheme; a share-based payment arrangement involving group entities (see 13.2 above), the use of an EBT (see 13.3 above) and a group recharge arrangement (see 13.2.7 above).

This illustrative example treats the recharge by the parent to the subsidiary as an income statement credit in the individual accounts of the parent and recognises the recharge when it is paid. In some situations, entities might consider it appropriate to apply alternative accounting treatments (see 13.2.7 above).

Illustration 13-3: Group share scheme (purchase of shares)

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded options under the H group share scheme over 3,000 shares in H plc at £1.50 each, exercisable between 1 July 20X4 and 1 July 20X7, subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4.

H plc is the grantor of the award and has the obligation to settle it. On 1 January 20X2, in connection with the award, the H plc group EBT purchases 3,000 shares from existing shareholders at a price of £2.00 per share, funded by a loan from H plc. On exercise of the option, S Limited is required to pay the differential between the purchase price of the shares and the exercise price of the option (£0.50 per share) to the EBT.

For the purposes of FRS 102, the options are considered to have a fair value at grant date of £1 per option. Throughout the vesting period of the option, H takes the view that the award will vest in full.

The option is exercised on 1 September 20X6, at which point the EBT uses the option proceeds, together with the payment by S Limited, to repay the loan from H plc.

H plc and its subsidiaries have a 31 December year end.

13.4.1 Consolidated financial statements

So far as the consolidated financial statements are concerned, the transactions to be accounted for are:

- The purchase of the shares by the EBT and their eventual transfer to the employee
And
- The cost of the award.

Transactions between H plc or S Limited and the EBT are ignored since the EBT is treated as an extension of H plc (see 13.3 above). The accounting entries required are set out below. As in other examples in this chapter, an entry to equity is not allocated to a specific reserve as this will vary between entities (although the most common for an entity complying with the Companies Act 2006 will be the profit and loss reserve or a separate 'other reserve' for share-based payments).

		£	£
y/e 31.12.20X1	Profit or loss (employee costs)*	500	
	Equity		500
1.1.20X2	Own shares (equity)	6,000	
	Cash		6,000
y/e 31.12.20X2	Profit or loss (employee costs)*	1,000	
	Equity		1,000
y/e 31.12.20X3	Profit or loss (employee costs)*	1,000	
	Equity		1,000
y/e 31.12.20X4	Profit or loss (employee costs)*	500	
	Equity		500
1.9.20X6	Cash (option proceeds)†	4,500	
	Equity‡	1,500	
	Own shares (equity)**		6,000

* Total cost £3,000 (3000 options × £1) spread over 36 months. Charge for period to December 20X1 is $6/36 \times £3,000 = £500$, and so on. In practice, where options are granted to a group of individuals, or with variable performance criteria, the annual charge will be based on a continually revised cumulative charge (see further discussion at 7.1 to 7.4 above).

† 3,000 options at £1.50 each.

‡ This reflects the fact that the overall effect of the transaction for the group in cash terms has been a 'loss' of £1,500 (£6,000 original cost of shares less £4,500 option proceeds received). However, under FRS 102 this is an equity transaction, not an expense.

** £6,000 cost of own shares purchased on 1 January 20X2 now transferred to the employee. In practice, it is more likely that the appropriate amount to be transferred would be based on the weighted average price of shares held by the EBT at the date of exercise, as in Illustration 13-1 at 13.3.3 above. In such a case there would be a corresponding adjustment to the debit to equity marked with ‡ above.

13.4.2 Parent

13.4.2.A Accounting by parent where the subsidiary company is the employing company

The parent accounts for the share-based payment transaction under FRS 102 as an equity-settled transaction since the parent settles the award by delivering its own equity instruments to the employees of the subsidiary (see 13.2.4 above). However, as discussed at 13.2.4 above, instead of recording an expense, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records the transactions of the EBT and the purchase of shares.

This gives rise to the following entries:

		£	£
y/e 31.12.20X1	Investment in subsidiary*	500	
	Equity		500
1.1.20X2	Own shares (equity)	6,000	
	Cash		6,000
y/e 31.12.20X2	Investment in subsidiary*	1,000	
	Equity		1,000
y/e 31.12.20X3	Investment in subsidiary*	1,000	
	Equity		1,000
y/e 31.12.20X4	Investment in subsidiary*	500	
	Equity		500
1.9.20X6	Cash†	6,000	
	Equity‡	1,500	
	Profit or loss§		1,500
	Own shares** (equity)		6,000

* Total increase in investment £3,000 (3000 shares × £1 fair value of each option) spread over 36 months. Increase during period to December 20X1 is $6/36 \times £3,000 = £500$, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion at 7.1 to 7.4 above).

† £4,500 option exercise proceeds from employee plus £1,500 contribution from S Limited.

‡ This is essentially a balancing figure representing the fact that the entity is distributing own shares with an original cost of £6,000 but has treated £1,500 of the £6,000 of the cash it has received as income (see § below) rather than as payment for the shares.

§ The £1,500 contribution by the subsidiary to the EBT has been treated as a distribution from the subsidiary (see 13.2.7 above) and recorded in profit or loss. It might then be necessary to consider whether, as a result of this payment, the investment in the subsidiary had become impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

** £6,000 cost of own shares purchased on 1 January 20X2 now transferred to employee. In practice, it is more likely that the appropriate amount to be transferred would be based on the weighted average price of shares held by the EBT at the date of exercise, as in Illustration 13-1 at 13.3.3 above.

13.4.2.B Parent company as employing company

If, in Illustration 13-3, the employing entity were the parent rather than the subsidiary, it would record an expense under FRS 102. It would also normally waive £1,500 of its £6,000 loan to the EBT (i.e., the shortfall between the original loan and the £4,500 option proceeds received from the employee).

As the EBT is treated as an extension of the parent, the accounting entries for the parent would be the same as those for the group, as set out at 13.4.1 above.

13.4.3 Employing subsidiary

The employing subsidiary is required to account for the FRS 102 expense and the contribution to the EBT on exercise of the award. This gives rise to the accounting entries set out below. The entries to reflect the expense are required by FRS 102 (see 13.2.3 above). The treatment of the contribution to the EBT as a distribution is discussed at 13.2.7 above.

	£	£
y/e 31.12.20X1 Profit or loss*	500	
Equity		500
y/e 31.12.20X2 Profit or loss*	1,000	
Equity		1,000
y/e 31.12.20X3 Profit or loss*	1,000	
Equity		1,000
y/e 31.12.20X4 Profit or loss*	500	
Equity		500
1.9.20X6 Equity†	1,500	
Cash		1,500

* Total cost £3,000 (3000 options × £1) spread over 36 months. Charge for period to December 20X1 is $6/36 \times £3,000 = £500$, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 7.1 to 7.4 above).

† This is to be treated as a reduction of whatever component of equity was credited with the £3,000 quasi-contribution from the parent in the accounting entries above.

13.5 Illustrative example of a group share scheme – equity-settled award satisfied by fresh issue of shares

The discussion in 13.5.1 to 13.5.3 below is based on Illustration 13-4 and addresses the accounting treatment for three distinct aspects of a group share scheme, a share-based payment arrangement involving group entities (see 13.2 above), the use of an EBT (see 13.3 above) and a group recharge arrangement (see 13.2.7 above). The illustration assumes that the share-based payment arrangement is settled by a fresh issue of shares.

This illustrative example treats the recharge by the parent to the subsidiary as an income statement credit in the individual accounts of the parent and recognises the recharge when it is paid. In some situations, entities might consider it appropriate to apply alternative accounting treatments (see 13.2.7 above).

Illustration 13-4: Group share scheme (fresh issue of shares)

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded options under the H group share scheme over 3,000 shares in H plc at £1.50 each, exercisable between 1 July 20X4 and 1 July 20X7, subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4. The fair value of the options on 1 July 20X1 is £1 each.

H plc grants the award and has the obligation to settle it.

When preparing accounts during the vesting period H plc and its subsidiaries assume that the award will vest in full. The options are finally exercised on 1 September 20X6, at which point H plc issues 3,000 new shares to the EBT at the then current market price of £3.50 for £10,500. The EBT funds the purchase using the £4,500 option proceeds received from the employee together with £6,000 contributed by S Limited, effectively representing the fair value of the options at exercise date ($3,000 \times [£3.50 - £1.50]$). H plc and its subsidiaries have a 31 December year end.

13.5.1 Consolidated financial statements

The consolidated financial statements need to deal with:

- The charge required by FRS 102 in respect of the award
- And
- The issue of shares.

Transactions between H plc or S Limited and the EBT are ignored since the EBT is treated as an extension of H plc (see 13.3 above). The accounting entries required are set out below. As in other examples in this chapter, an entry to equity is not allocated to a specific reserve as this will vary between entities (although the most common for an entity complying with the Companies Act 2006 will be the profit and loss reserve or a separate 'other reserve' for share-based payments).

		£	£
y/e 31.12.20X1	Profit or loss*	500	
	Equity		500
y/e 31.12.20X2	Profit or loss*	1,000	
	Equity		1,000
y/e 31.12.20X3	Profit or loss*	1,000	
	Equity		1,000
y/e 31.12.20X4	Profit or loss*	500	
	Equity		500
1.9.20X6	Cash	4,500	
	Other equity†	6,000	
	Share capital/premium†		10,500

* Total cost £3,000 (3000 options × £1) spread over 36 months. Charge for period to December 20X1 is $6/36 \times £3,000 = £500$, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 7.1 to 7.4 above).

† From the point of view of the consolidated group, the issue of shares results in an increase in net assets of only £4,500 (i.e., the exercise price received from the employee), since the £6,000 contribution from the employing subsidiary to the EBT is an intragroup transaction. However, an entity applying the Companies Act 2006 is required to increase its share capital and share premium accounts by the £10,500 legal consideration for the issue of shares. The £6,000 consideration provided from within the group is effectively treated as a bonus issue.

13.5.2 Parent

13.5.2.A Accounting by parent where subsidiary is the employing company

The parent accounts for the share-based payment transaction under FRS 102 as an equity-settled transaction since the parent settles the award by delivering its own equity instruments via its EBT to the employees of the subsidiary (see 13.2.4 above). However, as discussed at 13.2.4 above, instead of recording an expense, as in its consolidated financial statements, the parent records an increase in the carrying value of its investment in subsidiary. It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

In addition to accounting for the share-based payment transaction, the parent records the transactions of the EBT and the issue of shares.

		£	£
y/e 31.12.20X1	Investment in subsidiary*	500	
	Equity		500
y/e 31.12.20X2	Investment in subsidiary*	1,000	
	Equity		1,000
y/e 31.12.20X3	Investment in subsidiary*	1,000	
	Equity		1,000
y/e 31.12.20X4	Investment in subsidiary*	500	
	Equity†		500
1.9.20X6	Cash‡	10,500	
	Equity‡	6,000	
	Profit or loss**		6,000
	Share capital/premium‡		10,500

* Total increase in investment £3,000 (3,000 shares × £1 fair value of each option) spread over 36 months. Increase during period to December 20X1 is $6/36 \times £3,000 = £500$, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual adjustment would be based on a continually revised cumulative adjustment (see further discussion at 7.1 to 7.4 above).

† £4,500 option exercise proceeds from employee plus £6,000 contribution from the subsidiary.

‡ This assumes that local law requires the entity to record share capital and share premium of £10,500, as in 13.5.1 above. However, FRS 102 *prima facie* requires the £6,000 cash received by the EBT from the subsidiary to be treated as income (see ** below) rather than as part of the proceeds of the issue of shares. In order, in effect, to reconcile these conflicting analyses, £6,000 of the £10,500 required by law to be capitalised as share capital and share premium has been treated as an appropriation out of other equity.

** The £6,000 contribution by the subsidiary to the EBT has been treated as a distribution from the subsidiary (see 13.2.7 above) and recorded in profit or loss. It might then be necessary to consider whether, as a result of this payment, the investment in the subsidiary had become impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this illustration. Any impairment charge would be recorded in profit or loss.

13.5.2.B Parent company as employing company

If, in Illustration 13-4, the employing entity were the parent rather than the subsidiary, it would clearly have to record an expense under FRS 102. It would also have to fund the £6,000 shortfall between the option exercise proceeds of £4,500 and the £10,500 issue proceeds of the shares.

As the EBT is treated as an extension of the parent, the accounting entries for the parent would be the same as those for the group, as set out in 13.5.1 above.

13.5.3 Employing subsidiary

The employing subsidiary is required to account for the FRS 102 expense and the contribution to the EBT on exercise of the award. This gives rise to the accounting entries set out below. The entries to reflect the expense are required by FRS 102 (see 13.2.3 above). The treatment of the contribution to the EBT as a distribution is discussed at 13.2.7 above.

	£	£
y/e 31.12.20X1 Profit or loss*	500	
Equity		500
y/e 31.12.20X2 Profit or loss*	1,000	
Equity		1,000
y/e 31.12.20X3 Profit or loss*	1,000	
Equity		1,000
y/e 31.12.20X4 Profit or loss*	500	
Equity		500
1.9.20X6 Equity†	6,000	
Cash		6,000

* Total cost £3,000 (3,000 options × £1) spread over 36 months. Charge for period to December 20X1 $6/36 \times £3,000 = £500$, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 7.1 to 7.4 above).

† £3,000 of this payment is treated as a reduction of whatever component of equity was credited with the £3,000 quasi-contribution from the parent in the accounting entries above. The remaining £3,000 would be treated as a distribution and deducted from any appropriate component of equity.

13.6 Illustrative example - cash-settled transaction not settled by the entity receiving goods or services

The discussion in 13.6.1 to 13.6.3 below is based on Illustration 13-5.

Illustration 13-5: Cash-settled scheme not settled by receiving entity

On 1 July 20X1 an employee of S Limited, a subsidiary of the H plc group, is awarded a right, exercisable between 1 July 20X4 and 1 July 20X7, to receive cash equivalent to the value of 3,000 shares in H plc at the date on which the right is exercised. Exercise of the right is subject to a service condition and certain performance criteria being met in the three years ending 30 June 20X4. The cash will be paid to the employee not by S, but by H. Throughout the vesting period of the award, H and S take the view that it will vest in full.

The award does in fact vest, and the right is exercised on 1 September 20X6.

The fair value of the award (per share-equivalent) at various relevant dates is as follows:

Date	Fair value £
1.7.20X1	1.50
31.12.20X1	1.80
31.12.20X2	2.70
31.12.20X3	2.40
31.12.20X4	2.90
31.12.20X5	3.30
1.9.20X6	3.50

If the award had been equity-settled (i.e., the employee had instead been granted a right to 3,000 free shares), the grant date fair value of the award would have been £1.50 per share.

H plc and its subsidiaries have a 31 December year end.

13.6.1 Consolidated financial statements

The group has entered into a cash-settled transaction which is accounted for using the methodology discussed at 10.3 above. This gives rise to the following accounting entries:

		£	£
y/e 31.12.20X1	Profit or loss*	900	
	Liability		900
y/e 31.12.20X2	Profit or loss*	3,150	
	Liability		3,150
y/e 31.12.20X3	Profit or loss*	1,950	
	Liability		1,950
y/e 31.12.20X4	Profit or loss*	2,700	
	Liability		2,700
y/e 31.12.20X5	Profit or loss*	1,200	
	Liability		1,200
y/e 31.12.20X6	Profit or loss*	600	
	Liability		600
1.9.20X6	Liability	10,500	
	Cash		10,500

* Charge for period to 31 December 20X1 is $6/36 \times 3000 \times £1.80$ [reporting date fair value] = £900. Charge for year ended 31 December 20X2 is $18/36 \times 3000 \times £2.70$ = £4,050 less £900 charged in 20X1 = £3,150 and so on (refer to Illustration 10-2 at 10.3.2 above). In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 10 above).

13.6.2 Parent company

The parent accounts for the share-based payment transaction under FRS 102 as a cash-settled transaction, since the parent settles the award by delivering cash to the employees of the subsidiary (see 13.2.4 above).

How we see it

As discussed at 13.2.4 above, instead of recording a cost, consistent with the consolidated financial statements, the parent treats the debit entry (including, as a matter of accounting policy choice, any remeasurement of the liability) as an increase in the carrying value of its investment in subsidiary.

It might then be necessary to consider whether the ever-increasing investment in subsidiary is supportable or is in fact impaired. As this is a matter to be determined in the light of specific facts and circumstances, it is not considered in this example. Any impairment charge would be recorded in profit or loss.

This would result in the following accounting entries:

		£	£
y/e 31.12.20X1	Investment in subsidiary*	900	
	Liability		900
y/e 31.12.20X2	Investment in subsidiary*	3,150	
	Liability		3,150
y/e 31.12.20X3	Investment in subsidiary*	1,950	
	Liability		1,950
y/e 31.12.20X4	Investment in subsidiary*	2,700	
	Liability		2,700
y/e 31.12.20X5	Investment in subsidiary*	1,200	
	Liability		1,200
y/e 31.12.20X6	Investment in subsidiary*	600	
	Liability		600
1.9.20X6	Liability	10,500	
	Cash		10,500

* Increase in investment to 31 December 20X1 is $6/36 \times 3000 \times £1.80$ [reporting date fair value] = £900. Increase for year ended 31 December 20X2 is $18/36 \times 3000 \times £2.70$ = £4,050 less £900 charged in 20X1 = £3,150 and so on (refer to Illustration 10-2 at 10.3.2 above). In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 10 above).

Where the parent entity was also the employing entity (and therefore receiving goods or services), it would apply the same accounting treatment in its separate financial statements as in its consolidated financial statements (see 13.6.1 above).

13.6.3 Employing subsidiary

The employing subsidiary accounts for the transaction as equity-settled, since it receives services, but incurs no obligation to its employees (see 13.2.3 and 13.2.6 above). This gives rise to the following accounting entries:

		£	£
y/e 31.12.20X1	Profit or loss*	750	
	Equity		750
y/e 31.12.20X2	Profit or loss*	1,500	
	Equity		1,500
y/e 31.12.20X3	Profit or loss*	1,500	
	Equity		1,500
y/e 31.12.20X4	Profit or loss*	750	
	Equity		750

* Charge for period to 31 December 20X1 is $6/36 \times 3000 \times £1.50$ [grant date fair value] = £750, and so on. In practice, where options were granted to a group of individuals, or with variable performance criteria, the annual charge would be based on a continually revised cumulative charge (see further discussion at 7.1 to 7.4 above).

The effect of this treatment is that, while the group ultimately records a cost of £10,500, the subsidiary records a cost of only £4,500.

However, there may be cases where the subsidiary records a higher cost than the group. This would happen if, for example:

- The award vests, but the share price has fallen since grant date, so that the value of the award at vesting (as reflected in the consolidated financial statements) is lower than the value at grant (as reflected in the subsidiary's financial statements).

Or

- The award does not actually vest because of a failure to meet a market condition and/or a non-vesting condition (so that the cost is nil in the consolidated financial statements) but is treated by FRS 102 as vesting in the subsidiary's financial statements, because it is accounted for as equity-settled (see 7.3 and 7.4 above).

13.7 Employee transferring between group entities

It is not uncommon for an employee to be granted an equity-settled share-based payment award while in the employment of one subsidiary in the group, but to transfer to another subsidiary in the group before the award is vested, with the entitlement to the award remaining unchanged.

Section 26 does not specifically address the accounting in such cases. For entities applying the alternative accounting treatment for group plans in paragraph 16 of Section 26, that paragraph appears to support an appropriate allocation of the group expense between the employing entities (see 13.2.3.A above). In other cases, we suggest that group entities adopt an approach based on that in IFRS 2. Under IFRS 2, each subsidiary measures the services received from the employee by reference to the fair value of the equity instruments at the date those rights to equity instruments were originally granted, and the proportion of the vesting period served by the employee with each subsidiary. [IFRS 2.B.59]. In other words, for an award with a three-year vesting period granted to an employee of subsidiary A, who transfers to subsidiary B at the end of year 2, subsidiary A will (cumulatively) record an expense of 2/3, and subsidiary B 1/3, of the fair value at grant date. However, any subsidiary required to account for the transaction as cash-settled in accordance with the general principles discussed at 13.2 above accounts for its portion of the grant date fair value and for any changes in the fair value of the award during the period of employment with that subsidiary. [IFRS 2.B.60].

After transferring between group entities, an employee may fail to satisfy a vesting condition other than a market condition, for example by leaving the employment of the group. In this situation each subsidiary adjusts the amount previously recognised in respect of the services received from the employee in accordance with the general principles of FRS 102 and IFRS 2 (see 7.1 to 7.4 above). [IFRS 2.B.61].

14 Disclosures

The disclosure requirements of Section 26 fall into three main categories:

- The nature and extent of share-based payment arrangements (see 14.1 below)
- The measurement of share-based payment arrangements (see 14.2 below)

And

- The effect on the financial statements of share-based payment transactions (see 14.3 below).

The requirements apply to all entities applying FRS 102 although a 'qualifying entity', as defined in Section 1 Scope of FRS 102, may take advantage in its individual financial statements of an exemption from the requirements of paragraphs 18(b), 19 to 21 and 23 of Section 26 provided the following criteria are met:

- If the qualifying entity is a subsidiary, the share-based payment arrangement concerns equity instruments of another group entity.
- If the qualifying entity is an ultimate parent, the share-based payment arrangement concerns its own equity instruments and its separate financial statements are presented alongside the consolidated financial statements of the group,

and, in both cases, provided that the equivalent disclosures required by FRS 102 are included in the consolidated financial statements of the group in which the entity is consolidated. [FRS 102.1.8, FRS 102.1.9, FRS 102.1.10, FRS 102.1.11, FRS 102.1.12].

14.1 Nature and extent of share-based payment arrangements

IFRS 2 contains a general requirement that an entity must "disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period", [IFRS 2.44], and then lists the minimum disclosures required to meet the overall requirement.

FRS 102 does not include the overall requirement from IFRS 2, but picks up some of the detailed disclosures and includes the following disclosure requirements to enable users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period: [FRS 102.26.18]

Extract from Section 26

- 18** An entity shall disclose the following information about the nature and extent of share-based payment arrangements that existed during the period:
- (a) A description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity). An entity with substantially similar types of share-based payment arrangements may aggregate this information.
 - (b) The number and weighted average exercise prices of share options for each of the following groups of options:
 - (i) outstanding at the beginning of the period;
 - (ii) granted during the period;
 - (iii) forfeited during the period;
 - (iv) exercised during the period;
 - (v) expired during the period;
 - (vi) outstanding at the end of the period; and
 - (vii) exercisable at the end of the period.

How we see it

The reconciliation in (b) above, in our view, reflects all changes in the number of equity instruments outstanding. The reconciliation includes not just awards with a grant date during the period, but also includes subsequent additions to earlier grants e.g., options or shares added to the award in recognition of dividends declared during the period (where this is part of the original terms of the award), and changes to the number of equity instruments as a result of demergers, share splits or consolidations and other similar changes.

In addition, as drafted, the requirements in (b) above appear to apply only to share options. However, since there is little distinction between the treatment of an option with a zero exercise price and the award of a free share, in our view the disclosures are not be restricted to awards of options.

14.2 Measurement of share-based payment arrangements

IFRS 2 contains a general requirement that an entity must “disclose information that enables users of the financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined”, [IFRS 2.46], and then lists the minimum disclosures required to meet the overall requirement.

FRS 102 contains its own general disclosure requirements for equity-settled, cash-settled, modified and group share-based payment arrangements but does not mandate the disclosure of specific details other than as set out at 14.2.1 to 14.2.4 below.

14.2.1 Equity-settled arrangements

For equity-settled share-based payment arrangements, FRS 102 requires an entity to disclose: [FRS 102.26.19]

Extract from Section 26

19	For equity-settled share-based payment arrangements, an entity shall disclose information about how it measured the fair value of goods or services received or the value of the equity instruments granted. If a valuation methodology was used, the entity shall disclose the method and its reason for choosing it.

Unlike IFRS 2, FRS 102 has no specific requirement to disclose the inputs to an option pricing model and other assumptions made in the determination of fair value.

The requirement in FRS 102 to disclose the reason for choosing the valuation methodology used is not found in IFRS 2, but is consistent with the fact that FRS 102 allows directors to select an appropriate method of valuation rather than requiring the use of an option-pricing model (as is the case in IFRS 2 when market price information is not available).

14.2.2 Cash-settled arrangements

For cash-settled share-based payment arrangements, FRS 102 requires an entity to disclose: [FRS 102.26.20]

Extract from Section 26

20	For cash-settled share-based payment arrangements, an entity shall disclose information about how the liability was measured.

FRS 102 does not expand on this general requirement. There is no direct correlation between this requirement and the disclosure requirements of IFRS 2 as the latter do not specifically address the measurement of cash-settled arrangements. The FRS 102 requirement is therefore potentially more onerous.

14.2.3 Modification of share-based payment arrangements

Where share-based payment arrangements have been modified during the accounting period, FRS 102 requires an entity to disclose: [FRS 102.26.21]

Extract from Section 26

21	For share-based payment arrangements that were modified during the period, an entity shall disclose an explanation of those modifications.

Unlike IFRS 2, there is no specific requirement to disclose the incremental fair value or information about how that incremental value was measured.

14.2.4 Group share-based payment arrangements

If the reporting entity is part of a group share-based payment arrangement, FRS 102 requires the entity to disclose: [FRS 102.26.22]

Extract from Section 26

22	If the entity is part of a group share-based payment arrangement, and it measures its share-based payment expense on the basis of a reasonable allocation of the expense for the group, it shall disclose that fact and the basis for the allocation (see paragraph 26.16).

14.3 Effect of share-based payment transactions on financial statements

IFRS 2 contains a general requirement that an entity must “disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position”, [IFRS 2.50], and then lists the minimum disclosures required to meet the overall requirement.

FRS 102 does not include such a general requirement but picks up some of the detailed disclosures and requires an entity to: [FRS 102.26.23]

Extract from Section 26

23	An entity shall disclose the following information about the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position: (a) the total expense recognised in profit or loss for the period; and (b) the total carrying amount at the end of the period for liabilities arising from share-based payment transactions.

15 Taxes related to share-based payment transactions

15.1 Income tax deductions for the entity

The particular issues raised by the accounting treatment for income taxes on share-based payment transactions are discussed in Chapter 31 at 8.

15.2 Employment taxes of the employer

An employing entity in the UK is required to pay National Insurance on share options and other share-based payment transactions with employees, just as if the employees had received cash remuneration. This raises the question of how such taxes must be accounted for as FRS 102 contains no specific guidance in this area.

How we see it

Prior to the publication of the original version of FRS 102, UITF Abstract 25: National Insurance contributions on share option gains, specified the accounting for such taxes in a way that spread the anticipated cost over the vesting period. In our view, a similar approach is to be applied for National Insurance ('NI') contributions on outstanding share options (and similar awards) that are expected to be exercised.

UITF 25 required the provision to be:

- Calculated at the latest enacted NI rate applied to the difference between the market value of the underlying shares at the reporting date and the option exercise price
 - Allocated over the period from grant date to the end of the vesting period, after which it must be updated using the current market value of the shares
- And
- Expensed through profit or loss unless the options form part of capitalised staff costs.

In some situations, the entity may require employees to reimburse the amount of NI paid. UITF 25 required this to be treated in accordance with the general rules now in Section 21 for the reimbursement of the expenditure required to settle a provision.

15.3 Sale or surrender of shares by employee to meet employee's tax liability ('sell to cover' and net settlement)

An award of shares or options to an employee may give rise to a personal tax liability for the employee, often related to the fair value of the award when it vests or, in the case of an option, is exercised. To meet this tax liability, employees may wish to sell or surrender as many shares as are needed to raise proceeds equal to the tax liability (sometimes described respectively as 'sell to cover' or 'net settlement').

This does not, in our view, require the scheme to be considered as cash-settled, any more than if the employee wished to liquidate the shares in order to buy a car or undertake home improvements. However, if the manner in which the cash is passed to, or realised for, the employee gives rise to a legal or constructive obligation for the employer, then the scheme might well be cash-settled (see 10.2 above), to the extent of any such obligation.

Where employees must pay income tax on share awards, the tax is often initially collected from the employer, but with eventual recourse by the tax authorities to the employee for tax not collected from the employer. Such tax collection arrangements mean that even an equity-settled award results in a cash cost for the employer for the income tax.

In such a situation, the employer may require the employee, as a condition of taking delivery of any shares earned, to indemnify the entity against the tax liability, for example by:

- Direct payment to the entity.
 - Authorising the entity to deduct the relevant amount from the employee's salary.
- Or
- Surrendering as many shares to the entity as have a fair value equal to the tax liability.

How we see it

If the entity requires the employee to surrender the relevant number of shares, in our view the scheme must be treated as cash-settled to the extent of the indemnified amount, as explained in Illustration 15-1 below, unless the criteria to account for the arrangement as equity-settled under the limited exception in FRS 102 for a 'net settlement feature' are met (see below).

FRS 102 contains a limited exception to the general requirement to consider whether a net settlement feature needs to be split into equity-settled and cash-settled portions. An entity is required to account for a net settlement feature meeting certain specified criteria as equity-settled in their entirety. However, the exception is narrow in scope and the requirement to assess whether an arrangement has an equity-settled element and a cash-settled element continues to be relevant in many cases. The exception is discussed and demonstrated further in 15.3.1 below.

The following Illustration shows the application of IFRS 2 to an arrangement where the exception does not apply and the entity must separate the transaction into two elements.

Illustration 15-1: Surrendering of vested shares by employee to indemnify liability of entity to pay employee's tax liability (net settlement where FRS 102 exception does not apply)

An individual has a personal tax rate of 40% and free shares are taxed at their fair value on vesting. The individual is granted an award of 100 free shares with a grant date fair value of £3 each. The fair value at vesting date is £5, so that the employee's tax liability (required to be discharged in the first instance by the employer via PAYE) is £200 (40% of £500). Tax law or regulation does not require the entity to withhold an amount for the employee's tax obligation (see Illustration 15-2 below for a demonstration of that situation).

If the employee were required to surrender the 40 shares needed to settle the tax liability, the substance of the transaction is that, at grant date, the entity is making an award of only 60 shares (with a grant date fair value of £3 each) and is bearing the cost of the employment tax itself. On this analysis, the entity will have recorded the following entries by the end of the vesting period:

	£	£
Employee costs (based on 60 shares at grant date fair value)	180	
Equity		180
Employee costs (based on 40% of vesting date value)	200	
Employment tax liability		200

The award is then satisfied by the delivery of 60 shares by the entity to the employee.

If, instead of being required to surrender the shares needed to settle the tax liability, the employee has a free choice as to how to indemnify the employer, the employer will have recorded the following entries by the end of the vesting period:

	£	£
Employee costs (based on 100 shares at grant date fair value)	300	
Equity		300
Receivable from employee (based on 40% of vesting date value)	200	
Employment tax liability		200

The award is then satisfied by the delivery of 100 shares to the employee, and the employee indicates that he wishes to surrender 40 shares to discharge his obligation to the employer under the indemnity arrangement. The entity therefore receives 40 shares from the employee in settlement of the £200 receivable from him.

In practice, this would almost certainly be effected as a net delivery of 60 shares, but in principle there are two transactions:

- A release of 100 shares to the employee;
- And
- The re-acquisition of 40 of those shares at £5 each from the employee.

The entity then settles the tax liability:

	£	£
Employment tax liability	200	
Cash		200

Even in this case, some might take the view that the substance of the arrangement is that the employee has the right to put 40 shares to the employer, and accordingly 40% of the award must be accounted for as cash-settled, resulting in essentially the same accounting as when the employee is required to surrender 40 shares, as set out above. An entity must therefore make a careful assessment of the appropriate accounting treatment based on the terms of a particular arrangement.

An amendment to IFRS 2, issued in June 2016, introduced an exception to the requirement to split an award into an equity-settled element and a cash-settled element where certain specified criteria relating to an entity's tax withholding obligations are met. The exception means that net-settled arrangements that meet the criteria will be accounted for as entirely equity-settled under IFRS. Paragraph 15B(b) of Section 26 also contains a similar exception (see 15.3.1 below).

15.3.1 Share-based payments with a net settlement feature for withholding tax obligations (net settlement where FRS 102 exception applies)

Extract from FRS 102

Appendix I

Glossary

net settlement feature (of a share-based payment)

A term of a share-based payment arrangement that permits or requires the entity to withhold the number of equity instruments equal to the monetary value of the employee's tax obligation from the total number of equity instruments that otherwise would have been issued to the employee upon exercise (or vesting) of the share-based payment. Such terms may exist when tax laws or regulations oblige an entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount, normally in cash, to the tax authority on the employee's behalf.

Paragraph 15B of Section 26 contains an exception for specific types of share-based payment transactions with a net settlement feature, which was introduced to FRS 102 in the Periodic Review 2024 amendments to align Section 26 with the exception in IFRS 2. The exception relates to the classification of a share-based payment transaction in which an entity withholds a specified portion of shares that would otherwise be issued to the employee at the date of exercise or vesting. The shares are withheld in return for the entity settling the employee's tax obligation relating to the share-based payment.

Section 26 states that "When the counterparty has a choice of settlement of the transaction in cash (or other assets) or by the transfer of equity instruments, the entity shall account for the transaction as a wholly cash-settled share-based payment transaction in accordance with paragraph 26.14 unless ... the choice of settlement relates only to a net settlement feature and there is an obligation on the entity under tax laws or regulations to withhold an amount for an employee's tax obligation associated with that share-based payment". [FRS 102.26.15B(b)]. In such circumstances, the entity accounts for the transaction as a wholly equity-settled transaction in accordance with paragraphs 7 to 13A of Section 26. However, where an entity withholds an amount of shares that exceeds the monetary value of the employee's tax obligation, the entity accounts for the excess shares withheld as a cash-settled share-based payment when this amount is paid in cash (or other assets) to the employee.

The exception to the usual requirements of Section 26 (which are set out in 15.3 above) is narrow in scope and applies only in situations where there is a statutory withholding obligation.

If a transaction would have been classified entirely as equity-settled, were it not for this net settlement feature, then the exception in FRS 102 applies and the transaction is accounted for as equity-settled in its entirety (rather than being divided into an equity-settled portion and a cash-settled portion as discussed in 5.3 above).

An entity applying the exception must account for the withholding of shares to fund the payment to the tax authority as a deduction from equity. However, the deduction from equity may only be made up to the fair value at the net settlement date of the shares to be withheld. If the payment exceeds this fair value, the excess is expensed through profit or loss. [FRS 102.26.13A(c)].

Where the entity withholds any equity instruments in excess of the employee's tax obligation associated with the share-based payment (i.e., the entity withholds an amount of shares that exceeds the monetary value of the employee's tax obligation), then the excess shares must be accounted for as a cash-settled share-based payment when this amount is paid in cash (or other assets) to the employee. In other words, such shares are treated as a separate cash-settled share-based payment and fully recognised as an expense (rather than as a deduction from equity) as at the date of settlement.

To illustrate the application of the exception, the substance of Example 12B to the implementation guidance accompanying IFRS 2 has been reproduced as Illustration 15-3 below.

Illustration 15-3: Share-based payment transactions with a net settlement feature for withholding tax obligations (application of FRS 102 exception)

At the beginning of year 1 an entity grants an award of 100 shares to an employee. The award is conditional upon the completion of four years' service which the employee is expected to achieve.

The employee's tax obligation of 40% is based on the fair value of the shares at vesting date. Tax law in the entity's jurisdiction requires the entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount in cash to the tax authority on behalf of the employee.

The terms and conditions of the share-based payment arrangement require the entity to withhold shares from the settlement of the award to the employee in order to settle the employee's tax obligation. Accordingly, the entity settles the transaction on a net basis by withholding the number of shares with a fair value equal to the monetary value of the employee's tax obligation and issuing the remaining shares to the employee at the end of the vesting period.

The fair value at grant date is £2 per share and at the end of year 4 is £10 per share.

The fair value of the shares on the vesting date (end of year 4) is £1,000 ($100 \times £10$) and therefore the employee's tax obligation is £400 ($100 \times £10 \times 40\%$). Accordingly, on the vesting date, the entity issues 60 shares to the employee, withholds 40 shares from the employee and pays £400 (the fair value of the shares withheld) in cash to the tax authority on the employee's behalf. In effect, it is as if the entity issued 100 vested shares to the employee and then repurchased 40 of them at fair value.

Accounting during the vesting period and on recognition and settlement of the tax obligation

Over the four-year vesting period, the entity recognises a cumulative share-based payment expense of £200 (£50 per annum) with a corresponding credit to equity. This is calculated as 100 shares $\times$ £2 grant date fair value.

	£	£
Dr Employee costs	200	
Cr Equity		200
At the date of vesting the tax liability is recognised and subsequently paid:		
Dr Equity	400	
Cr Tax liability		400
Dr Tax liability	400	
Cr Cash		400

16 Other practical issues

We consider below the application of Section 26 to the following types of arrangement encountered in practice:

- Matching share awards (including deferred bonuses delivered in shares) (see 16.1 below)
 - Loans to employees to purchase shares (limited recourse and full recourse loans) (see 16.2 below)
 - Awards entitled to dividends or dividend equivalents during the vesting period (see 16.3 below)
 - Awards vesting or exercisable on an exit event or change of control (flotation, trade sale etc.) (see 16.4 below)
- And
- Shares used as a currency of payment (see 16.6 below).

16.1 Matching share awards (including deferred bonuses delivered in shares)

As noted in the discussion at 11.2.1 above, in our view the rules in Section 26 for awards where there is a choice of equity- or cash-settlement do not fully address awards where the equity and cash alternatives may have significantly different fair values and vesting periods. A matching share award is an example of the type of scheme giving rise to such issues.

Under a matching share award, the starting point is usually that an employee is awarded a bonus for a one-year performance period. At the end of that period, the employee may then be either required or permitted to take all or part of that bonus in shares rather than cash. To the extent that the employee takes shares rather than cash, the employing entity may then be required or permitted to make a 'matching' award of an equal number of shares (or a multiple or fraction of that number). The matching award will typically vest over a longer period.

Whilst such schemes can appear superficially similar, the accounting analysis may vary significantly, according to whether:

- The employee has a choice, or is required, to take some of the 'base' bonus in shares and whether any such shares must be retained by the employee for the matching shares to vest.
- And/or
- The employer has a choice, or is required, to match any shares taken by the employee.

The detailed accounting for such arrangements is beyond the scope of this publication but is addressed in EY's publication International GAAP®. The requirements of FRS 102 and IFRS 2 are not identical for awards where there is a choice of settlement but are closely aligned (see 11 above). However, it is expected that many companies with a matching share scheme will be part of a larger group arrangement and will potentially be able to recognise an expense based on the group expense in accordance with paragraph 16 of Section 26 (see 13.2.3.A above).

16.2 Loans to employees to purchase shares (limited recourse and full recourse loans)

Share awards to employees are sometimes made by means of so-called 'limited recourse loan' schemes. The detailed terms of such schemes vary, but typical features include the following:

- The entity makes an interest-free loan to the employee which is immediately used to acquire shares to the value of the loan on behalf of the employee.
- The shares may be held by the entity, or a trust controlled by it (see 13.3 above), until the loan is repaid.
- The employee is entitled to dividends, except that these are treated as paying off some of the outstanding loan.
- Within a given period (say, five years) the employee must either have paid off the outstanding balance of the loan, at which point the shares are delivered to the employee, or surrendered the shares. Surrender of the shares by the employee is treated as discharging any outstanding amount on the loan, irrespective of the value of the shares.

The effect of such an arrangement is equivalent to an option exercisable within five years with an exercise price per share equal to the share price at grant date less total dividends since grant date. There is no real loan at the initial stage. The entity has no right to receive cash or another financial asset, since the loan can be settled by the employee returning the (fixed) amount of equity 'purchased' at grant date.

Indeed, the only true cash flow in the entire transaction is any amount paid at the final stage if the employee chooses to acquire the shares at that point. The fact that the exercise price is a factor of the share price at grant date and dividends paid between grant date and the date of repayment of the 'loan' is simply an issue for the valuation of the option. The fair value of the option will generally need to be based on the employee's implicit right to buy the shares at a future date rather than being the share price at grant date (the face value of the loan).

The loan arrangement might have a defined period during which the employee must remain in service (five years in the example above) and during which there might also be performance conditions to be met. Where this is the case, the FRS 102 expense will be recognised by the entity over this period. However, where, as is frequently the case, such an award is subject to no future service or performance condition, i.e., the 'option' is, in effect, immediately exercisable by the employee should he choose to settle the 'loan', the cost will need to be recognised in full at grant date (see 7.1 above).

How we see it

As noted above, an arrangement with a limited recourse loan to the shares is equivalent to a share option provided to employees.

Where the limited recourse loan arrangement requires no future service or performance condition to be met by the employee, in effect, the 'option' is immediately exercisable, and the Section 26 expense is recognised in full at grant date. If the arrangement requires the employee to be in service that may include performance conditions to be met, the Section 26 expense is recognised over that period.

Under more complex arrangements, the loan to the employee to acquire the shares is a full recourse loan (i.e., it cannot be discharged simply by surrendering the shares and there can be recourse to other assets of the employee). However, the amount repayable on the loan is reduced not only by dividends paid on the shares, but also by the achievement of performance targets, such as the achievement of a given level of earnings.

The appropriate analysis of such awards is more difficult, as they could be viewed in two ways:

- Either the employer has made a loan (which the employee has chosen to use to buy a share), accounted for as a financial asset, and has then entered into a performance-related cash bonus arrangement with the employee, accounted for as an employee benefit.

Or

- The transaction is a share option where the exercise price varies according to the satisfaction of performance conditions and the amount of dividends on the shares, accounted for under Section 26.

The different analyses give rise to potentially significantly different expenses. This will particularly be the case where one of the conditions for mitigation of the amount repayable on the loan is linked to the price of the employer's equity. As this is a market condition, the effect of accounting for the arrangement under Section 26 may be that an expense is recognised in circumstances where no expense would be recognised if the arrangement were treated as an employee benefit under Section 28.

Such awards need to be carefully analysed, in the light of their particular facts and circumstances, in order to determine the appropriate treatment. Factors that could suggest that Section 26 is the more relevant would, in our view, include:

- The employee can use the loan only to acquire shares.
- The employee cannot trade the shares until the loan is discharged.
- The entity has a practice of accepting (e.g., from leavers) surrender of the shares as full discharge for the amount outstanding on the loan and does not pursue any shortfall between the fair value of the shares and the amount owed by the employee. This would tend to indicate that, in substance, the loan is not truly full recourse.

How we see it

As noted above, a loan arrangement subject to full recourse requires careful analysis of the particular facts and circumstances to determine which is the appropriate standard to apply; Section 11 and Section 12, Section 28 or Section 26, considering the factors noted above.

16.3 Awards entitled to dividends or dividend equivalents during the vesting period

Some awards entitle the holder to receive dividends on unvested shares (or dividend equivalents on options) during the vesting period.

For example, an entity might award shares that are regarded as fully vested for the purposes of tax legislation (typically because the employee enjoys the full voting and dividend rights of the shares), but not for accounting purposes (typically because the shares are subject to forfeiture if a certain minimum service period is not achieved). In practice, the shares concerned are often held by an EBT until the potential forfeiture period has expired.

Another variant of such an award that is sometimes seen is where an entity grants an employee an option to acquire shares in the entity which can be exercised immediately. However, if the employee exercises the option but leaves within a certain minimum period from the grant date, he is required to sell back the shares to the entity (typically either at the original exercise price, or the lower of that price or the market value of the share at the time of the buy-back).

Such awards do not fully vest for the purposes of Section 26 until the potential forfeiture or buy-back period has expired. The cost of such awards must therefore be recognised over this period.

This raises the question of the accounting treatment of any dividends paid to employees during the vesting period either as a charge to profit or loss as employee costs or a return on an equity instrument.

Conceptually, it could be argued that such dividends cannot be dividends for financial reporting purposes since the equity instruments to which they relate are not yet regarded as issued for financial reporting purposes. This would lead to the conclusion that dividends paid in the vesting period must be charged to profit or loss as an employment cost.

However, the charge to be made for the award under Section 26 will already take account of the fact that the recipient is entitled to receive dividends during the vesting period. Thus, it could be argued that also to charge profit or loss with the dividends paid is a form of double counting. Moreover, whilst the relevant shares may not have been fully issued for financial reporting purposes, the basic Section 26 accounting does build up an amount in equity over the vesting period. It could therefore be argued that, conceptually, if not legally, any dividend paid relates not to an issued share, but rather to the equity instrument represented by the cumulative amount that has been recorded for the award as a credit to equity and can therefore appropriately be shown as a deduction from equity.

However, this argument is valid only to the extent that the credit to equity represents awards that are expected to vest. It cannot apply to dividends paid to employees whose awards are either known not to have vested or treated as expected not to vest when applying Section 26 (since there is no credit to equity for these awards).

How we see it

When employees are entitled to dividends paid during the vesting period and reflected in the fair value of the award, we believe that the most appropriate approach is to analyse the dividends paid so that, by the date of vesting, cumulative dividends paid on awards treated by Section 26 as vested are deducted from equity and those paid on awards treated by Section 26 as unvested are charged to profit or loss. The allocation for periods prior to vesting is to be based on a best estimate of the final outcome, as demonstrated by Illustration 16-1 below.

Illustration 16-1: Award with rights to receive (and retain) dividends during vesting period

An entity grants 100 free shares to each of its 500 employees. The shares are treated as fully vested for legal and tax purposes, so that the employees are eligible to receive any dividends paid. However, the shares will be forfeited if the employee leaves within three years of the award being made. Accordingly, for the purposes of Section 26, vesting is conditional upon the employee working for the entity over the next three years. The entity estimates that the fair value of each share (including the right to receive dividends during the Section 26 vesting period) is £15. Employees are entitled to retain any dividend received even if the award does not vest.

20 employees leave during the first year, and the entity's best estimate at the end of year 1 is that 75 employees will have left before the end of the vesting period. During the second year, a further 22 employees leave, and the entity revises its estimate of total employee departures over the vesting period from 75 to 60. During the third year, a further 15 employees leave. Hence, a total of 57 employees (20 + 22 + 15) forfeit their rights to the shares during the three-year period, and a total of 44,300 shares (443 employees × 100 shares per employee) finally vest.

The entity pays dividends of £1 per share in year 1, £1.20 per share in year 2, and £1.50 in year 3.

Under FRS 102, the entity will recognise the following amounts during the vesting period for services received as consideration for the shares.

Year	Calculation of cumulative expense	Cumulative expense (£)	Expense for period (£)
1	100 shares × 425 employees × £15 × 1/3	212,500	212,500
2	100 shares × 440 employees × £15 × 2/3	440,000	227,500
3	100 shares × 443 × £15 × 3/3	664,500	224,500

On the assumption that all employees who leave during a period do so on the last day of that period (and thus receive dividends paid in that period), in our view the dividends paid on the shares must be accounted for as follows:

		£	£
Year 1	Dr. Profit or loss (employee costs) ¹	7,500	
	Dr. Equity ¹	42,500	
	Cr. Cash ²		50,000
Year 2	Dr. Profit or loss (employee costs) ³	3,300	
	Dr. Equity ³	54,300	
	Cr. Cash ⁴		57,600
Year 3	Dr. Profit or loss (employee costs) ⁵	1,590	
	Dr. Equity ⁵	67,110	
	Cr. Cash ⁶		68,700

¹ 20 employees have left and a further 55 are anticipated to leave. Dividends paid to those employees (100 shares × 75 employees × £1 = £7,500) are therefore recognised as an expense. Dividends paid to other employees are recognised as a reduction in equity.

² 100 shares × 500 employees × £1.

³ 22 further employees have left and a further 18 are anticipated to leave. The cumulative expense for dividends paid to leavers and anticipated leavers is therefore £10,800 (100 shares × 20 employees × £1 = £2,000 for leavers in year 1 + 100 shares × 40 employees × [£1 + £1.20] for leavers and anticipated leavers in year 2 = £8,800). £7,500 was charged in year 1, so the charge for year 2 is £10,800 - £7,500 = £3,300. This could also have been calculated as charge for leavers and expected leavers in current year £4,800 (100 shares × 40 [22 + 18] employees × £1.20) less reversal of expense in year 1 for reduction in anticipated final number of leavers £1,500 (100 shares × 15 [75 - 60] employees × £1.00). Dividends paid to other employees are recognised as a reduction in equity.

⁴ 100 shares × 480 employees in employment at start of year × £1.20.

⁵ 15 further employees have left. The cumulative expense for dividends paid to leavers is therefore £12,390 (£2,000 for leavers in year 1 (see 3 above) + 100 shares × 22 employees × [£1 + £1.20] = £4,840 for leavers in year 2 + 100 shares × 15 employees × [£1 + £1.20 + £1.50] = £5,550 for leavers in year 3). A cumulative expense of £10,800 (see 3 above) was recognised by the end of year 2, so the charge for year 3 is £12,390 - £10,800 = £1,590. This could also have been calculated as charge for leavers in current year £2,250 (100 shares × 15 employees × £1.50) less reversal of expense in years 1 and 2 for reduction in final number of leavers as against estimate at end of year 2 £660 (100 shares × 3 [60 - 57] employees × [£1.00 + £1.20]). Dividends paid to other employees are recognised as a reduction in equity.

⁶ 100 shares × 458 employees in employment at start of year × £1.50.

16.4 Awards vesting or exercisable on an exit event or change of control (flotation, trade sale etc.)

Entities frequently issue awards connected to a significant event such as a flotation, trade sale or other change of control of the business. It may be that an award that would otherwise be equity-settled automatically becomes cash-settled if such an event crystallises and the entity has no choice as to the method of settlement (as discussed at 11.3 above).

However, it may also be the case that an award vests only on such an event, which raises various issues of interpretation, as discussed below.

The sections below must be read together with the more general discussions elsewhere in this chapter (as referred to in the narrative below) on topics such as grant date, vesting period, vesting and non-vesting conditions and classification as equity-settled or cash-settled. References to flotation are required to be read as also including other exit events.

16.4.1 Grant date

Sometimes awards are structured so that they will vest on flotation, or so that they will vest on flotation subject to further approval at that time. For awards in the first category, grant date as defined in FRS 102 will be the date on which the award is first communicated to employees (subject to the normal requirements of Section 26 relating to a shared understanding, offer and acceptance, as discussed at 6.3 above). For awards in the second category, grant date will be at or around the date of flotation, when the required further approval is given.

This means that the cost of awards subject to final approval at flotation will generally be significantly higher than that of awards that do not require such approval. Moreover, as discussed further at 6.3 above, it may well be the case that employees begin rendering service for such awards before grant date (e.g., from the date on which the entity communicates its intention to make the award in principle). In that case, the entity would need to consider making an initial estimate of the value of the award for the purpose of recognising an expense from the date services have been provided and continually re-assess that value up until the actual grant date. As with any award dependent on a non-market vesting condition, an expense would be recognised only to the extent that the award is considered likely to vest. The classification of a requirement to float as a non-market vesting condition is discussed further at 16.4.3 below.

16.4.2 Vesting period

Many awards that vest on flotation have a time limit – in other words, the award lapses if flotation has not occurred on or before a given future date. In principle, as discussed at 7.2.3 above, when an award has a variable vesting period due to a non-market performance condition, the reporting entity is required to make a best estimate of the likely vesting period at each reporting date and calculate the Section 26 expense on the basis of that best estimate with the final cumulative charge based on the grant date fair value of the actual outcome. Such an approach appears to be taking account of a non-market performance condition in determining the fair value of an award where an award has a variable vesting period, contrary to the basic principle of paragraph 9 of Section 26. However, it is not the vesting conditions that are being taken into account *per se*, but the fact that the varying vesting periods will give rise to different lives for the award. That said, the impact of the time value of the different lives on the fair value of the award will, in many cases, be insignificant and it will therefore be a matter of judgement as to how precisely an entity switches from one fair value to another.

In practice, the likely timing of a future flotation is notoriously difficult to assess months, let alone years, in advance. In such cases, it would generally be acceptable simply to recognise the cost over the full potential vesting period until there is real clarity that a shorter period may be more appropriate. However, in making the assessment of the likelihood of vesting, it is important to take the company's circumstances into account. The likelihood of an exit event in the short- to medium-term is perhaps greater for a company owned by private equity investors seeking a return on their investment than for a long-established family-owned company considering a flotation.

It is worth noting that once an exit event becomes likely, the Section 26 expense will in some cases need to be recognised over a shorter vesting period than was originally envisaged as the probability of the exit event occurring will form the basis at the reporting date of the estimate of the number of awards expected to vest (see also the discussion at 7.2.3 and 8.6 above).

How we see it

To summarise the above, when an award has a variable vesting period due to a non-market performance condition, the reporting entity makes a best estimate of the likely vesting period at each reporting date and calculates the Section 26 charge on the basis of that best estimate, with the final cumulative expense based on the grant date fair value of the actual outcome. Judgement would need to be applied, and it is important to take the company's circumstances into account, as the likelihood of an exit event in the short- to medium-term is perhaps greater for a company owned by private equity investors seeking a return on their investment than for a long-established family-owned company considering a flotation. In addition to determining the vesting period, judgement would also be needed to determine the likelihood of vesting. Once the exit event becomes likely, the Section 26 expense may need to be recognised over a shorter vesting period than was originally envisaged as the probability of the exit event occurring will form the basis at the reporting date of the estimate of the number of awards expected to vest.

16.4.3 Is flotation or sale a vesting condition or a non-vesting condition?

There was debate in the past about whether a requirement for a flotation or sale to occur in order for an award to vest was a vesting condition or a non-vesting condition. The argument for it being a non-vesting condition was that flotation or sale may occur irrespective of the performance of the entity. The counter-argument was essentially that the price achieved on flotation or sale, which typically affects the ultimate value of the award (see 16.4.4 below), reflects the performance of the entity and is therefore a non-market performance condition (provided there is an associated service condition).

Based on discussions on the interpretation of IFRS 2 by the IASB and the IFRS IC, it appears appropriate to treat a requirement to float or be sold as a performance vesting condition rather than as a non-vesting condition, provided there is also a service condition for the duration of the performance condition. If the service period is not at least as long as the duration of the flotation or sale condition, the condition will need to be accounted for as a non-vesting condition.

How we see it

As discussed at 4.1 and 4.2 above, it is clear that a performance target period cannot extend beyond the end of the associated service period in order for the definition of a performance vesting condition to be met. Therefore, the flotation or sale condition will be treated as a non-vesting condition, rather than as a vesting condition, if the service period is not at least as long as the duration of the flotation or sale condition.

It is possible that in a share-based payment transaction a flotation or sale condition can be both a performance vesting condition and a non-vesting condition in an award that vests in instalments, 'graded vesting' (see 7.2.2 above). Where the share-based payment transaction vests in instalments and the service period is not at least as long as the duration of the flotation or sale condition, that condition will be treated as a non-vesting condition (see 4.2 above). In contrast, when the service condition is the same duration as the flotation and sale condition, that condition will be treated as non-market performance condition (see 4.1 above), this is demonstrated in Illustration 16-2 below.

Illustration 16-2: Award vesting in instalments with a flotation or sale condition

An entity issues an award to employees at the beginning of year 1 with gradual vesting over five years. The award will vest 20% in each year of service over the five-year period. In addition to the service condition there is a flotation or sale condition that must be met at the end of year 5. As discussed in section 7.2.2 above, for an award that vests in instalments, graded vesting accounting can be applied (or a simpler alternative to graded vesting accounting may be acceptable). If graded vesting accounting is applied, each instalment will be treated as five different tranches because each tranche has a different vesting period with different fair values. The flotation or sale condition will be a non-vesting condition and factored in the grant date fair value of tranches 1 to 4 as the service period is not as long as the duration of the flotation or sale condition. However, for tranche 5, the service and performance conditions are for the same duration, therefore the flotation or sale condition will be treated as a non-market performance condition and not factored into the grant date fair value but factored into the number of awards that will vest for tranche 5.

The impact of treating the flotation or sale condition differently, results in an expense being recognised for the first four tranches regardless of the flotation or sale condition being met, so long as the service condition is met, as the likelihood of not meeting the flotation or sale condition is factored into the grant date fair value. In contrast for tranche 5 if the flotation or service condition is not met but the service condition is met, no expense will be recognised as the non-market performance condition has not been met.

The flotation or sale condition even though is deemed to relate to the entity's own operations and therefore generally classified as a performance condition; it will sometimes be concluded that fulfilment of the condition is outside the control of both the entity and the counterparty. The settlement of an award in equity or cash might depend on the outcome of the condition i.e., there might be either cash- or equity-settlement that is entirely contingent on the exit event. Such contingent arrangements are discussed at 11.3 above.

16.4.4 Awards requiring achievement of a minimum price on flotation or sale

Some awards with a condition contingent on flotation (or another similar event) vest only if a minimum price per share is achieved. For example, an entity might grant all its employees share options, the vesting of which is contingent upon a flotation or sale of the shares at a price of at least £5 per share within five years, and the employee still being in employment at the time of the flotation or sale.

Taken alone, the requirement for a flotation or sale to occur is a non-market performance condition (see further below and at 16.4.3 above). However, if a minimum market price has to be achieved, the question arises as to whether, in addition to the service requirement, such an award comprises:

- A single market performance condition (i.e., float or sell within five years at a share price of at least £5).
- Or
- Two conditions:
 - A market performance condition (share price at time of flotation or sale of at least £5).
 - And
 - A non-market performance condition (flotation or sale achieved within five years).

The significance of this is the issue discussed at 7.3 above, namely that an expense must always be recognised for all awards with a market condition, if all the non-market vesting conditions are satisfied, even if the market condition is not. In either case, however, there is a market condition which needs to be factored into the valuation of the award.

If the view is that 'flotation or sale at £5 within five years' is a single market condition, the entity will recognise an expense for the award for all employees still in service at the end of the five-year period, since the sole non-market vesting condition (i.e., service) will have been met. Note that this assumes that the full five-year period is considered the most likely vesting period at grant date (see 16.4.2 above).

If, on the other hand, the view is that 'flotation or sale within five years' and 'flotation or sale share price at £5' are two separate conditions, and no flotation or sale occurs, no expense will be recognised since the performance element of the non-market vesting condition (i.e., 'flotation or sale within five years') has not been satisfied. However, even on this second analysis, if a sale or flotation is achieved at a price less than £5, an expense must be recognised, even though the award does not truly vest, since the non-market condition (i.e., 'flotation or sale within five years' with its associated service requirement) will have been met.

How we see it

In our view, the appropriate analysis in the example above is to regard 'flotation or sale within five years' and 'flotation or sale share price at £5' as two separate conditions.

The example above assumes that there is a service condition equal in duration to the other condition attached to the award and hence the analysis above only considers vesting conditions. If the fact pattern were such that there was no service condition, or a service condition that was of a shorter duration than the other conditions, then those conditions would need to be treated as non-vesting conditions rather than as performance vesting conditions.

16.4.5 Awards 'purchased for fair value'

As noted at 3.4.3 above, entities that are contemplating a flotation or trade sale may invite employees to subscribe for shares (often a special class of share) for a relatively nominal amount. In the event of a flotation or trade sale occurring, these shares may be sold or will be redeemable at a substantial premium. It is often argued that the initial subscription price paid represents the fair value of the share at the time, given the inherent high uncertainty as to whether a flotation or trade sale will in fact occur.

The premium paid on the shares in the event of a flotation or trade sale will typically be calculated in part by reference to the price achieved. The question therefore arises as to whether such arrangements fall within the scope of Section 26. It might be argued for example that, as the employee paid full fair value for the award at issue, there has been no share-based payment and, accordingly, the award is not within the scope of Section 26.

How we see it

In our view, in order to determine whether the arrangement, or a portion thereof, falls within the scope of Section 26, it is necessary to consider whether the arrangement has features that would not be expected in 'normal' equity transactions, in particular, a requirement for the holder of the shares to remain in employment until flotation or sale and/or individual buyback arrangements. If this is the case, regardless of the amount subscribed, the terms suggest that the shares are being awarded in connection with, and in return for, employee services and hence that the arrangement is within the scope of Section 26. This means that, even if the share-based payment transaction has no material fair value once the subscription price has been taken into account (and therefore gives rise to no FRS 102 expense), it will be necessary to make the disclosures required by Section 26.

Moreover, even if the amount paid by the employees can be demonstrated to be fair value for tax or other purposes, that amount would not necessarily meet the valuation requirements of Section 26. Specifically, a 'true' fair value would take into account non-market vesting conditions (such as a requirement for the employee to remain in employment until flotation or a trade sale occurs). However, a valuation for Section 26 purposes would not take such conditions into account (see 6.5 and 7.2.1 above) and would therefore typically be higher than the 'true' fair value.

Where the arrangement relates to a special class of share rather than ordinary equity shares, the underlying shares might well be classified under FRS 102 as a liability rather than as equity. However, if the redemption amount to be settled is linked to the flotation price of the 'real' equity, the arrangement will be a cash-settled share-based payment transaction under Section 26 (see 3.4.1 above).

It is common in such situations for the cost of satisfying any obligations to the holders of the special shares to be borne by shareholders rather than by the entity itself. This raises a number of further issues, which are discussed at 3.2.1 above and at 16.4.6 below.

The approach outlined in this section, i.e., that there will generally be no additional Section 26 expense to recognise when the counterparty subscribes for a share at fair value, is the approach most commonly applied in practice by entities. In this type of arrangement, the subscription price, or market value if lower, is often refundable to employees who leave employment before the shares vest.

How we see it

Where the subscription price, or market value if lower, is refundable to employees who leave employment before the shares vest, the amounts paid by the counterparty for the shares are generally classified as a liability by the entity until such time as the shares finally vest (at which point the cash paid will be treated as the proceeds of issuing shares).

16.4.6 'Drag along' and 'tag along' rights

An award might be structured to allow management of an entity to acquire a special class of equity at fair value (as in 16.4.5 above), but (in contrast to 16.4.5 above) with no redemption right on an exit event. However, rights are given:

- To any buyer of the 'normal' equity also to buy the special shares (sometimes called a 'drag along' right).
- To a holder of the special shares to require any buyer of the 'normal' equity also to buy the special shares (sometimes called a 'tag along' right).

Such schemes are particularly found in entities where the 'normal' equity is held by a provider of venture capital, which will generally be looking for an exit in the medium term.

It may well be that, under the scheme, the entity itself is required to facilitate the operation of the drag along or tag along rights, which may involve the entity collecting the proceeds from the buyer and passing them on to the holder of the special shares.

This raises the issue of whether such an arrangement is equity-settled or cash-settled. The fact that, in certain circumstances, the entity is required to deliver cash to the holder of a share suggests that the arrangement is an award requiring cash settlement in specific circumstances, the treatment of which is discussed at 11.3 above.

However, if the terms of the award are such that the entity is obliged to pass on cash to the holder of the share only if, and to the extent that, proceeds are received from an external buyer, in our view the arrangement may be economically no different to the 'broker settlement' arrangements typically entered into by listed entities.

Under such broker settlement arrangements, the entity may either sell employees' shares in the market on the employees' behalf or, more likely, arrange for a third-party broker to do so. A sale of shares on behalf of an employee is undertaken by the entity as agent and does not give rise to an increase in equity and an expense, although a share-based payment expense will be recognised for the award of shares. Such an arrangement does not of itself create a cash-settled award, provided that the entity has not created any obligation to the employees. If, however, the entity has either created an expectation among employees that it will step in to make good any lack of depth in the market or has indeed itself contracted to repurchase the shares in question, it may well mean that analysis as a cash-settled scheme is more appropriate. However, as the entity may enter into much the same transaction with a broker whether it is selling shares on its own behalf or on behalf of its employees, the challenge is for the entity to be able to demonstrate the true economic nature of the transaction.

Following on from the approach to broker settlement arrangements outlined above, an arrangement where the employees' shares are being sold to an external buyer could be regarded as equity-settled because the entity's only involvement as a principal is in the initial delivery of shares to employees. However, consideration must be given to all the factors that could suggest that the scheme is more appropriately regarded as cash-settled.

In making such an assessment, care needs to be taken to ensure that the precise facts of an arrangement are considered. For example, a transaction where the entity has some discretion over the amount of proceeds attributable to each class of shareholder might indicate that it is inappropriate to treat the entity simply as an agent in the cash payment arrangement. It might also be relevant to consider the extent to which, under relevant local law, the proceeds received can be 'ring fenced' so as not to be available to settle other liabilities of the entity.

It is also the case that arrangements that result in employees obtaining similar amounts of cash can be interpreted very differently under Section 26 depending on how the arrangement is structured and whether, for example:

- The entity is required to pay its employees cash on an exit (having perhaps held shares itself via a trust and those shares having been subject to 'drag along' rights).
- Or
- The employees themselves have held the right to equity shares on a restricted basis with vesting, and 'drag along' rights, taking effect on a change of control and the employees receiving cash for their shares.

How we see it

For 'drag along' and 'tag along' rights, if for example, there is no discretion over the amount of proceeds attributable to each class of shareholder and the entity is obliged to pass on cash received from the external buyer to the holder of the shares, in our view, the arrangement is economically no different to the broker settlement arrangements typically entered into by listed entities. This could allow the arrangement to be regarded as equity-settled as the entity's only involvement as principal is in the initial delivery of the shares. The appropriate accounting treatment in such cases requires a significant amount of judgement based on the precise facts and circumstances.

16.5 Shares used as a currency of payment

Settlement of share-based payment arrangements can take many forms, and in some instances the market value of shares is used as currency to settle the share-based payment transaction. Section 26 contains little guidance on how to measure such arrangements. Awards of equity instruments to a fixed monetary value, as discussed at 6.3.5 above, is one example where the market value of the equity instrument at vesting date is used as a currency to settle an award to a fixed value. An award issued to employees of a subsidiary or business unit which is settled by reference to the fair value of shares in another group entity is another example where the market value of shares is used as a currency to settle the share-based payment transaction (see discussion below).

16.5.1 Awards assessed on the market value of a subsidiary or business unit and settled by reference to the fair value of shares in the parent entity

Some entities implement share-based remuneration schemes which aim to reward employees by reference to the 'market' value of the equity of the business unit for which they work provided service conditions are met. This could arise where the Group considers the parent's share price to be a somewhat blunt instrument for measuring the performance of the employees of a particular subsidiary or business unit. Indeed, it is not difficult to imagine situations in which a particular subsidiary might perform well but the parent's share price might be dragged down by other factors, or conversely where the parent's share price might rise notwithstanding poor results for that subsidiary. The detail of such schemes varies, but they generally take the form as follows:

- At grant date, the employee is awarded a (real or notional) holding in the equity of the employing subsidiary, the market value of which is measured at grant date and the listed parent will convert the market value of those subsidiary shares at vesting date, into equal value of parent shares to settle the award (scenario 1).
- Or
- The employee is granted an award of as many shares of the listed parent as have a value, at a specified future date (often at, or shortly after, the end of the vesting period but sometimes at a later date), equal to the increase over the vesting period in the market value of the employee's (notional) holding in the equity of the employing subsidiary, otherwise known as share-settled share appreciation rights (akin to an option granted to the employee that is settled in the parent's shares) (scenario 2).

In the two scenarios above, the parent's shares are used as a currency to settle an arrangement with the subsidiary employees that is not dependent on the parent's share price. The share price of the parent's shares is used to determine the number of parent shares that will be issued on settlement. Put another way, the parent's share price (either at grant date or subsequently) does not affect the measurement of the award (see 6.3.5 above).

After grant date, Section 26 requires remeasurement of an equity-settled share-based payment transaction only for changes in the service condition being met and other non-market vesting conditions. There is no remeasurement after grant date for market conditions and non-vesting conditions. Therefore, an important feature in accounting for the awards in the scenarios outlined above is to assess, whether the basis on which the subsidiary's equity is valued truly yields a market price (or value) to determine the type of performance conditions attached to the awards.

If the basis on which the subsidiary's equity is valued yields a 'market value', the awards in the two scenarios are considered as containing only a service condition, and those awards would not be considered as containing a non-market vesting condition or market condition (there is no specific target share price to be achieved). The awards are measured at grant date using valuation inputs related to the subsidiary's share price and are not remeasured. The fair value at vesting date is used as a conversion feature to determine the number of parent shares to be received as an exit mechanism, and the employee is receiving 'value for value'. The expense recognised is only adjusted for the failure to meet vesting conditions other than market conditions (e.g., service conditions).

If the 'market value' of the subsidiary is based on a constant formula (e.g., an EBITDA multiple), an assessment is required whether that formula provides a good surrogate for the market value of the subsidiary on an ongoing basis (see 3.4.5 above). If deemed not to provide a good surrogate for the market value, the awards outlined in the scenarios above could then be considered as containing a non-market vesting condition as the constant formula used by the subsidiary will result in variable number of shares that will vest based on the performance of that entity (see 4.1 above). This would then result in an expense recognised that is revised at each reporting date consistent with the accounting for non-market vesting conditions. If the formula used to determine the number of parent's shares to be delivered can be determined sometime after the employee has satisfied the service vesting condition, then that formula driven condition would be treated as a non-vesting condition (see 4.2 above). In contrast to the approach used to measure the non-market vesting condition, the non-vesting condition is taken into account in estimating the fair value of the award granted and not subsequently remeasured. The expense recognised is only adjusted for the failure to meet vesting conditions other than market conditions (e.g., service conditions).

How we see it

As noted above, where the parent's shares are used as a currency to settle a share-based payment arrangement with subsidiary employees based on the subsidiary equity instrument value in the scenarios above, the measurement of the award is not affected by the parent's share price.

In addition, the arrangement is not dependent on the parent's share price.

However, an important feature in accounting for the awards in the scenarios outlined above is to assess whether the basis on which the subsidiary's equity is valued truly yields a market price (or value) to determine the type of performance conditions attached to the awards and whether the awards contain non-vesting conditions.

17 First-time adoption and transitional provisions

17.1 Transitional provisions on first-time adoption of FRS 102

Section 35 sets out the transitional provisions for first-time adoption of FRS 102 and is discussed in Chapter 37. Issues arising from the specific requirements of Section 35 in relation to share-based payment transactions are discussed below.

Subject to the special provisions outlined below, a first-time adopter is not required to apply Section 26:

- To equity instruments (including the equity component of share-based payment transactions previously treated as compound instruments) that were granted before the date of transition to FRS 102.
- To liabilities arising from share-based payment transactions that were settled before the date of transition to FRS 102. *[FRS 102.35.10(b)].*

There are special provisions for first-time adopters of FRS 102 that have previously applied IFRS 2 or FRS 101 which are discussed further below.

Where a first-time adopter has previously applied IFRS 2 or FRS 101 Reduced Disclosure Framework, it must “apply either IFRS 2 (as applicable) or Section 26 of this FRS at the date of transition” to equity instruments (including the equity component of share-based payment transactions previously treated as compound instruments) granted before the date of transition to FRS 102. Therefore, unlike the full exemption from accounting for pre-transition grants given to those first-time adopters that have not previously accounted for share-based payments, those who have previously applied IFRS 2 are required to continue accounting for ongoing awards either under the previous standard or under Section 26.

[FRS 102.35.10(b)].

How we see it

In our view, the intention is simply that an entity may complete the accounting for a pre-transition grant using the original grant date fair value and it is not intended that the application of Section 26 to such grants must necessarily result in a remeasurement. However, there is nothing in paragraph 10(b) of Section 35 to prohibit such a remeasurement (for example, as a result of applying the group allocation arrangements of paragraph 16 of Section 26).

FRS 102 and IFRS 2 are not identical for awards where there is a choice of settlement but are closely aligned (see 11 above), therefore it is less likely that the classification of a share-based payment transaction as equity-settled or cash-settled will differ depending on whether an entity is applying FRS 102 or IFRS 2. If a classification difference does still result from adoption of FRS 102, it appears that an entity could continue with the IFRS 2 classification for existing awards, even if new grants would be classified differently under FRS 102.

There is a lack of clarity in relation to certain other aspects of the requirements for those entities with share-based payments to which IFRS 2 or FRS 101 has previously been applied but where the accounting treatment of such arrangements differs, or could differ, under Section 26. For example, it is unclear whether a company which has recognised an expense for a transaction for which no apparent consideration has been received has a choice as to whether it carries on doing so (given that there is no general equivalent of paragraph 13A of IFRS 2 (see 3.2.3 above)).

18 Summary of GAAP differences

The differences between FRS 102 and IFRS are set out below.

	FRS 102	IFRS 2
Scope: Definitions and transactions within scope (see 2.1 above)	FRS 102 does not provide guidance or examples in areas such as: 1. The meaning of 'goods' in 'goods and services' when used in the definition of a share-based payment transaction. 2. Vested transactions. 3. Transactions with shareholders as a whole. 4. Interaction with accounting for financial instruments. Or 5. Contribution of a business on formation of a joint venture.	IFRS 2 has specific guidance or examples in these areas.
Recognition: Accounting after the vesting date (see 2.2.1 above)	FRS 102 includes no guidance on accounting for awards after vesting.	IFRS 2 specifically prohibits a reversal of the expense once awards have vested.
Recognition: Equity instruments vesting in instalments ('graded' vesting) (see 2.2.2 above)	FRS 102 does not explicitly require the graded vesting approach be used for equity instruments vesting in instalments.	The implementation guidance of IFRS 2 supports that the graded vesting accounting approach is applied.
Measurement of equity-settled transactions: Non-vesting conditions (see 2.3.1 above)	FRS 102 contains no definition of conditions that are not vesting conditions, but the example provided is similar to that provided for non-vesting conditions in IFRS 2.	IFRS 2 does not include a definition of a 'non-vesting condition' but includes examples of such conditions as part of the Implementation Guidance.
Employees and others providing similar services (see 2.3.2 above)	FRS 102 offers no additional guidance on the meaning of 'others providing similar services'.	This term is explained/defined in Appendix A to IFRS 2.
Valuation methodology (see 2.3.3 above)	FRS 102 draws a more explicit distinction than IFRS 2 between the valuation of shares and the valuation of options and appreciation rights. It does not mandate use of an option pricing model in the absence of market price information.	IFRS 2 requires the use of a market price or an option pricing model for the valuation of equity-settled transactions. The standard includes guidance in Appendix B about the selection and application of option pricing models.
Awards where fair value cannot be measured reliably (see 2.3.4 above)	FRS 102 contains no specific requirements and assumes that it will always be possible to fair value an award.	IFRS 2 includes an approach based on intrinsic value to be used in 'rare cases' where an entity is unable to measure fair value reliably.

FRS 102		IFRS 2
Cancellation of awards (see 2.3.5 above)	FRS 102 contains no specific requirements to mirror those in IFRS 2.	IFRS 2 makes clear that an award may be cancelled either by the entity or the counterparty and that a failure to meet non-vesting conditions must, in certain situations, be considered cancellation of an award.
Replacement awards following a cancellation or settlement (see 2.3.6 above)	FRS 102 includes no guidance on the accounting treatment of equity-settled awards to replace a cancelled award during the vesting period.	Under IFRS 2 replacement awards may be accounted for on the basis of their incremental fair value rather than being treated as a completely new award.
Share-based payment transactions with cash alternatives: Counterparty has choice of settlement in equity or cash (see 2.4.1 above)	FRS 102 requires cash-settled accounting unless there is no commercial substance to the amount of the cash settlement alternative.	IFRS 2 requires a split accounting approach, splitting the arrangement into equity-settled and cash-settled components.
Settlement of an award with cash alternatives when the entity has choice of settlement (see 2.4.2 above)	There is no guidance in FRS 102 on how to account for the settlement in equity of an award accounted for as cash-settled. FRS 102 provides guidance on how to account for the settlement in cash of an award accounted for as equity-settled, requiring an additional expense when the payment exceeds the fair value of the equity instruments that would otherwise have been issued at settlement date.	IFRS 2 does not specifically address how to account for the settlement in equity of an award accounted for as cash-settled, however other provisions in IFRS 2 provides guidance. When an award is accounted for as equity-settled, but the entity then elects the settlement alternative with the higher value at that date, the excess value provided is recognised as an additional expense.
Modification of award from equity-settled to cash-settled and vice versa (see 2.5 above)	FRS 102 contains no guidance.	IFRS 2 has no specific guidance when an equity-settled award is modified to cash-settled. IFRS 2 provides specific guidance when a cash settled award is modified to equity-settled. The equity-settled award is measured at modification date, with a credit to equity to the extent goods or services have been received, the liability is derecognised, with the difference between the carrying amount of the liability derecognised and the amount recognised in equity on modification date recognised

FRS 102		IFRS 2
		immediately in profit or loss. This accounting approach also applies when a cash-settled award is cancelled and an equity-settled granted is identified as a replacement for that cancelled cash-settled award.
Alternative accounting treatment for group plans (see 2.6 above)	Where a share-based payment award is granted by an entity to the employees of one or more group entities, those group entities are permitted, as an alternative to the measurement requirements of FRS 102, to recognise the share-based payment expense on the basis of a reasonable allocation of the group expense.	IFRS 2 has no corresponding alternative treatment.
Unidentifiable goods or services (see 2.7 above)	In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, which is consistent with IFRS 2. But Section 26 then appears to restrict the requirements for certain government-mandated plans where the goods or services received or receivable are not identifiable and requires the award to be valued on the basis of the equity instruments rather than the goods or services.	Under IFRS 2, the scope is not restricted to government-mandated plans.
Disclosures (see 2.8 above)	The disclosure requirements of FRS 102 are generally derived from, but less extensive than, those of IFRS 2. However, there are certain specific requirements that are not found in IFRS 2. There are disclosure exemptions for certain entities.	There are no exemptions from disclosure under IFRS 2.

Appendix A – Defined terms

Extract from FRS 102

Appendix I Glossary

asset	A present economic resource controlled by the entity as a result of past events.
business combination	The bringing together of separate entities or businesses into one reporting entity.
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.
cash	Cash on hand and demand deposits.
cash-settled share-based payment transaction	A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of the equity instruments (including shares and share options) of the entity or another group entity.
control	The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
equity	The residual interest in the assets of the entity after deducting all its liabilities.
equity-settled share-based payment transaction	A share-based payment transaction in which the entity: (a) receives goods or services as consideration for its own equity instruments (including shares or share options); or (b) receives goods or services but has no obligation to settle the transaction with the supplier.
expenses	Decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
fair value	fair value is the amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction. ²³²
financial position	The relationship of the assets, liabilities and equity of an entity as reported in the statement of financial position.
grant date	The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.
group	A parent and all its subsidiaries.
impracticable	Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.
liability	A present obligation of the entity to transfer an economic resource as a result of past events.

²³² [This definition of 'Fair value' is as defined in paragraph 1C of Section 26 which differs from the general definition of fair value in FRS 102 Appendix I Glossary.](#)

market vesting condition	A performance condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group), such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price (or value) of the entity's equity instruments (or the equity instruments of another entity in the same group) relative to an index of market prices of equity instruments of other entities. A market vesting condition requires the counterparty to complete a specified period of service (ie a service condition); the service requirement can be explicit or implicit.
measurement	The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.
net settlement feature	A term of a share-based payment arrangement that permits or requires the entity to withhold the number of equity instruments equal to the monetary value of the employee's tax obligation from the total number of equity instruments that otherwise would have been issued to the employee upon exercise (or vesting) of the share-based payment. Such terms may exist when tax laws or regulations oblige an entity to withhold an amount for an employee's tax obligation associated with a share-based payment and transfer that amount, normally in cash, to the tax authority on the employee's behalf.
performance condition	A vesting condition that requires: (a) the counterparty to complete a specified period of service (i.e., a service condition); the service requirement can be explicit or implicit; and (b) specified performance target(s) to be met while the counterparty is rendering the service required in (a). The period of achieving the performance target(s): (a) shall not extend beyond the end of the service period; and (b) may start before the service period on the condition that the commencement date of the performance target is not substantially before the commencement of the service period. A performance target is defined by reference to: (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group (ie a non-market vesting condition); or (b) the price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group (including shares and share options) (i.e., a market vesting condition). A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.
profit or loss	The total of income less expenses, excluding the components of other comprehensive income.
recognition	The process of capturing for inclusion in the statement of financial position or statement of comprehensive income an item that meets the definition of one of the elements of financial statements: (a) assets; (b) liabilities; (c) equity; (d) income; or (e) expenses.

	Recognition involves depicting the item in one of those statements - either alone or in aggregation with other items - in words and by a monetary amount, and including that amount in one or more totals in that statement.
reporting date	The end of the latest period covered by financial statements or by an interim financial report.
service condition	A vesting condition that requires the counterparty to complete a specified period of service during which services are provided to the entity. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, it has failed to satisfy the condition. A service condition does not require a performance target to be met.
share-based payment	The equity instruments (including shares and share options), cash or other assets to which a counterparty may become entitled in a share-based payment transaction.
share-based payment arrangement	An agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive: (a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity; or (b) equity instruments (including shares or share options) of the entity or another group entity, (c) provided the specified vesting conditions, if any, are met.
share-based payment transaction	A transaction in which the entity: (a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement; or (b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.
share option	A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specific period of time.
vest	Become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.
vesting conditions	The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions are either service conditions or performance conditions.
vesting period	The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

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Chapter 29

Impairment of assets

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Overview

Section 27 *Impairment of Assets* ('Section 27') applies to the impairment of assets and the recognition of impairment of losses, except in relation to:

- Contract assets and assets arising from costs to obtain or fulfil a contract
- Deferred tax assets
- Assets arising from employee benefits
- Financial assets within the scope of Section 11 *Basic Financial Instruments* or Section 12 *Other Financial Instruments Issues*
- Investment property measured at fair value
- Biological assets related to agricultural activity measured at fair value less costs to sell

Deferred acquisition costs and intangible assets arising from contracts within the scope of FRS 103 *Insurance Contracts*.

What you need to know

- Section 27 sets out the accounting and reporting requirements for the impairment of inventories and most non-current non-financial assets.
- For assets other than inventories, Section 27 specifies when an entity needs to perform an impairment test, how to perform it, how impairment loss and reversals are recognised, and the related disclosures.
- Section 27 requires entities to assess at each reporting date whether there is any indication that an asset may be impaired. Entities are only required to carry out an impairment test if there is an indication of impairment. An entity is not required to perform an impairment test if there is no indication of impairment.
- The purpose of the impairment test is to ensure that tangible and intangible assets, including goodwill, are not carried at a figure greater than their recoverable amount. This recoverable amount is compared with the carrying value of the asset to determine if the asset is impaired.
- Recoverable amount is defined as the higher of fair value less costs to sell (FVLCS) and value in use (VIU); the general principle being that an asset must not be carried at more than the amount it will raise, either from selling it now or from using it.
- In many cases assets will be tested for impairment at a cash generating unit ('CGU') level.
- Entities must assess inventories for impairment at the end of each reporting period. Inventories are impaired if their carrying value exceeds their selling price less costs to complete and sell. Impairment of inventories is discussed in Chapter 16 at 3.3.

1 Introduction

In principle an asset is impaired when an entity will not be able to recover that asset's balance sheet carrying value, either through use or sale. If circumstances arise which indicate assets might be impaired, a review must be undertaken of their cash generating abilities either through use (value in use) or sale (fair value less costs to sell). This review will produce an amount (recoverable amount) which is compared with the asset's carrying value. If the carrying value is higher, the difference must be written off as an impairment loss.

These principles are consistent with those under IAS 36 *Impairment of Assets*, although there are some differences in application as discussed at 2 below. The relevant provisions are set out within Section 27 *Impairment of Assets* and are discussed at 3 to 9 below.

2 Comparison between Section 27 and IFRS

2.1 Scope

The scope of Section 27 includes inventories unlike IAS 36. The requirements for impairment of inventories under IFRS are dealt with in IAS 2 *Inventories*. Differences between IAS 2 and Section 27 are discussed in Chapter 16.

The scope of Section 27 is discussed at 3.1 below.

2.2 Timing of impairment tests

On an annual basis, entities must consider whether there are indicators of impairment in respect of all assets within the scope of Section 27. Entities need only undertake a full impairment test when such indicators are found. Indicators of impairment are discussed at 4.3 below.

This differs to IAS 36, which requires annual impairment tests for goodwill, indefinite-lived intangibles and intangibles not yet available for use. [IAS 36.10].

The timing of impairment tests under Section 27 is discussed at 4.1 below.

2.3 Allocation of goodwill

Under both IAS 36 and Section 27, goodwill acquired in a business combination is allocated to each of the acquirer's CGUs that are expected to benefit from the acquisition, whether or not the acquiree's other assets or liabilities are assigned to those units. [IAS 36.80, FRS 102.27.25].

However, if it is not possible to allocate goodwill to a CGU (or group of CGUs) non-arbitrarily, Section 27 contains provisions that allow entities to test for impairment by determining the recoverable amount of either the acquired entity as a whole (if goodwill relates to a non-integrated acquired entity) or the entire group of entities, excluding non-integrated entities (if goodwill relates to an integrated entity).

[FRS 102.27.27]. IAS 36 contains no such provision. All goodwill must be allocated to a CGU (or group of CGUs).

The allocation of goodwill under Section 27 is discussed further at 5 below.

2.4 Disclosure differences

Section 27 requires less detailed disclosures than IAS 36. The specific disclosure requirements under Section 27 are discussed at 9 below.

3 Requirements of Section 27 for impairment

3.1 Objective and scope

Section 27 explains that an impairment loss occurs when the carrying amount of an asset exceeds its recoverable amount, whether that is its value in use or its fair value less costs to sell. If, and only if, the recoverable amount of an asset is less than its carrying amount, the entity must reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss. [FRS 102.27.5].

Section 27 has a general application to all assets, but certain items are outside its scope: [FRS 102.27.1]

Extract from Section 27

- 27.1** This section applies to the impairment of assets and the recognition of impairment losses except in relation to:
- (a) contract assets and assets arising from costs to obtain or fulfil a contract (see paragraphs 23.121 to 23.123);
 - (b) deferred tax assets (see Section 29 *Income Tax*);
 - (c) assets arising from employee benefits (see Section 28 *Employee Benefits*);
 - (d) financial assets within the scope of Section 11 *Basic Financial Instruments* - or Section 12 *Other Financial Instruments Issues*;
 - (e) investment property measured at fair value (see Section 16 *Investment Property*);
 - (f) biological assets related to agricultural activity measured at fair value less costs to sell (see Section 34 *Specialised Activities*); and
 - (g) deferred acquisition costs and intangible assets arising from contracts within the scope of FRS 103 *Insurance Contracts*.

A parent, in its separate financial statements, must select and adopt a policy of accounting for the following investments at either cost less impairment; at fair value with changes in fair value recognised in other comprehensive income in accordance with Section 17 *Property, Plant and Equipment*; or, at fair value with changes in fair value recognised in profit or loss: [FRS 102.9.26]

- Subsidiaries (as defined in Section 9 *Consolidated and Separate Financial Statements*)
 - Associates (as defined in Section 14 *Investments in Associates*)
- And
- Jointly controlled entities (as defined in Section 15 *Investments in Joint Ventures*)

When entities make an accounting policy choice to account for these investments at cost less impairment, they fall within scope of Section 27 for impairment purposes. Similarly, where an entity that is not a parent makes an accounting policy choice to account for their investments in associates and jointly controlled entities at cost less impairment in their individual financial statements, as permitted by Sections 14 and 15 respectively, those investments also fall within scope of Section 27. [FRS 102.14.5, FRS 102.15.10]. Section 27 also includes within its scope investments in associates and joint ventures accounted for using the equity method in the consolidated accounts of a group. [FRS 102.14.8A, FRS 102.15.13]. The requirements of Sections 9, 14 and 15 are discussed further in Chapters 8, 17 and 18.

3.2 Impairment of inventories

While Section 27 includes specific requirements relating to the impairment of inventories, readers need to refer to Chapter 16 where we have chosen to discuss those requirements together with the other principles on the recognition and measurement of inventories.

4 Impairment of assets other than inventories

4.1 General principles

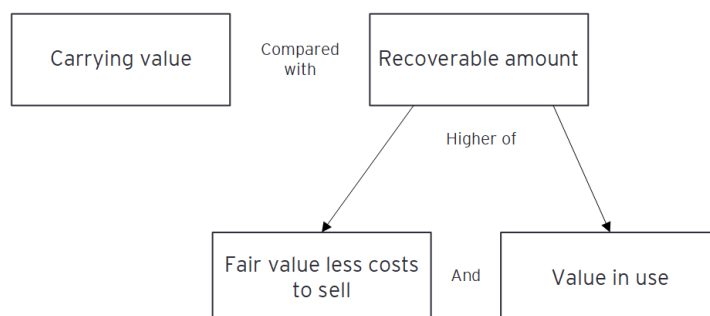
Section 27 requires entities to assess at each reporting date whether there is any indication that an asset may be impaired. Entities are only required to carry out an impairment test if there is an indication of impairment. [FRS 102.27.7].

As it might be unduly onerous for all assets in scope to be tested for impairment every year, Section 27 requires assets to be tested only if there is an indication that impairment may have occurred. If there are indications that the carrying amount of an asset may not be fully recoverable, an entity must estimate the recoverable amount. The 'indications' of impairment may relate to either the assets themselves or to the economic environment in which they are operated. Possible indicators of impairment are discussed further at 4.3 below.

The purpose of the impairment test is to ensure that tangible and intangible assets, including goodwill, are not carried at a figure greater than their recoverable amount. This recoverable amount is compared with the carrying value of the asset to determine if the asset is impaired.

Recoverable amount is defined as the higher of fair value less costs to sell (FVLCS) and value in use (VIU); the general principle being that an asset must not be carried at more than the amount it will raise, either from selling it now or from using it. [FRS 102.27.11].

Fair value less costs to sell essentially means what the asset could be sold for, having deducted costs of disposal (incrementally incurred direct selling costs). Value in use is defined in terms of discounted future cash flows, as the present value of the cash flows expected from the future use and eventual sale of the asset at the end of its useful life. As the recoverable amount is to be expressed as a present value, not in nominal terms, discounting is a central feature of the impairment test. Diagrammatically, this comparison between carrying value and recoverable amount, and the definition of recoverable amount, can be shown as follows:



It may not always be necessary to identify both VIU and FVLCS, as if either of VIU or FVLCS is higher than the carrying amount then there is no impairment and no write-down is necessary. Thus, if FVLCS is greater than the carrying amount then no further consideration need be given to VIU, or to the need for an impairment write down. The more complex issues arise when the FVLCS is not greater than the carrying value, and so a VIU calculation is necessary.

If, and only if, the recoverable amount of an asset is less than its carrying amount, the entity must reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss.

[FRS 102.27.5].

4.2 Key features of Section 27

Although an impairment test can theoretically be conducted on individual assets, this will not always be possible. Goodwill does not have a separate FVLCS at all. Even if FVLCSs can be obtained for individual items of property, plant and equipment, estimates of VIUs usually cannot be. This is because the cash flows necessary for the VIU calculation are not usually generated by single assets, but by groups of assets being used together.

Often, therefore, the impairment test cannot be done at the level of the individual asset, and it must be applied to a group of assets. Section 27 uses the term cash-generating unit (CGU) for the smallest identifiable group of assets that together have cash inflows that are largely independent of the cash inflows from other assets and that therefore can be the subject of a VIU calculation. This focus on the CGU is fundamental, as it has the effect of making the impairment test essentially a business-value test. The issue of testing individual assets or CGUs is discussed further at 4.4 below. Goodwill cannot always be allocated

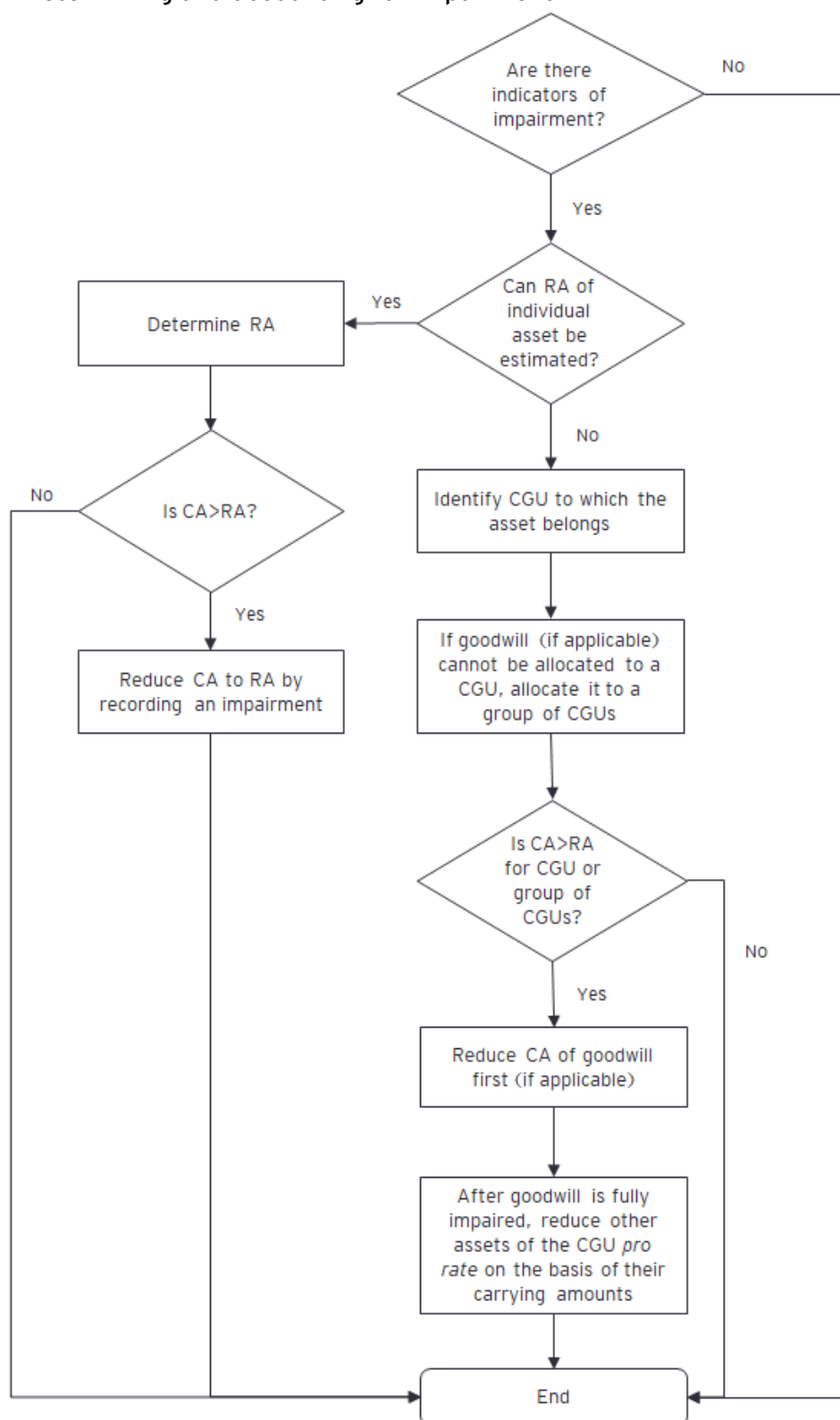
to an individual CGU, but to a group of CGUs. Section 27 has guidance in respect of the level at which goodwill is tested for impairment which is discussed in section 5 below.

Assets and CGUs need only be tested for impairment if there are indicators of impairment. The 'indications' of impairment relate to either the assets themselves or to the economic environment in which they are operated. Section 27 gives examples of indications of impairment, which entities are required to consider, but these indicators are explicitly referred to as the minimum indications an entity needs to consider, and therefore the list is not intended to be exhaustive. [FRS 102.27.9]. As such the entity may identify other indications that an asset is impaired, that would equally trigger an impairment test.

An impairment loss occurs when the carrying amount ('CA') of an asset or CGU exceeds its recoverable amount ('RA'), whether that is its value in use ('VIU') or its fair value less costs to sell ('FVLCS').

Figure 1-1 below illustrates the key stages in the process of measuring and recognising impairment losses under Section 27. The key components of the diagram are discussed in detail in the remainder of this chapter.

Figure 1-1: Determining and accounting for impairment



The entity assesses at each reporting date, whether an impairment assessment is required and acts accordingly:

- PP&E classified as investment property (see Chapter 19), except where the investment property is rented to another group company and the reporting entity chooses to apply the cost model.
- Biological assets related to agricultural activity (see Chapter 36).
- If there is an indication that an asset could be impaired, an impairment test is required.
- An asset is assessed for impairment either at an individual asset level or the level of a CGU depending on the level at which the recoverable amount can be determined, meaning the level at which largely independent cash inflows are generated.

- If the impairment test is performed at a CGU level, the entity needs to be divided into CGUs.
- After the identification of the CGUs, the carrying amount of the CGUs is determined. Note, notional adjustments to the carrying value of the CGU are required when testing non-wholly owned CGUs with goodwill (see 5.4 below).
- If goodwill cannot be allocated to CGUs on a non-arbitrary basis, then it is allocated:
 - To the acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated.
 - Or
 - To the entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated.
- The recoverable amount of the asset or CGU assessed for impairment is established and compared with the carrying amount.
- The asset or CGU is impaired if its carrying amount exceeds its recoverable amount, defined as the higher of FVLCS and VIU.
- For assets carried at cost, any impairment loss is recognised as an expense in profit or loss.
- For assets carried at revalued amount, any impairment loss is recorded first against any previously recognised revaluation gains in other comprehensive income in respect of that asset.
- Impairment losses in a CGU are first recorded against goodwill and second, if the goodwill has been written off, on a *pro rata* basis to the carrying amount of other assets in the CGU. However, the carrying amount of an asset cannot be reduced below the highest of its FVLCS, VIU or zero. If the preceding rule is applied, further allocation of the impairment loss is made *pro rata* to the other assets of the unit (group of units).
- An impairment loss for an asset other than goodwill recognised in prior periods is reversed if and only if the reasons for the impairment loss have ceased to apply. An impairment loss recognised for goodwill is not reversed.

The application of the guidance in Section 27 may require significant judgement, for example in relation to the determination of the recoverable amount. Where this does not result in a materially different outcome, simplifications and approximations are applied in practice to reduce the complexity of the exercise.

4.3 Indicators of impairment

Identifying indicators of impairment is a crucial stage in the impairment assessment process. An entity must assess at each reporting date whether there is any indication that an asset may be impaired. If any such indication exists, the entity must estimate the recoverable amount of the asset. If there is no indication of impairment, it is not necessary to estimate the recoverable amount. [FRS 102.27.7]. Section 27 gives examples of indications of impairment, but makes it clear this is not an exhaustive list. They are divided into external and internal indications.

External sources of information:

- (a) During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
- (b) Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.
- (c) Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect materially the discount rate used in calculating an asset's value in use and decrease the asset's fair value less costs to sell.
- (d) The carrying amount of the net assets of the entity is more than the estimated fair value of the entity as a whole (such an estimate may have been made, for example, in relation to the potential sale of part or all of the entity).

Internal sources of information:

- (e) Evidence is available of obsolescence or physical damage of an asset.
- (f) Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

- (g) Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. In this context economic performance includes operating results and cash flows. [FRS 102.27.9].

How we see it

While it is not specifically set out in Section 27, in our view the presence of indicators of impairment will not necessarily mean that the entity is required to calculate the recoverable amount of the asset. A previous calculation may have shown that an asset's recoverable amount was significantly greater than its carrying amount and it may be clear that subsequent events have been insufficient to eliminate this headroom. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one or more of these indicators.

Clearly there is an important judgement to be made in deciding whether an impairment review is needed. As discussed below, once triggered, an impairment review can become a complicated process with serious implications for the financial statements of an entity. Many will therefore wish to avoid performing such a process and thus may wish to argue that there has not been an indication of impairment of significant consequence. Much might depend on the judgement of matters such as whether there has been a 'significant' adverse change in the market or just an adverse change.

Section 27 also explains that if there is an indication that an asset may be impaired, this may indicate that the entity needs to also review the remaining useful life, the depreciation (amortisation) method or the residual value for the asset and adjust it in accordance with the applicable section of FRS 102 (e.g., Section 17 *Property, Plant and Equipment* and Section 18 *Intangible Assets other than Goodwill*), even if no impairment loss is recognised for the asset. [FRS 102.27.10].

The complete destruction of a non-current asset would result in the derecognition of that asset rather than an impairment. That is because the complete destruction of an asset means that no future economic benefits are expected either from its use or disposal (except for disposal benefits, e.g., from metal content in the scrap). See Chapter 20 at 3.8 for more information on the derecognition guidance in Section 17.

4.3.1 Future performance

The specific wording in (g) above makes clear that FRS 102 requires an impairment review to be undertaken if performance is or will be worse than expected. Thus Section 27 requires an impairment test to be undertaken if performance is or will be significantly below that previously budgeted. In particular, there may be indicators of impairment even if the asset is profitable in the current period if budgeted results for the future indicate that there will be losses or net cash outflows when these are aggregated with the current period results.

4.3.2 Individual assets or part of CGU?

Some of the indicators are aimed at individual fixed assets rather than the CGU of which they are a part, for example a decline in the market value of an asset or evidence that it is obsolete or damaged. Such indicators may also imply that a wider review of the business or CGU is required. However, this is not always the case. For instance, if the market value of a new head office drops below its carrying value due to a property slump, this is an indicator of impairment and may trigger a review. However, if the asset belongs to a CGU and it is clear the CGU as a whole is not impaired, it may not be necessary to re-estimate the asset's recoverable amount, even if its individual value has declined. In short, it may be irrelevant to the recoverable amount of the CGU that it contains a head office whose market value has fallen.

Similarly, if a machine has been damaged but continues to form part of a factory, being the CGU (i.e., the damage did not result in the asset's derecognition), no impairment loss will be recognised as long as the factory is not impaired.

4.3.3 Interest rates

Including interest rates as indicators of impairment could imply that assets are judged to be impaired if they are no longer expected to earn a market rate of return, even though they may generate the same cash flows as before. However, an upward movement in general interest rates will not give rise to a write-down in assets if they do not materially affect the rate of return expected from the asset or CGU itself. Although not explicitly stated in the standard, it is possible that the asset's recoverable amount is not sensitive to a particular indicator.

The discount rate used in a VIU calculation must be based on the rate specific for the asset. An entity is not required to make a formal estimate of an asset's recoverable amount if the discount rate used in calculating the asset's VIU is unlikely to be affected by the increase in market rates. For example, it is possible that the recoverable amount of an asset that has a long remaining useful life is not materially affected by increases in short-term rates. Further an entity is not required to make a formal estimate of an asset's recoverable amount if previous sensitivity analysis of the recoverable amount show that it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase to compensate for the increase in market rates. Consequently, the potential decrease in recoverable amount may simply be unlikely to result in a material impairment loss.

Geopolitical events (such as a war) can result in a significant increase in interest rates in the affected countries. This may affect an entity's discount rate when using a discounted cash flow model, as it could impact current market assessments of the time value of money and the risks specific to the asset(s) or cash-generating unit(s) for which the future cash flow estimates have not been adjusted.

4.4 Dividing the entity into cash generating units (CGUs)

If an impairment assessment is required, one of the first tasks will be to identify the individual assets affected and if those assets do not have individually identifiable and largely independent cash inflows, to divide the entity into CGUs. An asset's cash generating unit is the smallest identifiable group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [FRS 102.27.8].

The group of assets that is considered together must be as small as is reasonably practicable, i.e., the entity must be divided into as many CGUs as possible - an entity must identify the lowest aggregation of assets that generate largely independent cash inflows.

It must be emphasised that the focus is on the asset group's ability to generate cash inflows. Cash outflows or any bases for cost allocation have no relevance for the identification of CGUs.

The division cannot go beyond the level at which each income stream is 'capable' of being separately monitored. For example, it may be difficult to identify a level below an individual factory as a CGU but of course an individual factory may or may not be a CGU.

An entity can identify independent cash inflows for individual factories or other assets or groups of assets such as offices, retail outlets or assets that directly generate revenue such as those held for rental or hire. Intangible assets such as brands, customer relationships and trademarks used by an entity for its own activities are less likely to generate largely independent cash inflows and will therefore be tested together with other assets at a CGU level (see further discussion at 4.4.2).

Focusing on cash inflows avoids a common misconception in identifying CGUs. Management may seek to argue that the costs for each of their retail outlets are not largely independent because of purchasing synergies and therefore these outlets cannot be separate CGUs. However, this will not be the deciding feature. Section 27 explicitly refers to the allocation of cash outflows that are necessarily incurred to generate the cash inflows. If they are not directly attributed, cash outflows can be 'allocated on a reasonable and consistent basis'. [FRS 102.27.17(b)]. Goodwill has to be allocated to CGUs as described in section 5 below. In addition, although Section 27 does not contain any guidance in respect of 'corporate assets' (an asset that does not generate cash inflows independently of other assets or groups of assets and whose carrying amount cannot be fully attributed to one CGU), we would expect that such assets would also need to be allocated to CGUs in a similar way (see 4.5.2 below).

A practical approach to identifying CGUs involves two stages, the first being to work down to the smallest group of assets for which a stream of cash inflows can be identified. These groups of assets will be CGUs unless the performance of their cash inflow-generating assets is dependent on those generated by other assets, or *vice versa* their cash inflows are affected by those of other assets. If the cash inflows generated by the group of assets are not largely independent of those generated by other assets, the second stage is to add other assets to the group to form the smallest collection of assets that generates largely independent cash inflows. The existence of a degree of flexibility over what constitutes a CGU is obvious. The identification of cash generating units will require judgement and Section 27 itself does not give any further guidance on this area. However, under the hierarchy in Section 10 *Accounting Policies, Estimates and Errors*, users may wish to refer to the associated guidance in IAS 36.

Under IAS 36, in identifying whether cash inflows from an asset are largely independent of the cash inflows from other assets, entities are advised to consider various factors including:

- How management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas).

Or

- How management makes decisions about continuing or disposing of the entity's assets and operations. [IAS 36.69].

While monitoring by management may help identify CGUs, it does not override the requirement that the identification of CGUs is based on largely independent cash 'inflows'.

In practice, different entities will have varying approaches to determining their CGUs. While a CGU as defined in Section 27 is the smallest identifiable group of assets that generates cash inflows that are largely independent, the level of judgement involved means that there is still likely to be a reasonable degree of flexibility in most organisations. In practice, most entities may tend towards larger rather than smaller CGUs to keep the complexity of the process within reasonable bounds, but this leads to the risk that lower level impairments are avoided because poor cash flows from some assets may be offset by better ones from other assets in the CGU.

The following Illustrations show how an entity might identify their CGUs.

Illustration 4-1: Identification of CGUs - Independent cash flows

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows of other assets or groups of assets are the cash inflows generated by the five routes together. The cash generating unit for each route is the bus company as a whole.

Illustration 4-2: Identification of CGUs - Management monitoring and decision making

Scenario A - magazine titles

A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit.

Scenario B - suburban newspapers

An entity publishes 10 suburban newspapers, each with a different masthead, across 4 distinct regions within a city centre. The price paid for a purchased masthead is recognised as an intangible asset. The newspapers are distributed to residents free of charge. No newspaper is distributed outside its region. All of the revenue generated by each newspaper comes from advertising sales. An analysis of advertising sales shows that for each masthead:

- Approximately 90% of sales come from advertisers purchasing 'bundled' advertisements that appear in all those newspapers published in one particular region of the city.
 - Approximately 6% of sales come from advertisers purchasing 'bundled' advertisements that appear in all 10 newspapers in the city.
- And
- Approximately 4% of sales come from advertisers purchasing advertisements that appear in one newspaper only.

What is the CGU for an individual masthead?

Identify the smallest aggregation of assets for which a stream of cash inflows can be identified.

The fact that it is possible to use a *pro rata* allocation basis to determine the cash inflows attributable to each newspaper means that each masthead is likely to represent the smallest aggregation of assets for which a stream of cash inflows can be identified.

Are the cash inflows generated by an individual masthead largely independent of those of other mastheads and, conversely, is that individual masthead affecting the cash inflows generated by other mastheads?

As approximately 96% of cash inflows for each masthead arise from 'bundled' advertising sales across multiple mastheads, the cash inflows generated by an individual masthead are not largely independent.

Therefore, the individual mastheads would most likely need to be aggregated to form the smallest collection of assets that generates largely independent cash inflows. On the basis that approximately 90% of cash inflows for each masthead arise from 'bundled' advertising sales across all of the newspapers published in a particular region, it is likely that those mastheads published in one region will together form a CGU.

Scenario C - retail outlets

An entity has a chain of retail outlets located in the same country. The business model of the entity is highly integrated and the majority of the entity's revenue generating decisions, such as decisions about investments and monitoring of performance, are carried out at an entity level by the executive committee, with some decisions (such as product range and marketing) delegated to the regional or store levels. The majority of the operations, such as purchasing, are centralised. Management operates its business on a regional basis; but sales are monitored at the individual store level.

The outlets are usually bought and sold in packages of outlets that are subject to common economic characteristics, e.g., outlets of similar size or location such as a shopping centre or city or region. Only in rare situations has the entity sold or closed down an individual outlet.

The determining factor for CGUs is the level at which largely independent cash inflows are generated, and not the manner in which the entity's operations are organised and monitored. The fact that operations and costs are managed centrally does not in itself affect the source and independence of the cash inflows. The interdependence of cash outflows is unlikely to be relevant to the identification of CGUs.

The key issue in deciding whether CGUs must be identified at the level of the individual store as opposed to a group of stores is whether, if a store is closed down, all the customers of that store would seek out another of the entity's stores such that there is no significant 'leakage' of customers from the store closure. Unless the customers transfer their business to another of the entity's stores, the individual stores are separate CGUs.

Management in Scenario C can consider that the primary way in which they monitor their business is on a regional or segmental basis, but cash inflows are monitored at the level of an individual store. Individual stores generate independent cash inflows in most circumstances and the overriding requirement under Section 27 is that the identification of CGUs is based on largely independent cash inflows. This means that in many circumstances an entity will need to conclude that an individual store represents a separate CGU.

Scenario C discusses a traditional 'bricks and mortar' retail business. It is important to be aware that the business models of some retailers have significantly changed over recent years, and with the increased importance of internet sales will probably further change in the years ahead. Evolving 'omni-channel' business models have potential impacts on the identification of CGUs in the retail sector which require careful consideration. For further guidance on the identification of CGUs in omni-channel business models in the retail sector, see the EY publication, International GAAP®, Chapter 21, Section 3.1. Another specific issue of particular relevance to retailers is that of so-called 'flagship stores' where questions can arise as to whether these stores are separate cash-generating units for the purpose of impairment testing, and which cash flows to include in the test. This matter is also discussed in further detail in the EY publication, International GAAP®, Chapter 21, Section 3.6.

4.4.1 Grouping of assets

As shown in Illustration 4-3 below, it is possible that the entity is capable of identifying individual cash inflows from assets. However, as stated in 4.4 above, the process to identify a CGU is based on the presence of individually identifiable and independent cash inflows. It is possible that the individually identifiable cash inflows are not independent when the allocation of cash inflows to individual assets is solely based on a management decision.

Illustration 4-3: Identification of CGUs - grouping of assets

Scenario A - A tour operator's hotels

A tour operator owns three hotels of a similar class near the beach at a large holiday resort. These hotels are advertised as alternatives in the operator's brochure, at the same price. Holidaymakers are frequently transferred from one to another and there is a central booking system for independent travellers. In this case, the hotels can be regarded as offering genuinely substitutable products by a sufficiently high proportion of potential guests and can be grouped together as a single CGU. Effectively, the hotels are being run as a single hotel on three sites. The entity will have to bear in mind that disposal decisions can still be made on a hotel-by-hotel basis and have to weigh this appropriately in its determination of its CGUs.

Scenario B - Container ships

A shipping company operates a series of container vessels of similar size in a specific region that it considers to be a single CGU. As well as this shipping business, it has other types and regions of shipping operations where CGUs are established on an appropriate basis.

Management can identify the actual cash inflows from the individual vessels, but it determines that the following are the principal features that indicate that these container ships comprise a single CGU:

- The vessels are interchangeable within the contracts and none is on a long-term hire to any individual client.
- The pricing of the contract is not vessel specific.
- A reasonable portion of the contracts require the operator to have a certain level of capacity available, comprising multiple vessels.
- The investment, continuance and disposal decisions are made by class of vessel and not linked to the actual revenue generated by that vessel.
- The class of vessels has a clear and distinctive market and management views and makes decisions by reference to the CGU, not individual assets.

The fact that one or more of the assets could be used individually, i.e., taken out of the 'pool', would not in itself prevent the assets being considered part of a single CGU. Management concluded that, as the allocation of contracts to individual vessels is solely based on a management decision, the individual container vessel does not generate independent cash inflows. The container vessels therefore need to be tested together at a CGU level.

In Scenario B above, an analogy can be made to the conclusion in one of the illustrative examples to IAS 36, IE11-IE16, that plants B and C of entity M are part of one CGU which is illustrated in the following Illustration 4-4:

Illustration 4-4: Identification of CGUs - single product entity

Entity M produces a single product and owns plants A, B, C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold worldwide from either plant B or C. For example, B's product can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels from B and C depend on the allocation of sales between the two sites. There is no active market for A's products.

It is likely that A, B and C together, therefore M as a whole, are the smallest identifiable group of assets that generates cash inflows that are largely independent. This is due to:

- A's cash inflows depending on sales of the final product by B and C
- And
- Cash inflows for B and C depend on the allocation of the production across the two sites

As explained in 4.4.4 below, the conclusion would be different if an active market for A's product existed, resulting in A being one CGU and B and C together another CGU.

As a result of applying the methodology illustrated in Illustration 4-2 above, an entity could identify a large number of CGUs. However, it is acceptable to make reasonable approximations and one way in which entities can apply this in practice is to group together assets that are separate CGUs, but which if considered individually for impairment would not be material. Retail outlets, usually separate CGUs, can be grouped if they are all subject to the same economic circumstances and grouping them together rather than examining them individually will have an immaterial effect. However, the entity will still have to scrutinise the individual CGUs to ensure that those that it intends to sell or that have significantly underperformed are not supported by the others with which they are grouped. They would need to be identified and dealt with individually.

In practice, different entities will inevitably have varying approaches when determining their CGUs. There is judgement to be exercised in determining an income stream and in determining whether it is largely independent of other streams. Given this, entities tend towards larger rather than smaller CGUs, to keep the complexity of the process within reasonable bounds.

4.4.2 CGUs and intangible assets

The same requirements apply to testing intangible assets for impairment under Section 27 as for all other assets. The recoverable amount is the higher of the FVLCS or VIU of the individual asset or of the CGU to which the asset belongs. If the individual intangible asset's FVLCS is lower than the carrying amount and it does not generate largely independent cash inflows, the CGU to which it belongs will be reviewed for impairment.

Many intangible assets do not generate independent cash inflows as individual assets and so they are tested for impairment with other assets of the CGU of which they are part. A trademark, for example, will generate largely independent cash inflows if it is licensed to a third party but more commonly it will be part of a CGU.

If impairment is tested by reference to the FVLCS or VIU of the CGU, impairment losses, if any, will be allocated in accordance with Section 27. Any goodwill allocated to the CGU has to be written off first. After that, the other assets of the CGU, including the intangible asset, will be reduced *pro rata* based on their carrying amount (see 6.2 below). [FRS 102.27.21]. However, the carrying amount of an asset cannot be reduced below the highest of its FVLCS, VIU or zero. [FRS 102.27.22]. If the preceding rule is applied, further allocation of the impairment loss is made *pro rata* to the other assets of the unit (group of units).

[FRS 102.27.23].

If the intangible asset is no longer useable then it must be written off, e.g., an in-process research and development project that has been abandoned, so it is no longer part of the larger CGU, and its own recoverable amount is nil.

4.4.2.A Intangible assets as corporate assets

As discussed at 4.4.2 above, many intangible assets do not generate independent cash inflows as individual assets and must therefore be tested for impairment with other assets of the CGU of which they are part. However, one question an entity would need to assess beforehand, is whether the intangible asset in question might constitute a 'corporate asset' (an asset that does not generate cash inflows independently of other assets or groups of assets and whose carrying amount cannot be fully attributed to one CGU) or whether the intangible asset is a core asset to the cash-generating nature of a CGU? Section 27 provides no definition of corporate assets or specific guidance on how to deal with such assets, although they would certainly fall within its scope. Under the hierarchy in Section 10, users may consider guidance which is provided under IAS 36. Corporate assets are discussed further at 4.5.2 below.

The judgement as to whether an asset is a corporate asset or is attributed to specific CGU can have a significant impact on the level at which CGUs are identified and therefore at which level assets are assessed for impairment. A careful consideration of all facts and circumstances is required to avoid carrying out impairment tests at a level that is too high with the result of masking potential impairments.

Assume a scenario where Entity A acquires Entity B. Entity B operates in a different industry to A. The reason for the acquisition was diversification with no expected cross synergies between A's and B's operations. Entity B sells product X under a European wide well-known brand and operates across Europe. Each country has its own manufacturing site from which mainly small local companies in the same country are served. Before the acquisition, entity B concluded that every manufacturing site in each country is a separate CGU. On acquisition of Entity B an intangible asset for the brand is recorded in Entity A's group financial statements. No goodwill was recorded. At which level is Entity A required to set the CGUs for the acquired business? In this specific example, the single brand would not result in a determination that the CGU(s) of Entity B's business are at the overall level of B. There are individual production sites in each European country from which customers in the same country are served and there is no cross selling of products to customers in other European countries, therefore independent cash inflows can be identified on a country level resulting in the identification of CGUs on a country level. The treatment of the brand would follow the guidance as set out at 4.5.2 below for corporate assets.

On the other hand, if in the example above B was a professional services company operating across Europe and Entity B's brand identifies Entity B as one integrated pan-European service provider and markets itself to customers as such, the determination of CGU(s) of Entity B's business at an overall level of B including the brand can be appropriate, particularly where a majority of the customers have a presence in multiple European countries and are looking for one supplier that can serve each local presence.

As explained above, the identification of CGUs involves judgement and a careful consideration of all facts and circumstances is required.

How we see it

In our view, significant judgement can be required when making the distinction between what constitutes a corporate asset and what is a core asset to the cash-generating nature of a group of assets. This is particularly true when it comes to intangible assets. Careful consideration of all facts and circumstances is required. When it comes to intangible assets like (corporate) brands and trademarks an entity often concludes that their nature is more akin to corporate assets to avoid setting the CGU level too high with the potential risk of masking impairments.

On the other hand, an entity can have a brand driven business model and previous business acquisitions that resulted in the recognition of significant amounts of intangible assets for brands and trademarks. In such a case, an entity can conclude that the main drivers for the CGU definition are the (individual) brands and trademarks. It is important to note that this does not mean that the brands and trademarks are tested on a stand-alone basis, they would rather be the driver for the CGU identification with allocation of all other assets needed to generate the largely independent cash inflows.

4.4.3 Leased assets and CGUs

Many right-of-use assets recorded under Section 20 *Leases* will be assessed for impairment at a CGU level rather than on individual asset level. While there can be instances where leased assets generate largely independent cash inflows, many leased assets will be used by an entity as an input in its main operating activities whether these are service providing or production of goods related. If a right-of-use asset is tested on a stand-alone basis and is fully impaired, the entity would have to assess the need to recognise an additional onerous lease provision for amounts not already recognised in the lease liability.

One question that can arise, particularly in relation to real estate leases, is what the unit of account for impairment purposes is. In other words, whether the right-of-use asset(s) resulting from a lease governed by one lease contract needs to be assessed and treated consistently at the overall contract level or whether for example the usage of different areas or floors of a leased building for different purposes could result in separate right-of-use assets for impairment assessments. Next to the general principle in Section 27 on how assets contribute to the generation of independent cash inflows (individual asset or part of a CGU), the answer to this question depends on whether the lease contract is over identifiable asset(s) portions that are physically distinct and therefore could effectively be separate units of account. In making this assessment, the guidance in paragraphs 22 and 29 of Section 20 of FRS 102 (See Chapter 23 at 4.1.2 and 4.2.1) and paragraph 4 of Section 16 of FRS 102 (see Chapter 19 at 2.2) could be considered. For leased assets/buildings that are used in parts for different purposes and where these portions are physically distinct, the usage and therefore the generation of independent cash inflows will drive the considerations under Section 27. Judgement may be needed to determine the unit of account of the right-of-use asset(s), and their allocation to different CGUs. This is shown in the following Illustration:

Illustration 4-5: Identification of CGUs - leased assets

Retail store chain M leases 5 floors in a 10-storey building. The floors are used as follows by M:

- Ground floor: used for M's store X, leasehold improvements were made at the beginning of the lease
- First floor and second floor: used for M's HR and marketing department
- Third floor: originally it was planned that the space would be utilised together with the fourth floor for the payroll department, but then floor four was sub-let to a law firm
- Fourth floor: previously partially occupied by Entity M as office space, but currently unoccupied. There is no intention to sublet the space and M now expects that the floor will be empty through the end of the lease

Entity M signed one lease contract with the lessor for the five floors. The lease specifies the rent per floor, which equals the stand-alone price per floor. The building is configured in a way that every floor could be closed off, leased and used separately from the rest of the building.

As the five leased floors are used by entity M for different purposes and each floor is a physically distinguishable unit, M concluded that it needs to assess them separately in its CGU determination exercise.

In identifying CGUs for the stores, M considers whether, for example

- Internal management reporting is organised to measure performance on a store-by-store basis
- The business is run on a store-by-store profit basis or on a region/city basis

The leased ground floor is used for retail store X. The ground floor does not generate largely independent cash inflows from the store and is therefore assessed for impairment together with the store. All M's stores are in different neighbourhoods and were determined to have different customer bases. Although store X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. M therefore concluded that store X is a separate CGU.

The leased first and second floor are used for marketing and human resources corporate functions. These floors are therefore used in functions which support the entity as a whole rather than specific CGUs. As FRS 102 does not have specific guidance on the application of Section 27 for such assets, the entity has developed an accounting policy based on the requirements of IAS 36. In applying this policy, the part of the right-of-use-asset in relation to these floors is a corporate asset and is allocated on a reasonable and consistent basis to the CGUs to which it relates (see 4.5.2 below).

The leased third floor is sub-let to a law firm. M assessed under the guidance of Section 20 whether the sublease is classified as a finance lease, resulting in de-recognition of the right-of-use asset and recording of a lease receivable equal to the amount of the net investment in the lease, or an operating lease, with continuing recognition of the right-of-use asset (see Chapter 23 at 8.2). M's assessment classified the sub-lease as an operating lease. Under Section 20, M is required to apply the fair value model in Section 16 *Investment Properties* to right-of-use assets that meet the definition of investment property (unless it is applying the exemption in paragraph 16.4A(b)(ii), which would not be applicable in this example as the exemption applies only to investment property rented to another group entity). Therefore, the right of use asset relating to the third floor would be outside the scope of Section 27 and would instead be carried at fair value.

Floor four was previously partially occupied for Entity Ms own use as office space, but is unoccupied and is expected to remain so for the remainder of the lease term. M therefore determines that this part of the right-of-use asset needs to be assessed for impairment on a stand-alone basis by comparing the carrying amount with the recoverable amount (higher of VIU and FVLCD). As the floor is expected to be unoccupied through the end of the lease the VIU will be zero. The fact that M expects not to use the fourth floor or and is not looking for a tenant does not necessarily mean the FVLCD is zero. M would need to determine the fair value under consideration of Section 2A (see Chapter 10) and in addition M would need to consider the need for any accelerated depreciation.

4.4.3.A Decision to change the use of or abandon a right-of-use asset

When entities decide to change the use of or abandon right-of-use assets, they need to consider how such a decision must be assessed from a Section 27 point of view. As highlighted in 4.3 above, paragraph 9 of Section 27 states that significant changes in the manner in which an asset is used, or expected to be used, is an internal source of information for indication of impairment. The entity's decision to change the use of the right-of-use asset (or the entity's conclusion that it has no realistic alternative but to do so) would, therefore, also indicate that an asset, a group of assets or CGU(s) may be impaired. This is particularly true when a store is to be closed or where the decision impacts the level at which the right-of-use asset is assessed for impairment. The existence of an impairment indicator would require an entity to perform an impairment test for the asset or CGU.

To perform an impairment test, an entity would first need to assess at which level such an impairment test must be performed. An entity's decision to change the expected use of a right-of-use asset raises the question of whether the expected use has changed in such a way that it affects the composition of the CGU and, if it does, when this change in the CGU determination is reflected. A decision to abandon or sublease a right-of-use asset impacts the CGU identification differently depending on the nature of the asset and how it is used by the entity. For example, each retail store is often determined to be a separate CGU. In contrast, administrative offices are often tested together with other assets in a CGU or classified as corporate assets and allocated on a reasonable and consistent basis to the CGUs to which they belong.

If an entity concludes that it needs to update its CGU(s), the entity first has to assess when the expected change in use would impact the CGU determination. One important consideration is whether and when the decision to change the use has been made by the level of management that is authorised to make such decisions. This will often be executive management and/or the board of directors. In addition, it is necessary to assess whether the entity has the ability to change the use in the expected manner or whether the lessor's approval is required.

The impact of the change in use will be different depending on the timing of the decision. In particular for real estate leases used as part of a larger CGU, it is important to consider how long the right-of-use asset is expected to be used within the current CGU and, therefore, continues to support the generation of cash inflows of the CGU. In addition, entities have to take into account the length of the remaining lease term and any other facts and circumstances that are relevant to the CGU assessment. Significant judgement will often be required and can, therefore, warrant additional disclosures in the financial statements.

There may be circumstances in which it would be appropriate to test the right-of-use asset on a stand-alone basis rather than as part of its original CGU. For example, when the right-of-use asset is to be used within the original CGU for only a short period of time before the abandonment or sublease occurs, one may, depending on facts and circumstances, judge that the right-of-use asset and the CGU generate largely independent cash inflows. This would mean that the right-of-use asset has to be tested for impairment on a stand-alone basis.

The longer the time between the decision to abandon or sublease the right-of-use asset and the actual change in use occurring, the less likely it is that the decision will immediately impact the level at which any impairment assessment has to be performed. The shorter the time between making the decision and the expected change in use occurring, the more likely it is that the expected change in use currently has to be reflected in the CGU determination and the resulting impairment test. If, having considered all facts and circumstances, it is concluded that the decision will not immediately impact the level at which any impairment assessment is performed, then an entity would still need to reassess the useful lives and residual values of the affected assets.

Illustration 4-6: Decision to change the use of or abandon a right-of-use asset

Scenario A - Abandonment of a right-of-use real estate asset

Entity X ('the entity') recognises a right-of-use asset for a building that it currently occupies as office space. The entity has occupied the building for nine years and has three years remaining on the original 12-year lease. The lease does not include an option to extend or terminate the lease. The right-of-use asset was always tested for impairment as part of CGU 1 as it was not generating largely independent cash inflows. There is significant headroom (i.e., the amount by which the recoverable amount exceeds the carrying amount) in CGU 1. As such, no impairment is identified at the level of CGU 1. It is assumed that the FVLCS of the right-of-use asset is measurable. With many employees working from home, the space is used in a substantially reduced way. Immediately prior to Entity X's year-end of 31 December 20X2, its board (in conjunction with management) made a final decision to permanently cease using the space. There will be a period of five months before the entity vacates the property where the space will continue to be used by CGU 1 to facilitate the transition. Entity X is not able to sublease the space given the location, relatively short remaining lease term and market conditions for office space.

The entity concludes that the decision is an impairment trigger for the right-of-use asset at the balance sheet date as it is considered an internal indicator of impairment as per FRS 102.27.9(f). In this fact pattern, a final decision to vacate the space has been made. The period between the decision and the date at which the entity will vacate the property is short and, therefore, its contribution to the cash inflows of the CGU is not expected to be significant. As the property cannot be subleased for the remaining lease term, the entity concludes that the right-of-use asset's FVLCS is also not expected to be significant and is expected to be close to the right-of-use asset's value in use. Therefore, the entity concludes that it is appropriate to test the right-of-use asset separately from CGU 1 when the decision to vacate is made.

Scenario B - Subleasing of a right-of-use real estate asset

Entity X ('the entity') recognises a right-of-use asset for a building that it currently occupies as office space. The entity has occupied the building for nine years and has eleven years remaining on the original 20-year lease. The lease does not include an option to extend or terminate the lease. The right-of-use asset was always tested for impairment as part of CGU 1 as it was not generating largely independent cash inflows. There is significant headroom (i.e., the amount by which the recoverable amount exceeds the carrying amount) in CGU 1. As such, no impairment is identified at the level of CGU 1. It is assumed that the FVLCS of the right-of-use asset is measurable. With many employees working from home, the space is used in a substantially reduced way. Immediately prior to Entity X's year-end of 31 December 20X2, its board (in conjunction with management) made a final decision to permanently cease using the space. There will be a period of five months before the entity vacates the property where the space will continue to be used by CGU 1 to facilitate the transition. Entity X is permitted to sublease the property and has therefore engaged a property consultant who confirmed that there is a strong demand for properties in the area of the leased property.

The entity concludes that the decision is an impairment trigger for the right-of-use asset at the balance sheet date as it is considered an internal indicator of impairment as per FRS 102.27.9(f). In this fact pattern, a final decision to vacate the space has been made. The period between the decision and the date at which the entity will vacate the property is short and, therefore, its contribution to the cash inflows of the CGU are not expected to be significant, as such the VIU of the right-of-use asset will mainly be driven by the achievable sublease rental income. The entity concludes that the right-of-use asset's FVLCS is expected to be close to the right-of-use asset's value in use. Due to the short period of own use of five months, in this case the entity judges that the right-of-use asset and the CGU generate largely independent cash inflows and therefore that the right-of-use asset must be tested on a stand-alone basis for impairment.

The conclusion would likely be different, if in Scenario B the fact pattern were that the entity expected to use the right-of-use asset for another 30 months before vacating it and the start of a potential lease.

How we see it

Entities need to assess the potential impact of their decision to change the use of a right-of-use asset on their CGUs and, therefore, the level at which impairment assessments are performed. A decision to change the use of a right-of-use asset can result in the need to test the right-of-use asset on a stand-alone basis and, as such, can result in impairment. The shorter the time between the decision and the actual change in use occurring, the more likely the decision will impact the CGU identification.

4.4.4 Active markets and identifying CGUs

Although not directly addressed in FRS 102, IAS 36 stresses the significance of an active market for the output of an asset in identifying a CGU. If an active market exists for the output produced by an asset or group of assets, that asset or group of assets is identified as a cash generating unit, even if some or all of the output is used internally. [IAS 36.70]. The reason for this rule is that the existence of an active market means that the assets or CGU could generate cash inflows independently from the rest of the business by selling on the active market. Paragraph 71 of IAS 36 states “... if the entity could sell the output on an active market...”, [IAS 36.71], thereby making the ability of the entity to access the active market, and sell its output on it, an important consideration. If substantial restrictions to accessing the active market exist, then this must be considered when assessing the CGU determination. For example, if the output could not be sold on an active market without having essential infrastructure in place that would take significant time and effort to be developed, then this would impact the entity's assessment of whether there is an ability to sell on the active market.

An active market is defined in FRS 102 as one in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. [FRS 102 Appendix I].

There are active markets for many metals, energy products (various grades of oil product, natural gas) and other commodities that are freely traded.

Illustration 4-7: Identification of CGUs - Active market

Entity M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold worldwide from either B or C. For example, B's production can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels of B and C depend on the allocation of sales between the two sites. There is also an active market for A's product.

As there is an active market for its products, it is likely that A is a separate cash-generating unit. Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent.

In determining the value in use of A and B plus C, M adjusts financial budgets/forecasts to reflect its best estimate of future prices that could be achieved in arm's length transactions for A's products.

4.5 Identifying the carrying amount of CGU assets

After an entity has established its CGU(s) for the impairment assessment, it needs to determine the carrying amount of the CGU(s). Section 27 does not provide any explicit guidance on determining the carrying amount of a cash-generating unit. However, in order to perform a meaningful impairment test, the carrying amount must be determined on a basis that is consistent with the way in which the recoverable amount is determined.

A CGU is defined as the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Therefore, entities generally would not include liabilities in arriving at the carrying amount of a CGU, unless the recoverable amount of the cash-generating unit cannot be determined without taking it into account. Both FVLCS and VIU of a CGU are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised.

It is important to ensure that every asset used in generating the cash flows of the CGU being tested is included in the CGU; otherwise, an impaired CGU can appear to be unimpaired, as its carrying value would be understated by having excluded assets.

As noted above, there are exceptions to the general rule that recognised liabilities are not included in arriving at the CGU's carrying value or VIU. If the buyer would have to assume a liability if it acquired an asset or group of assets, then the FVLCS would be the price to sell the assets or group of assets and the liability together. The liability would then need to be deducted from the CGU's carrying amount and VIU. This would enable a meaningful comparison between carrying amount and recoverable amount, whether the latter is based on FVLCS or VIU.

For practical reasons the entity can determine the recoverable amount of a CGU after taking into account assets and liabilities such as receivables or other financial assets, trade payables, pensions and other provisions that are outside the scope of IAS 36 and therefore not part of the CGU. If the VIU calculation for a CGU or its FVLCS are determined taking into account these sorts of items, then it is essential that the carrying amount of the CGU is determined on a consistent basis. However, this frequently causes confusion in practice, as described at 4.5.1 below.

It is possible that other assets such as goodwill and corporate assets cannot be attributed on a reasonable and consistent basis. In the case of goodwill, Section 27 has separate rules regarding its treatment which are discussed at 5 below. Section 27 does not provide guidance on corporate assets, so entities may refer to the requirements in IAS 36 in developing their accounting policy. Corporate assets are discussed further at 4.5.2 below.

4.5.1 Consistency and the impairment test

Consistency is a very important principle when performing an impairment test. In testing for impairment entities must ensure that the carrying amount of the CGU is consistent for VIU and FVLCS calculations. In calculating VIU, or using a discounted cash flow methodology for FVLCS, entities must ensure that there is consistency between the assets and liabilities of the CGU and the cash flows taken into account, as there must also be between the cash flows and discount rate.

As stated at 4.5, there are exceptions to general rule that recognised liabilities are not included in arriving at the CGU's carrying value. If the buyer would have to assume a liability if it acquired an asset or group of assets (CGU), then the fair value less costs of disposal of the CGU would be the price to sell the assets of the CGU and the liability together, less the costs of disposal. To provide a meaningful comparison this liability must then be deducted from both the VIU and the carrying amount of the asset or group of assets (CGU).

The requirement to deduct the liability from both the CGU's carrying amount and from its VIU avoids the danger of distortion that can arise when cash flows that will be paid to settle the contractual obligation are included in the VIU discounted cash flow calculation. If the liability cash flows are included in the VIU discounted cash flow calculation, they would potentially be discounted using a different discount rate to the rate used to calculate the carrying value of the liability causing distortion.

From a practical point of view an entity could simply calculate the VIU of a CGU excluding the liability cash outflows and compare that to the CGU carrying amount excluding the liability. While this would mean that the VIU is not comparable to the FVLCS, this would not cause an issue as long as the calculated VIU is above the CGU's carrying amount, therefore providing evidence that the CGU is not impaired.

It is also accepted that an entity, for practical reasons, may determine the recoverable amount of a CGU after taking into account assets and liabilities such as receivables or other financial assets, trade payables, pensions and other provisions that are outside the scope of Section 27.

In all cases:

- The carrying amount of the CGU must be calculated on the same basis for VIU and FVLCS, i.e., including the same assets and liabilities.
- And
- It is essential that cash flows are prepared on a consistent basis to the assets and liabilities within CGUs.

In addition, some of these assets and liabilities have themselves been calculated using discounting techniques. Therefore, a danger of distortion arises resulting from differing discount rates, as discussed above.

For further discussion on points around consistency in impairment tests relating to the treatment of provisions, working capital, pensions and hedging, see the EY publication, International GAAP®.

4.5.1.A Lease liabilities under Section 20

A CGU can include a right-of-use asset recorded under Section 20. Right-of-use assets are assessed for impairment by applying Section 27.

When it comes to lease arrangements, in most cases a CGU would be disposed of together with the associated lease arrangements. FVLCS for the CGU would consider the associated lease arrangements and therefore the need to make the contractual lease payments. This would require deducting the carrying amount of the lease liabilities when determining the carrying amount of the CGU.

It is important to note that lease payments reflected in the lease liability recorded in the statement of financial position will have to be excluded from the VIU calculation. If the carrying amount of the lease liabilities is deducted to arrive at the carrying amount of the CGU, the same carrying amount of the lease liabilities would need to be deducted from the VIU. It is not appropriate to calculate the VIU on a net basis directly, through reducing the future cash flows by the lease payments as this bears the risk of distortion that will arise due to the difference in the discount rate used for the VIU calculation and the discount rate used to calculate the carrying amount of the lease liability. See 4.8.9 below for further discussion around VIU and lease payments.

4.5.2 Corporate assets

An entity may have assets that do not generate cash inflows independently of other assets or groups of assets and that contribute to more than one CGU, such as headquarters buildings or central IT facilities. The characteristics that distinguish these corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to one CGU. Section 27 provides no specific guidance on how to deal with such assets, although they would certainly fall within its scope. Under the hierarchy in Section 10, users may consider guidance which is provided under IAS 36.

Corporate assets are defined in IAS 36 as "...assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units" [IAS 36.6]. Corporate assets can include intangible assets like brands and trademarks (see 4.4.2.A above).

In order to test properly for impairment, the corporate asset's carrying value has to be tested for impairment along with the CGUs. Corporate assets therefore have to be allocated to the CGUs to which they belong and then tested for impairment along with those CGUs.

This presents a problem in the event of those assets themselves showing indications of impairment. It also raises a question of what those indications can be, in the absence of cash inflows directly relating to this type of asset. Some, but not all, of these assets can have relatively easily determinable fair values but while this is usually true of a headquarters building, it could not be said for a central IT facility. We have already noted at 4.3.2 above that a decline in value of the asset itself does not always trigger a need for an impairment test, in particular when it is obvious that the related CGUs are not showing any indications of impairment - unless, of course, management has decided to dispose of the asset. It is most likely that a corporate asset will show indications of impairment if the CGU or group of CGUs to which it relates are showing indications and this is reflected in the methodology by which corporate assets are tested.

If possible, the corporate assets are allocated to individual CGUs on a reasonable and consistent basis. This is not expanded upon in IAS 36 and affords some flexibility, although consistency is vital; the same criteria must be applied at all times. If the carrying value of a corporate asset can be allocated on a reasonable and consistent basis between individual CGUs, each CGU's impairment test is performed separately and its carrying value includes its share of the corporate asset. When allocating corporate assets, entities need to ensure there is no double counting by eliminating any intra-group charges for the use of the corporate assets from the CGU's cash flows. Some entities include a charge for the use of corporate assets rather than allocating the assets to CGUs or groups of CGUs. This is an acceptable approximation as long as entities ensure that the allocation is reasonable and that the total charge has the same NPV as the carrying amount of those assets and there is no impairment. Otherwise, there could be double counting or the omission of assets or cash outflows from CGUs, or the misallocation of impairment to the assets of the CGU. Overheads are discussed further at 4.8.7 below.

If the corporate asset's carrying value cannot be allocated on a reasonable and consistent basis to an individual CGU, IAS 36 suggests the following three steps:

- The CGU (excluding the corporate asset) is tested for impairment and any impairment is recognised.
- The smallest group of CGUs is identified to which, as a group, all or part of the carrying value of the corporate asset can be allocated on a reasonable and consistent basis. This group must include the CGU that was the subject of the first test.

- All CGUs in this group have to be tested to determine if the group's carrying value (including the allocation of the corporate asset's carrying value) is in excess of the group's recoverable amount. If it is not sufficient, the impairment loss will be allocated *pro rata* (subject to the limitation in paragraph 22 of Section 27) to all assets in the group of CGUs and the allocated portion of the corporate asset, as described at 6.2 below.

In the illustrative examples accompanying IAS 36, Example 8 has a fully worked example of the allocation and calculation of a VIU involving corporate assets. The table below is included in the example, and serves to illustrate the allocation of the corporate asset to CGUs:

Illustration 4-8: Allocation of corporate assets

An entity comprises three CGUs and a headquarters building. The carrying amount of the headquarters building of 150 is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

Calculation of a weighted allocation of the carrying amount of the headquarters building:

End of 20X0	A	B	C	Total
Carrying amount	100	150	200	450
Remaining useful life	10 years	20 years	20 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	100	300	400	800
<i>Pro rata</i> allocation of the building	(100 ÷ 800)= 12%	(300 ÷ 800)= 38%	(400 ÷ 800)= 50%	100%
Allocation of the carrying amount of the building (based on <i>pro rata</i> above)	19	56	75	150
Carrying amount (after allocation of the building)	119	206	275	600

IAS 36 does not require the allocation to be based on carrying value. In certain circumstances, financial measures such as revenue, employee numbers or a time basis are considered a valid basis.

One effect of this *pro rata* allocation process is that the amount of the head office allocated to each CGU will change as the useful lives and carrying values change. In the above example, the allocation of the head office to CGU A will be redistributed to CGUs B and C as A's remaining life shortens. Similar effects will be observed if the sizes of any other factor on which the allocation to the CGUs is made change relative to one another.

4.5.2.A Leased corporate assets

Companies frequently enter into lease arrangements on a corporate level, such as a leased corporate headquarters or leased IT equipment. Under Section 20 these lease arrangements will result in the recognition of right-of-use assets. Similar to other corporate assets, the right-of-use assets carrying values have to be tested for impairment along with the CGUs they serve. An entity will frequently need to allocate the carrying amount of corporate right-of-use assets to (groups of) CGUs when performing the impairment test. As discussed at 4.5.2 above, some entities include a charge for the use of corporate assets rather than allocating the assets to CGUs or groups of CGUs.

4.6 Measuring recoverable amount

Section 27 requires the carrying amount to be compared with the recoverable amount when there is an indicator of impairment. The recoverable amount of an asset or a CGU is the higher of its fair value less costs to sell and its value in use. [FRS 102.27.11]. If either the FVLCS or the VIU is higher than the carrying amount, the asset is not impaired and it is not necessary to estimate the other amount. [FRS 102.27.12].

The recoverable amount is calculated for an individual asset, unless that asset does not generate cash inflows that are largely independent of those from other assets or groups of assets, in which case the recoverable amount must be estimated for the CGU to which the asset belongs. [FRS 102.27.8].

VIU is defined as the present value of the future cash flows expected to be derived from an asset or CGU. FVLCS is defined as the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Estimating the VIU of an asset involves estimating the future cash inflows and outflows that will be derived from the continuing use of the asset and from its ultimate disposal, and discounting them at an appropriate rate. [FRS 102.27.15]. There can be complex issues involved in determining the relevant cash flows and choosing a discount rate and these are discussed at 4.8 below.

FVLCS is a measurement based on fair value, applying the guidance in Section 2A *Fair Value Measurement*. [FRS 102.27.14]. The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date. When an unadjusted quoted price is not available, the price of a recent orderly transaction between market participants for an identical or comparable asset or liability provides evidence of fair value. However, this price may not be a reliable estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of the transaction, and the measurement date. If neither a quoted price nor a recent price for a comparable asset is available, management must estimate FVLCS using another valuation technique. [FRS 102.2A.15]. This can be a complex process as discussed at 4.7 below.

Section 27 mentions circumstances in which it may be appropriate to use an asset or CGU's FVLCS without calculating its VIU, as the measure of its recoverable amount. There may be no reason to believe that an asset's VIU materially exceeds its FVLCS, in which case the asset's FVLCS may be used as its recoverable amount. [FRS 102.27.13]. This is the case, for example, if management is intending to dispose of the asset or CGU, and apart from its disposal proceeds there will be few if any cash flows from further use.

It is not uncommon for the FVLCS of an asset to be readily obtainable while the asset itself does not generate largely independent cash inflows, as is the case with many property assets held by entities. If the FVLCS of the asset is lower than its carrying value then the recoverable amount (which means the higher of FVLCS and VIU) will have to be calculated by reference to the CGU of which the asset is a part. However, as explained at 4.3.2 above, it may be obvious that the CGU to which the property belongs has not suffered an impairment. In such a case it would not be necessary to assess the recoverable amount of the CGU.

4.7 Fair value less costs to sell ('FVLCS')

Section 2A specifies how to measure fair value but does not change when fair value is required or permitted under FRS 102. Section 2A is discussed in detail in Chapter 10.

FRS 102 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. [FRS 102 Appendix I]. When measuring FVLCS, fair value is measured in accordance with Section 2A.

Fair value, like FVLCS, is not an entity-specific measurement but is focused on market participants' assumptions for a particular asset or liability. [FRS 102.2A.3]. For non-financial assets, fair value has to take account of the highest and best use by a market participant to which the asset could be put. [FRS 102.2A.9]. An entity's current use of a non-financial asset is presumed to be its highest and best use unless market or other factors suggest that a different use by market participants would maximise the value of the asset. [FRS 102.2A.11].

Whilst Section 2A makes it clear that transaction costs are not part of a fair value measurement, in all cases, FVLCS must take account of estimated disposal costs. These include legal costs, stamp duty and other transaction taxes, costs of moving the asset and other direct incremental costs. Costs to sell must not include factors that have already been taken into account when determining the fair value of an asset. [FRS 102.2A.14A]. We would not expect business reorganisation costs and employee termination costs to be treated as costs of disposal.

If the disposal of an asset would entail the buyer assuming a liability and there is only a single FVLCS for both taken together, then, to enable a meaningful comparison, the obligation must also be taken into account in calculating VIU and the carrying value of the asset. This is discussed at 4.5.1 above.

4.7.1 Estimating fair value less costs to sell

Section 2A does not prescribe the valuation techniques an entity must use to measure fair value, but requires that that entities select techniques that are 'appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of inputs determined by reference to a market price in an active market'. An active market is a market in which transactions take place with sufficient frequency and volume to provide pricing information on an ongoing basis. [FRS 102 Appendix I]. Section 2A requires that the following methodology be applied to estimate fair value:

- (a) The best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date.

- (b) When an unadjusted quoted price is not available, entities will refer to the price of a recent orderly transaction between market participants for an identical or comparable asset or liability as evidence of fair value. However, Section 2A explains that this price may not be a reliable estimate if there has been a significant change in economic circumstances or a significant period of time between the date of the transaction, and the measurement date.
- (c) If neither (a) nor (b) are available or reliable, fair value must be estimated using another valuation technique, with the objective being to estimate the price at which an orderly transaction would take place between market participants at the measurement date. [FRS 102.2A.15].

Under this methodology, when there is no quoted price for an identical or comparable asset, an entity refers to the price of a recent orderly transaction between market participants for an identical or comparable asset or liability. [FRS 102.2A.15]. If the entity has only recently acquired the asset or CGU in question then it may be able to demonstrate that its purchase price remains an appropriate measure of FVLCS, although it would have to make adjustments for material costs to sell.

To rely on the outcome of a recent transaction for an identical or comparable asset by a third party, the following conditions are considered:

- The transaction needs to be in the same industry, unless the asset is generic and its fair value would not be affected by the industry in which the purchaser operates.
 - The economic environment of the entity needs to be similar to the environment in which the previous sale occurred (e.g., no material circumstances have arisen since the earlier transaction that affect the value of the asset). This means that previous transactions are particularly unreliable if markets are falling.
- And
- The period of time between the date of the transaction and the measurement date cannot be significant.

Where it is necessary under the above methodology to use another valuation technique to estimate fair value, any valuation technique can be applied, provided it is consistent with one of the three valuation approaches in the standard: the market approach, the cost approach and the income approach.

[FRS 102.2A.16]. Section 2A does not place any preference on the techniques that are used as long as the entity achieves the objective of a fair value measurement. In some cases, a single valuation technique will be appropriate, while in other cases, multiple valuation techniques will need to be used. An entity must apply the valuation technique(s) consistently. A change in a valuation technique is considered a change in an accounting estimate in accordance with Section 10 *Accounting Policies, Estimates and Errors*. However, an entity need not provide the disclosures required by paragraph 10.18. [FRS 102.2A.17].

The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business. [FRS 102.2A.16]. For items within scope of Section 27, market techniques will usually involve market transactions in comparable assets or, for certain assets valued as businesses, market multiples derived from comparable transactions.

The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (i.e., current replacement cost). [FRS 102.2A.16]. It is expected to be based on what a market participant buyer would pay to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence includes physical deterioration, technological (functional) and economic obsolescence so it is not the same as depreciation under Section 17.

The income approach reflects expectations of future performance (e.g., cash flows or income and expenses). This will usually mean using a discounted cash flow technique or one of the other techniques that fall into this classification (e.g., option pricing and multi-period excess earnings methods).

[FRS 102.2A.16].

See Chapter 10 for a further discussion of these valuation approaches.

Using the approach required by Section 2A, most estimates of fair value for Section 27 purposes will use inputs that are directly or indirectly observable and inputs that are not based on observable market data but reflect assumptions used by market participants, including risk.

The objective of using a valuation technique is to establish what the transaction price would have been between market participants at the measurement date. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-determined inputs. A valuation technique would be expected to arrive at a reliable estimate of the fair value if:

- It reasonably reflects how the market could be expected to price the asset.
- And

- The inputs to the valuation technique reasonably represent market expectations and measures of the risk return factors inherent in the asset. [FRS 102.2A.19].

It is clear that in calculating FVLCS it may be appropriate to use cash flow valuation techniques such as discounted cash flows or other valuation techniques such as earnings multiples, if it can be demonstrated that they would be used by the relevant 'market participants' i.e., other businesses in the same industry; while Section 2A emphasises the need to prioritise market inputs i.e., those which are visible to all, over inputs determined by the entity itself. [FRS 102.2A.15].

When selecting and using a valuation technique to estimate FVLCS, an entity would consider all of the following:

- Relevance of the available valuation models - this may include consideration of industry practice. For example, multiples based on occupancy, revenue and EBITDA can be inputs in estimating the fair value of a hotel, but the value of an oilfield would depend on its reserves. The fair value of an oil field would include the costs that would be incurred in accessing those reserves based on the costs a market participant expects to incur instead of the entity's own specific cost structure.
- Assumptions used in the model - these are only those that other market participants would use. They are not to be based on management's uncorroborated views or information that would not be known or considered by other market participants.

And

- Whether there is reliable evidence showing that these assumptions would be taken into account by market participants. For this purpose, it may be necessary for the entity to obtain external advice.

Additionally, when markets are unstable, entities must ensure that multiples remain valid. They cannot assume that the basis underlying the multiples remains unchanged.

An entity must use the best information that is available to it and adjust its own data if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants such as an entity-specific synergy. An entity need not undertake exhaustive efforts to obtain information about market participant assumptions, but must take into account all information about market participant assumptions that is reasonably available.

A discounted cash flow technique may be used if this is commonly used in that industry to estimate fair value. Cash flows used when applying the model can only reflect cash flows that market participants would take into account when assessing fair value. This includes the type of cash flows, for example future capital expenditure, as well as the estimated amount of cash flows. For example, an entity may wish to take into account cash flows relating to future capital expenditure, which would not be permitted for a VIU calculation (see 4.8.2 below). These cash flows must be included if, and only if, other market participants would consider them when evaluating the asset. It is not permissible to include assumptions about cash flows or benefits from the asset that would not be available to or considered by a typical market participant.

It is also important to ensure that the cash flows included in the discounted cash flow model are consistent with the asset or CGU being tested. For example, if working capital balances such as trade debtors and creditors are included in the carrying value of the CGU, the cash inflows and outflows from those assets and liabilities must be included in the related cash flow projections.

The following simple Illustration shows how an entity might determine FVLCS for an asset.

Illustration 4-9: Estimating FVLCS

An entity owns two ships, one a chemical tanker designed to transport liquids for entities in the chemical industry and the other a container ship supplying the freight industry. The cash inflows for each ship are independent and as such, each ship is considered a CGU.

At the end of 20X0 the chemical tanker has a carrying value of £9,000,000 (original cost (£19,000,000; accumulated depreciation £10,000,000). The original estimate of the life of the tanker was seven years (measured from the date the tanker was first recognised by the entity) and it had an estimated residual value of £5,000,000.

Because of increased port taxes for liquid chemical consignments in the region, the entity has seen a substantial decrease in demand for use of the tanker since the prior year. The market price for the tanker in an active resale market is £6,000,000. Licence and title fees associated with selling the tanker are £200,000.

The reduction in use is an internal indicator that the tanker is impaired.

The price in an active market provides an estimate of fair value. The entity has calculated the VIU of the tanker as £4,500,000 which is lower than the resale value in an active market. Consequently, the recoverable amount of the tanker is £5,800,000 (£6,000,000 fair value less £200,000 costs to sell). The entity makes the following entries to record the impairment of the tanker:

Dr. Profit or loss (impairment of tanker)	£3,200,000
Cr. Accumulated impairment (property, plant and equipment)	£3,200,000
To recognise the impairment loss on property, plant and equipment.	

4.7.2 Effect of restrictions on fair value

When determining an asset's fair value less costs to sell, consideration must be given to any restrictions imposed on that asset. Costs to sell must also include the cost of obtaining relaxation of a restriction where necessary in order to enable the asset to be sold. If a restriction would also apply to any potential purchaser of an asset, the fair value of the asset may be lower than that of an asset whose use is not restricted.

[FRS 102.27.14A].

Where a restriction on the sale or use of an asset would apply to any potential purchaser of the asset, the effect of that restriction is taken into account in pricing the fair value of the asset. Where the restriction is specific to the entity holding the asset and so would not transfer to a potential purchaser, then that restriction would not reduce the fair value of the asset.

The following Illustration shows a situation where a certain restriction would apply to any potential purchaser of the asset concerned while a further restriction applies to the specific entity holding the asset, but not to other market participants. Only the first of these restrictions will reduce fair value when compared with an equivalent unrestricted asset.

Illustration 4-10: Restrictions on assets

A donor of land specifies that the land must be used by a sporting association as a playground in perpetuity. Upon review of relevant documentation, the association determines that the donor's restriction would not transfer to potential purchasers if the association sold the asset (i.e., the restriction on the use of the land is specific to the association). Furthermore, the association is not restricted from selling the land. Without the restriction on the use of the land, the land could be used as a site for residential development. In addition, the land is subject to an easement (a legal right that enables a utility to run power lines across the land).

Under these circumstances, the effect of the restriction and the easement on the fair value measurement of the land is as follows:

- Donor restriction on use of land - The donor restriction on the use of the land is specific to the association and thus would not apply to potential purchasers. Therefore, a market participant would not take this restriction into consideration when pricing the land and fair value might therefore be based on a residential development.
- Easement for utility lines - Because the easement for utility lines would apply to any potential purchaser, the fair value of the land would include the effect of the easement, regardless of whether the land's valuation premise is as a playground or as a site for residential development.

4.8 Value in use ('VIU')

Value in use ('VIU') is defined as the present value of the future cash flows expected to be derived from an asset or cash-generating unit. [FRS 102 Appendix I].

The calculation of VIU involves the following steps: [FRS 102.27.15]

- Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal.

And

- Applying the appropriate discount rate to those future cash flows.

The following extract from Section 27 states the required elements an entity would need to reflect in the VIU calculation: [FRS 102.27.16]

Extract from Section 27

- 16** The following elements shall be reflected in the calculation of an asset's value in use:
- (a) an estimate of the future cash flows the entity expects to derive from the asset;
 - (b) expectations about possible variations in the amount or timing of those future cash flows;
 - (c) the time value of money, represented by the current market risk-free rate of interest;
 - (d) the price for bearing the uncertainty inherent in the asset; and
 - (e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Uncertainty as to the timing of cash flows or the market's assessment of risk in the assets ((b), (d) and (e) above) must be taken into account either by adjusting the cash flows or the discount rate. Specifically, the discount rate used to measure an asset's VIU must not reflect risks for which the future cash flow estimates have been adjusted, to avoid double counting. [FRS 102.27.20]. The intention is that the VIU represents the expected present value of those future cash flows.

If possible, recoverable amount is calculated for the individual asset. However, if it is not possible to estimate the recoverable amount of an individual asset, the entity estimates the recoverable amount of the CGU to which the asset belongs. [FRS 102.27.8]. This will frequently be necessary because:

- The single asset may not generate sufficiently independent cash inflows, as is often the case.
- And
- In the case of the possible impairment of a single asset, FVLCS will frequently be lower than the carrying amount.

Goodwill cannot be tested by itself, so must always be tested as part of a CGU or group of CGUs (see 5 below). [FRS 102.27.24].

Where a CGU is being reviewed for impairment, this will involve calculation of the VIU of the CGU as a whole unless a reliable estimate of the CGU's FVLCS can be made and the resulting FVLCS is above the total of the CGU's net assets.

VIU calculations at the level of the CGU will thus be required when no satisfactory FVLCS is available or FVLCS is below the CGU's carrying amount and:

- Goodwill is suspected of being impaired.
- A CGU itself is suspected of being impaired.

Or

- Individual assets are suspected of being impaired and individual future cash flows cannot be identified for them.

In order to calculate VIU there are a series of steps to follow, as set out below. Within each step, we must discuss the practicalities and difficulties in determining the VIU of an asset. The steps in the process are:

- 1: Dividing the entity into CGUs (at 4.4 above).
- 2: Allocating goodwill to CGUs or groups of CGUs (see 5.1 below).
- 3: Identifying the carrying amount of CGU assets (see 4.5 above).
- 4: Estimating the future pre-tax cash flows of the CGU under review (at 4.8.1-4.8.10 below).
- 5: Identifying an appropriate discount rate and discounting the future cash flows (at 4.8.11 below).
- 6: Comparing carrying value with VIU and recognising impairment losses (at 6 below).

Although this process describes the determination of the VIU of a CGU, steps 4 to 6 are the same as those that would be applied to an individual asset if it generated cash inflows independently of other assets.

Illustration 4-11 shows a simple example of how an entity would calculate the VIU of an individual asset following the principles set out at 4.8.1-4.8.10 below.

Illustration 4-11: Estimating value in use

Entity A manufactures an electrical component using a specialised machine. During 20X0, one of Entity A's competitors starts producing an alternative component using a less expensive material. The competitor is able to market their product at a lower cost than Entity A and so sales of Entity A's product fall sharply.

Entity A's specialised machine cannot be modified to work with this cheaper material and so at the end of 20X0 they test the machine for impairment. The machine was bought five years ago for £300,000 when its useful life was estimated to be 15 years and the estimated residual value was nil. At 31 December 20X0, after recognising the depreciation charge for 20X0, the machine's carrying amount is £200,000 and the remaining useful life is 10 years.

The machine's VIU is calculated using a pre-tax discount rate of 14 per cent per year. Budgets approved by management reflect estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition.

Assume for simplicity, expected future cash flows occur at the end of the reporting period. An estimation of the VIU of the machine at the end of 20X0 is shown below:

Year	Probability-weighted future cash flow	Present value factor 14% ¹	Discounted cash flow
	£		£
20X1	19,949	0.877193	17,499
20X2	19,305	0.769468	14,855
20X3	18,084	0.674972	12,206
20X4	21,016	0.592080	12,443
20X5	20,767	0.519369	10,786
20X6	19,115	0.455587	8,709
20X7	17,369	0.399637	6,941
20X8	16,596	0.350559	5,818
20X9	14,540	0.307508	4,471
20Y0 ²	12,568	0.269744	3,390
Value in use			<u>97,118</u>

¹ The present value factor is calculated as $1/(1+i)^n$ where i is the discount rate and n is the number of periods of discount e.g., for 20Y0 the present value factor is calculated as follows: $1/(1.14)^{10} = 1/3.707221 = 0.269744$.

² The expected future cash flow for year 20Y0 includes £2,500 expected to be paid for the disposal of the asset at the end of its useful life. The residual value is nil because it is expected that the machine will be scrapped at the end of 20Y0.

Assuming that the FVLCS is lower than VIU (and thus VIU is the recoverable amount), the calculation of the impairment loss at the end of 20X0 is as follows:

Carrying amount before impairment loss	£200,000
Less recoverable amount	<u>(£97,118)</u>
Impairment loss	<u>£102,882</u>
Carrying amount after impairment loss	<u>£97,118</u>

As a consequence of the impairment loss recognised at 31 December 20X0, the carrying amount of the machine immediately after the impairment recognition is equal to the recoverable amount of the machine i.e., £97,118. In this case, in subsequent periods, assuming all variables remain the same as at the end of 20X0, the depreciable amount will be £97,118, so the depreciation charge will be £9,712 per year.

4.8.1 Estimating the future pre-tax cash flows of the CGU under review

In measuring value in use, the entity needs to estimate the future cash flows that it will derive from its use and consider possible variations in their amount or timing.

Unlike IAS 36, Section 27 does not mandate that cash flow projections be based on the most recent financial budgets/forecasts approved by management. However, the standard states that entities “may wish to use any recent financial budgets or forecasts to estimate the cash flows, if available”, and in practice, this is the approach we expect to see where such budgets/forecasts are available (also see 4.8.10 below).

However, it must be noted that significant adjustments to the cash flows in the budgets/forecasts can be required to ensure the resulting future cash flows satisfy the requirements of the Section 27. For example, it is necessary to exclude lease payments included in lease liabilities (see 4.8.9) and cash flows that are expected to arise from improving or enhancing the asset’s performance (see 4.8.2). Depending on the entity’s facts and circumstances, these adjustments can require significant effort and judgement. It is important for entities to consider materiality when determining the extent to which the task can be simplified.

In addition, whilst cash flow projections based on the most recent financial budgets/forecasts approved by management will typically be the most appropriate start point, it is usually appropriate and required to revise forecasts where the economic environment or conditions have changed since the most recent financial budgets and forecasts were approved by management (see 4.8.10 below).

This stage of the impairment test illustrates the point that it is not only fixed assets that are being assessed. The future cash flows to be forecast are all cash flows - receipts from sales, purchases, administrative expenses, etc. It is akin to a free cash flow valuation of a business with the resulting valuation then being compared to the carrying value of the assets in the CGU.

As explained in the following standard extract, the cash flow forecast must include three elements:
[FRS 102.27.17]

Extract from Section 27

- 33** In measuring value in use estimates of future cash flows shall include:
- (a) projections of cash inflows from the continuing use of the asset;
 - (b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and
 - (c) net cash flows, if any, expected to be received (or paid) for the disposal of the asset at the end of its useful life in an arm’s length transaction between knowledgeable, willing parties.
- The entity may wish to use any recent financial budgets or forecasts to estimate the cash flows, if available. To estimate cash flow projections beyond the period covered by the most recent budgets or forecasts an entity may wish to extrapolate the projections based on the budgets or forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified.

As noted at 4.8 above, uncertainties as to the timing of cash flows or the market’s assessment of risk in the assets must be taken into account *either* by adjusting the cash flows or the discount rate. Entities must take care to avoid double counting. [FRS 102.27.20]

Although not specified in Section 27, our normal expectation would be for entities to apply a similar rule of thumb to that under IAS 36, being the application of a five-year maximum, for the period before which a steady or declining growth rate could be assumed. This five-year rule is based on general economic theory that postulates above-average growth rates will only be achievable in the short-term, because such above-average growth will lead to competitors entering the market. This increased competition will, over a period of time, lead to a reduction of the growth rate, towards the average for the economy as a whole.

Cash flows can be estimated by taking into account general price changes caused by inflation (nominal terms), or on the basis of stable prices (real terms). If inflation is excluded from the cash flow then the discount rate selected must also be adjusted to remove the inflationary effect. Generally entities will use whichever method is most convenient to them and that is consistent with the method they use in their budgets and forecasts. It is, of course, fundamental that cash flows and discount rate are both estimated on a consistent basis.

The expected future cash flows of the CGU being assessed for impairment must not include cash inflows or outflows from financing activities (including lease payments included in lease liabilities) or tax receipts or payments (see 4.8.3 below).

4.8.2 Cash inflows and outflows from restructuring and improvements

While cash flow projections must include costs of day-to-day servicing, future cash flows are estimated for the asset in its current condition. Estimates of future cash flows must not include estimated future cash inflows or outflows that are expected to arise from: [FRS 102.27.19]

- A future restructuring to which an entity is not yet committed.

Or

- Improving or enhancing the asset's performance.

While the restriction on enhanced performance may be understandable, it adds an element of unreality that is hard to reconcile with other assumptions made in the VIU calculation process. For example, the underlying forecast cash flows an entity uses in its VIU calculation are likely to be based on the business as it is actually expected to develop in the future, growth, improvements and all. Producing a special forecast based on unrealistic assumptions, even for this limited purpose, may be difficult.

Nevertheless, Section 27 explicitly states that projected cash flows must not include expenditure to improve or enhance performance of an asset. [FRS 102.27.19]. The implication of this requirement is that if an asset is impaired the asset will still have to be written down even if the entity is going to make the future expenditure to reverse that impairment. Subsequently, the asset's impairment can be reversed, to the degree appropriate, after the expenditure has taken place. Reversal of asset impairment is discussed at 7 below.

Section 27 does not specifically address the treatment of part completed assets when determining VIU. In contrast, IAS 36 makes it clear that for a part-completed asset, all expected cash outflows required to make the asset ready for use or sale must be considered in the estimate of future cash flows and mentions a building under construction or a development project as examples. [IAS 36.42]. A similar approach would generally be expected under Section 27. Both Section 27 and IAS 36 are clear that the estimate of future cash flows must not include the estimated future cash inflows that are expected to arise from the increase in economic benefits associated with cash outflows to improve or enhance an asset's performance until an entity incurs these cash outflows. [IAS 36.48]. This raises the question of what to do once a project to enhance or improve the performance of an asset or a CGU has commenced, and it has started to incur cash outflows.

How we see it

In our view, once an entity is committed to a future restructuring or an asset is under construction (but not yet ready for use or sale), an entity must consider future cash inflows that are expected to arise from the increase in economic benefits associated with the cash outflows to improve or enhance the asset. Important to note is that it must take into consideration all future cash outflows required to complete the project and any risks in relation with the project, reflected either in the cash flows or the discount rate.

An assumption of new capital investment is in practice intrinsic to the VIU test. What has to be assessed are the future cash flows of a productive unit such as a factory or hotel. The cash flows, out into the far future, will include the sales of product, cost of sales, administrative expenses, etc. They must necessarily include capital expenditure as well, at least to the extent required to keep the CGU functioning as forecast in its current condition.

Accordingly, some capital expenditure cash flows must be built into the forecast cash flows. Whilst improving capital expenditure may not be recognised, routine or replacement capital expenditure necessary to maintain the level of economic benefits expected to arise from the asset (or CGU) in its current condition has to be included. Entities must therefore distinguish between maintenance, replacement and enhancement expenditure. This distinction may not be easy to draw in practice, as shown in the following Illustration.

Illustration 4-12: Distinguishing enhancement and maintenance expenditure

A telecommunications company provides fixed line, telephone, television and internet services. It must develop its basic transmission infrastructure (overhead wires or cables along streets or railway lines etc.) and in order to service a new customer it will have to connect the customer's home via cable and other equipment. It will extend its network to adjoining areas and perhaps acquire an entity with its own network. It will also reflect changes in technology, e.g., fibre optic cables replacing copper ones.

Obviously, when preparing the budgets which form the basis for testing the network for impairment, it will make assumptions regarding future revenue growth and will include the costs of connecting those customers. However, its infrastructure maintenance spend will inevitably include replacing equipment with the current technology. There is no option of continuing to replace equipment with something that has been technologically superseded. Once this technology exists it will be reflected in the entity's budgets and taken into account in its cash flows when carrying out impairment tests, even though this new equipment will enhance the performance of the transmission infrastructure.

Further examples indicate another problem area - the effects of future expenditure that the entity has identified but which the entity has not yet incurred. An entity may have acquired an asset with the intention of enhancing it in future and may, therefore, have paid for future synergies which will be reflected in the calculation of goodwill. Another entity may have plans for an asset that involve expenditure that will enhance its future performance and without which the asset may be impaired.

Examples could include:

- A social media company that, in acquiring another, would expect to pay for the future right to migrate customers from the competing platform to its own platform.
- Or
- An aircraft manufacturer that expects to be able to use one of the acquired plants for a new model at a future point, a process that will involve replacing much of the current equipment.

In both cases the long-term plans reflect both the capital spent and the cash flows that will flow from it. There is no obvious alternative to recognising an impairment when calculating the CGU or CGU group's VIU as Section 27 states that the impairment test has to be performed for the asset in its current condition. This means that it is not permitted to include the benefit of improving or enhancing the asset's performance in calculating its VIU.

An entity in this situation may attempt to avoid an impairment write down by calculating the appropriate FVLCS, as this is not constrained by rules regarding future capital expenditure. As discussed above, these cash flows can be included only to the extent that other market participants would consider them when evaluating the asset. It is not permissible to include assumptions about cash flows or benefits from the asset that would not be available to or considered by a typical market participant.

Section 27 contains similar rules with regard to any future restructuring that may affect the VIU of the asset or CGU. The prohibition on including the results of restructuring applies only to those plans to which the entity is not committed. This is because of the general rule that the cash flows must be based on the asset in its current condition so future events that may change that condition must not be taken into account. [FRS 102.27.19]. When an entity becomes committed to a restructuring Section 27 then allows an entity's estimates of future cash inflows and outflows to reflect the cost savings and other benefits from the restructuring, based on the most recent financial budgets/forecasts approved by management.

As is the case for improvement expenditure above, entities will sometimes be required to recognise impairment losses on assets or CGUs that will be reversed once the expenditure has been incurred and the restructuring completed.

4.8.3 Financing and taxation

Estimates of future cash flows must not include: [FRS 102.27.18]

- Cash inflows or outflows from financing activities.
- Or
- Income tax receipts or payments.

The first of these exclusions is required because the discount rate applied to the cash flow projections represents the associated financing costs (so to include financing cash flows would be double counting this effect). For consistency, generally, financial liabilities are excluded from the carrying amount of the CGU, although there are exceptions, for example, lease liabilities. Consistency and the impairment test is discussed further at 4.5.1 above. Discount rates are discussed further at 4.8.11 below. Similarly, income tax receipts and payments must also be excluded on consistency grounds as Section 27 requires the use of a pre-tax discount rate to be used in the VIU calculation. [FRS 102.27.20].

4.8.4 Future cash flows after the forecast period ('terminal values')

In the case of non-current assets, a large component of value attributable to an asset or CGU arises from its terminal value, which is the net present value of all the forecast free cash flows that are expected to be generated by the asset or CGU after the explicit forecast period.

Where an asset is to be sold at the end of its useful life the disposal proceeds and costs must be based on current prices and costs for similar assets, adjusted if necessary for price level changes if the entity has chosen to include this factor in its forecasts and selection of a discount rate. The entity needs to ensure that its estimate is based on a proper assessment of the amount that would be received in an arm's length transaction.

Whether the life of an asset or CGU is considered to be finite or indefinite will have a material impact on the terminal value. It is therefore of the utmost importance for management to assess carefully the cash generating ability of the asset or CGU and whether the period over which this asset or CGU is capable of generating cash flows is defined or not. While many CGUs containing goodwill will have an indefinite life, the same is not necessarily true for CGUs without allocated goodwill. For example, if a CGU has one main operating asset with a finite life, as in the case of a mine, the cash flow period needs to be limited to the life of the mine. Whether it would be reasonable to assume that an entity would replace the principal assets of a CGU and therefore whether it would be appropriate to calculate the terminal value under consideration of cash flows into perpetuity will depend on the specific facts and circumstances.

In the case of assets or CGUs with indefinite useful lives, the terminal value is calculated by having regard to the forecast maintainable cash flows that are expected to be generated by the asset or CGU in the final year of the explicit forecast period ('the terminal year').

It is essential that the terminal year cash flows reflect maintainable cash flows as otherwise any material one-off or abnormal cash flows that are forecast for the terminal year will inappropriately increase or decrease the valuation. It is essential that the terminal year cash flows reflect maintainable cash flows as otherwise any material one-off or abnormal cash flows that are forecast for the terminal year will inappropriately increase or decrease the valuation.

The maintainable cash flow expected to be generated by the asset or CGU is then capitalised by a perpetuity factor based on either:

- The discount rate if cash flows are forecast to remain relatively constant.
- Or
- The discount rate less the long-term growth rate if cash flows are forecast to grow.

Care is required in assessing the growth rate to ensure consistency between the long-term growth rate used and the assumptions used by the entity generally in its business planning.

4.8.5 Foreign currency cash flows

The cash inflows attributable to an asset or CGU may be generated in a foreign currency. Section 27 does not provide any guidance on this issue, but under the hierarchy in Section 10, entities may wish to consider the guidance in IAS 36. IAS 36 states that foreign currency cash flows must first be estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. The entity can then translate the present value calculated in the foreign currency using the spot exchange rate at the date of the VIU calculation. [IAS 36.54].

This is to avoid the problems inherent in using forward exchange rates, which would result in double-counting the time value of money, first in the discount rate and then in the forward rate. [IAS 36.BCZ49]. However, the method requires an entity to perform, in effect, separate impairment tests for cash flows generated in different currencies but make them consistent with one another so that the combined effect is meaningful. Arriving at a suitable discount rate could be an extremely difficult exercise as many different factors need to be taken into account including relative inflation rates and relative interest rates as well as appropriate discount rates for the currencies in question. Entities may wish to engage valuers to assist them in this situation.

4.8.6 Internal transfer pricing

Section 27 does not provide any guidance on the estimation of cash flows in situations where the actual cash flows are based on internal transfer pricing.

How we see it

In our view, if the cash inflows generated by an asset or CGU are based on internal transfer pricing, management must use their best estimate of an external arm's length transaction price in estimating the future cash flows to determine the asset's or CGU's VIU.

Further guidance on the approach to internal transfer pricing in value in use calculations is included in the EY publication, International GAAP®.

4.8.7 Overheads

As noted at 4.8.1 above, when measuring VIU, entities must include projections of cash outflows that are: *[FRS 102.27.17(b)]*

- Necessarily incurred to generate the cash inflows from continuing use of the asset (or CGU).
And
- Can be directly attributed, or allocated on a reasonable and consistent basis to the asset (or CGU).

Projections of cash outflows must therefore include those for the day-to-day servicing of the asset/CGU as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset/CGU.

How we see it

In our view, all overhead costs must be considered, and most must be allocated to CGUs when testing for impairment. Judgements can however be required to determine how far down to allocate some overhead costs and in determining an appropriate allocation basis. This is particularly important when it comes to stewardship costs and overhead costs incurred at a far higher level in a group to the CGU/asset assessed for impairment. Careful consideration of the entity's specific relevant facts and circumstances and cost structure is needed.

Generally, overhead costs that provide identifiable services to a CGU (e.g., IT costs from a centralised function) as well as those that would be incurred by a CGU if it needed to perform the related tasks when operating on a 'stand-alone basis' (e.g., financial reporting function) must be allocated to the CGU being tested for impairment.

Conversely, overhead costs that are incurred with a view to acquire and develop a new business (e.g., costs for corporate development such as M&A activities) would generally not be allocated. These costs are similar in nature to future cash inflows and outflows that are expected to arise from improving or enhancing a CGU's performance which are not considered in the VIU. *[FRS 102.27.19(b)]*.

The selection of a reasonable and consistent allocation basis for overhead costs will require analysis of various factors including the nature of the CGU itself. A reasonable allocation basis for identifiable services may be readily apparent, for example in some cases volume of transaction processing for IT services or headcount for human resource services may be appropriate. However, a reasonable allocation basis for stewardship costs that are determined to be necessarily incurred by the CGU to generate cash inflows may require more analysis. For example, an allocation basis for stewardship costs such as revenue or headcount may not necessarily be reasonable when CGUs have different regulatory environments, (i.e., more regulated CGUs may require more governance time and effort) or maturity stages (i.e., CGUs in mature industries may require less governance effort). The allocation basis may need to differ by type of cost and in some cases may need to reflect an average metric over a period of time rather than a metric for a single period or may need to reflect future expected, rather than historic, metrics.

Overheads not fully pushed down to the lowest level of CGUs might need to be included in an impairment test at a higher-level group of CGUs if it can be demonstrated that the overhead costs are necessarily incurred and can be attributed directly or allocated on a reasonable and consistent basis at that higher level. After a careful analysis, there could be instances when certain overhead costs are excluded from the cash flow projections on the basis that they do not meet the criteria under paragraph 17(b) of Section 27.

Many entities make internal charges, often called management charges, which purport to transfer overhead charges to other group entities. Care must be taken before using these charges as a surrogate for actual overheads as they are often based on what is permitted, (e.g., by the taxation authorities), rather than actual overhead costs. There is also the danger of double counting if a management charge includes an element for the use of corporate assets that have already been allocated to the CGU being tested e.g., an internal rent charge.

In certain situations, it may be argued that some stewardship costs are already included in the impairment test through the discount rate used. This would, among other factors, depend on the way the discount rate has been determined, and whether the relevant stewardship cost can be regarded more as a shareholder cost covered in the shareholders' expected return rather than a cost necessarily incurred by the CGU to generate the relevant cash flows. Due to the complexity of such an approach, it would need to be applied with appropriate care.

4.8.8 Share-based payments

Often employees' remuneration packages include share-based payments. Share-based payments may be cash-settled, equity-settled or give the entity or the counterparty the choice of settlement in equity or in cash. In practice, many share-based payment transactions undertaken by entities are awards of equity settled shares and options. This gives the entity the possibility of rewarding employees without incurring any cash outflows and instead the cash costs are ultimately borne by the shareholders through dilution of their holdings.

When it comes to impairment assessment a question that often faces entities is whether and how to consider share-based payments in the recoverable amount, in particular the VIU calculation. Section 27 itself does not provide any specific guidance in respect of whether or how share-based payments must be considered in determining the recoverable amount.

As Section 27 focuses on cash flows in determining VIU, it seems that expected cash outflows in relation to cash-settled share-based payments would need to be reflected in the VIU calculation. As noted at 4.5.1 above, consistency is a very important principle underlying Section 27. Therefore, in relation to cash-settled share-based payments, entities must be consistent in the extent to which cash flows resulting from these arrangements are included in the carrying amount of the CGU and the cash flows used to determine the value in use. Where the future expected cash flows used in determining the value in use are limited to the expected cash outflows in excess of the liability already recognised at that date in the VIU calculation, the liability already recognised at the date of the VIU determination cannot be included in the carrying amount of the CGU. In contrast, if the entity includes all the future expected cash outflows in determining the value in use, the liability already recognised at the date of the VIU determination must be included in the carrying amount of the CGU in order to be consistent.

Assume for example a cash-settled share-based payment plan with total expected cash outflow of CU90 of which CU30 has already been recognised in a liability. If CU60 is included in the cash flows used to determine the value in use, the liability of CU30 cannot be included in the carrying amount of the CGU. If on the other hand CU90 is included in the cash flows used to determine the value in use, the liability of CU30 must be included in the carrying amount of the CGU.

Whilst theoretically this seems to be straight forward, in practice it can be quite a challenging and judgemental task, particularly when the entity consists of a large number of CGUs. Share-based payments are in general awarded by the parent to employees within the group and any change in the value of share-based payments after the grant date might be disconnected from the performance of the employing CGU. This may be relevant in assessing whether and how such changes in value and the ultimate expected cash flows are allocated to a specific CGU.

What is even less clear is whether an entity should reflect equity-settled share-based payments in the VIU calculation. Such share-based payment transactions may never result in any cash outflows for the entity - for example when newly issued shares are used to settle the equity-settled share-based payment plan, and therefore a literal reading of Section 27 may indicate that they can be ignored in determining the recoverable amount. However, some might argue an entity must appropriately reflect all share-based payments in the VIU calculation, whether or not these result in a real cash outflow to the entity. They note that such share-based payments are part of an employee's remuneration package and therefore costs for services from the employee, which are necessary as part of the overall cash flow generating capacity of the entity. Others may argue that they need to be considered through adjusting the discount rate in order to reflect a higher return to equity holders to counter the dilutive effects of equity settled share-based payment awards. This also depends on the way the discount rate is determined, and whether the level of equity-settled share-based plans are in line with the peer group used to determine the discount rate. If this is not the case, it is likely adjustments are needed in order to reflect the higher return in the current market assessment. In practice this can be very difficult and judgmental to determine.

Averages and computational short cuts may provide reasonable approximations of the detailed computations. In certain situations, it may be acceptable for elements to be included either in the discount rate or in the cash flows. Based on this it might be possible to adjust the cash flows in order to get to a reasonable approximation of the effect on value in use.

The time span over which the recoverable amount is calculated is often much longer than the time period for which share-based payments have been awarded. Companies and their employees would often expect that further share-based payment awards will be made in the future during the time period used for the recoverable amount calculation. Depending on the respective facts and circumstances an entity would need to consider whether to include the effect of share-based payments over a longer period, considering the discussion above.

How we see it

Section 27 itself does not provide any specific guidance as to whether or how share-based payments are considered in determining the recoverable amount. As Section 27 focuses on cash flows in determining VIU, it is our view that share-based payments that result in cash outflows (for example cash-settled share-based payments) would need to be reflected in the VIU calculation.

What is less clear is how an entity reflects equity-settled share-based payments in the VIU calculation when these will not result in a cash outflow for the entity (for example where employees receive newly issued shares of the entity to settle equity-settled share-based payments). In our view a significant amount of judgement can be required to assess how to appropriately reflect such share-based payments in VIU calculations, either by adjusting the cash flows or adjusting the discount rate.

4.8.9 Lease payments

4.8.9.A Lease payments during the lease term

As mentioned in 4.5.1.A above, the VIU calculation does not consider any cash flows for lease liabilities recorded in the statement of financial position. If the carrying amount of the lease liability is deducted to arrive at the carrying value of the CGU, the same carrying amount of the lease liability would need to be deducted from the VIU.

It is important to note that, while under Section 20 in-substance fixed lease payments in connection with lease arrangements are reflected in the lease liability, other lease payments are not. Variable lease payments that do not depend on an index or a rate, such as those based on performance or usage of the underlying asset, are not reflected in the recognised lease liability. These contractual payments therefore would still need to be reflected in the cash flow forecast used for the VIU calculation.

An entity accounts for each non-lease component within a contract separately from the lease component of the contract, unless the lessee applies the practical expedient in paragraph 33 of Section 20. Therefore, unless the practical expedient is applied, the non-lease components would need to be considered in the VIU calculation. If the practical expedient is applied, then the same guidance as discussed above for variable lease payments would apply to variable payments in relation to non-lease components.

In addition, Section 20 has certain exemptions for low-value assets and short-term leases. If a lessee elects to use these exemptions and therefore not to record a right-of-use asset and a lease liability on the balance sheet for these leases, then the cash flows in relation to these leases would still need to be included in the VIU cash flow forecast.

4.8.9.B Lease payments beyond the current lease term

When testing (groups) of CGUs it will frequently be the case that cash flow forecasts in a VIU model are for a longer period than the lease term of the right-of-use assets included in the carrying amount of the CGU.

An assumption of new capital investments is in practice intrinsic to the VIU test. What must be assessed are the future cash flows of the CGU. The cash flows, out into the future, will include sales of products or services, the cost of sales or services and all other cash flows necessary to generate independent cash inflows. They must necessarily include capital expenditure as well, at least to the extent required to keep the CGU functioning as forecast.

In cases where the cash flows of the CGU are dependent on the underlying right-of-use assets, but the lease term will end during the cash flow forecast period, renewal, extension or replacement of the underlying right-of-use asset will have to be assumed. This can be done either by assuming a new lease will be entered into, and therefore considering lease payments for this replacement lease in the cash flow forecast or terminal value, or by assuming a replacement asset will be purchased. This will depend on the entity's planned course of action, including the consideration of any already committed leases that have not yet commenced. It would be inappropriate not to reflect such replacement needs in the CGU's cash flows that the CGU's future cash inflows depend thereon.

Special attention is required when a terminal value calculation is used, where the terminal value is calculated before the end of the lease term. For example, the terminal value can be based on the extrapolation of the cash flow expected for year 5, while the lease term ends at the end of year 8. This means that the cash flow at the end of year 5 does not represent a sustainable cash flow going forward. This can be addressed by including replacement leases or capital expenditures in the terminal year, and separately calculating an adjustment to reflect that some of these expenditures will only start after year 8 (if material).

4.8.10 Events after the reporting period

Events after the reporting period and information received after the end of the reporting period must be considered in the impairment assessment only if changes in assumptions provide additional evidence of conditions that existed at the end of the reporting period. Judgement of all facts and circumstances is required to make this assessment.

Information available after the year end can provide evidence that conditions were much worse than assumed. Whether an adjustment to the impairment assessment would be required or not would depend on whether the information casts doubt on the assumptions made in the estimated cash flows for the impairment assessment.

Competitive pressures resulting in price reductions after the year end do not generally arise overnight but normally occur over a period of time and can represent a reaction to conditions that already existed at the year-end in which case management would reflect this in the year end impairment assessment.

Section 32 *Events after the Reporting Period* distinguishes events after the reporting period between adjusting and non-adjusting events (see Chapter 34). Section 32 mentions abnormally large changes after the reporting period in asset prices or foreign exchange rates as examples of non-adjusting events and therefore these changes would in general not be a reason to update year end impairment calculations. The standard implies that abnormally large changes must be due to an event that occurred after the period end and therefore more or less assumes that the cause of such abnormally large changes are not conditions that existed at the year-end. However, management would need to carefully assess the reason for the abnormally large change and consider whether it is due to conditions which existed at the period end.

As stated in 4.8.1 above, cash flow projections used for the impairment test are generally based on recent financial budgets/forecasts approved by management where available. This begs the question - what to do if a new budget/forecast is approved by management after the reporting period end but before the accounts are authorised for issue? A similar question arises in group scenarios where subsidiaries' accounts are authorised for issue a significant time after the group accounts were authorised for issue. In both scenarios the same general considerations as explained above would apply. An entity would need to assess whether the revised budget/forecast is due to conditions that existed at the reporting period end and therefore would need to be considered in the impairment assessment, or whether the change in budget/forecast is due to circumstances that arose after the end of the reporting period and therefore would only be considered in subsequent impairment tests. In a group scenario, this could lead to a situation where the revised budget/forecast would need to be considered on a subsidiary level when the subsidiaries' accounts are authorised for issue after the revised budget was approved, despite the fact that the group accounts were already authorised for issue based on the previous budget.

4.8.11 Risk in present value: 'traditional' and 'expected cash flow' approaches

The elements that must be taken into account in calculating VIU are described in 4.8 above. Section 27 requires an estimate of the future cash flows the entity expects to derive from the asset and the time value of money, represented by the current market risk-free rate of interest, to be reflected in the VIU calculation. However, the other elements that must be taken into account, all of which measure various aspects of risk, are dealt with either as adjustments to the discount rate or to the cash flows. These elements are:

- Expectations about possible variations in the amount or timing of those future cash flows.
 - The price for bearing the uncertainty inherent in the asset.
- And
- Other factors, such as illiquidity that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset. *[FRS 102.27.16]*.

Section 27 does not provide guidance on how to adjust for these factors, but further guidance is provided in IAS 36 which entities may refer to. Adjusting for these factors in the discount rate is termed the 'traditional approach' in Appendix A to IAS 36. Alternatively, under the 'expected cash flow' approach these adjustments are made in arriving at the risk-adjusted cash flows. Under IAS 36, either method can be used to compute the VIU of an asset or CGU. *[IAS 36.A2]*.

The traditional approach uses a single set of estimated cash flows and a single discount rate, often described as 'the rate commensurate with the risk'. This approach assumes that a single discount rate convention can incorporate all expectations about the future cash flows and the appropriate risk premium, and therefore places most emphasis on the selection of the discount rate.

Due to the problems and difficulties around capturing and reflecting all the variables into a single discount rate (for example, when there is significant uncertainty related to future events), IAS 36 notes that the expected cash flow approach could be the more effective measurement tool.

The expected cash flow approach is a probability weighted net present value approach. This approach uses all expectations about possible cash flows instead of a single most likely cash flow and assigns probabilities to each cash flow scenario to arrive at a probability weighted net present value. The use of probabilities is an essential element of the expected cash flow approach. The discount rate then considers the risks and variability for which the cash flows have not been adjusted. Appendix A to IAS 36 notes some of the downsides of this approach, e.g., that the probabilities are highly subjective and that it can be inappropriate for measuring a single item or one with a limited number of outcomes. Nonetheless, it considers the most valid objection to the method to be the costs of obtaining additional information when weighed against its 'greater reliability'.

Even where an expected cash flow approach is used, an entity would still need to consider adjusting the discount rate for the general uncertainties and risks not reflected in the cash flows. The key message is therefore that an entity needs to ensure that consistent assumptions are used for the estimation of cash flows and the selection of an appropriate discount rate in order to avoid any double-counting or omissions.

4.8.12 Discount rate

After identifying the relevant cash flows for the asset or CGU, the next step is to identify an appropriate discount rate to use in deriving the present value of those cash flows.

The discount rate(s) used in the present value calculation need to be a pre-tax rate(s) that reflect(s) current market assessments of:

- The time value of money.
- And
- The risks specific to the asset for which the future cash flow estimates have not been adjusted.

The discount rate(s) used to measure an asset's value in use must not reflect risks for which the future cash flow estimates have been adjusted, to avoid double-counting. *[FRS 102.27.20]*.

This means the discount rate to be applied needs to be an estimate of the rate that the market would expect on an equally risky investment. The discount rate specific for the asset or CGU will take account of the period over which the asset or CGU is expected to generate cash inflows, and it may not be sensitive to changes in short-term rates.

If at all possible, the rate must be obtained from market transactions or market rates, which means the rate must be the rate implicit in current market transactions for similar assets or the weighted average cost of capital (WACC) of a listed entity that has a single asset (or a portfolio of assets) with similar service potential and risks to the asset under review. If such a listed entity could be found, care would have to be taken in using its WACC as, to determine the VIU, an entity must use a pre-tax discount rate that is independent of the entity's capital structure and the way it financed the purchase of the asset.

Only in rare cases (e.g., property assets) can such market rates be obtained. If an asset-specific rate is not available from the market, estimates will be required. Determining the discount rate that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset will not be easy.

As a starting point, the entity may take into account the following rates:

- The entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model.
- The entity's incremental borrowing rate.
- And
- Other market borrowing rates.

From that starting point the rate must be adjusted to:

- Reflect the specific risks associated with the projected cash flows (such as country, currency, price and cash flow risks).
- Exclude risks that are not relevant to the asset or CGU concerned.
- Avoid double counting, by ensuring that the discount rate does not reflect risks for which future cash flow estimates have already been adjusted.

And

- Reflect a pre-tax rate if the basis for the starting rate is post-tax (such as WACC).

As the rate required is one which is specific to the asset (or CGU) and not to the entity, the discount rate must be independent of the entity's capital structure and the way it financed the purchase of the asset.

In practice many entities will use the WACC as a starting point to estimate the appropriate discount rate. WACC is an accepted methodology based on a well-known formula and widely available information and in addition, many entities already know their own WACC. However, it can only be used as a starting point for determining an appropriate discount rate. Some of the issues that must be taken into account are as follows:

- The WACC is a post-tax rate and VIU is required to be calculated using pre-tax cash flows and a pre-tax rate. Converting the former into the latter is not simply a question of grossing up the post-tax rate by the effective tax rate.
- Other tax factors may need to be considered, whether or not these will result in tax cash flows in the period covered by budgets and cash flows.
- An entity's own WACC may not be suitable as a discount rate if there is anything atypical about the entity's capital structure compared with 'typical' market participants.
- The WACC must reflect the risks specific to the asset and not the risks relating to the entity as a whole, such as default risk.

And

- The entity's WACC is an average rate derived from its existing business, yet entities frequently operate in more than one sector. Within a sector, different types of projects may have different levels of risk (e.g., a start-up as against an established product).

The selection of the discount rate is obviously a crucial part of the impairment testing process and in practice it will probably not be possible to obtain a theoretically perfect rate. The objective, therefore, must be to obtain a rate which is sensible and justifiable and in order to do so, specialist advice may be needed.

For further discussion on calculation of an appropriate discount rate there is a considerable amount of guidance included in the EY publication, International GAAP®, which would be relevant for entities applying Section 27 of FRS 102. This includes discussion of how entities can derive the appropriate pre-tax equivalent rate from a starting point of WACC and how VIU can be calculated using post tax cash flows.

Ultimately the selection of discount rates leaves considerable room for judgement and it is likely that many very different approaches will be applied in practice, even though this may not always be evident from the financial statements. Once the discount rate has been chosen, the future cash flows are discounted in order to produce a present value figure representing the VIU of the CGU or individual asset that is the subject of the impairment test.

4.8.13 Assets held for their service potential

While in a for-profit entity it is appropriate to determine VIU by measuring the present value of the cash flows derived from an asset or CGU, this may be less relevant in the context of Public Benefit Entities (PBEs). A PBE is defined in FRS 102 as an entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.

In a PBE assets may be held not for cash generating purposes but for their service potential i.e., where the benefits are expected to be derived through use of the asset along with proceeds from sale. To acknowledge this, Section 27 includes the following alternative approach for such assets.

For assets held for their service potential a cash flow driven valuation (such as value in use) may not be appropriate. In these circumstances value in use (in respect of assets held for their service potential) is determined by the present value of the asset's remaining service potential plus the net amount the entity will receive from its disposal. In some cases this may be taken to be costs avoided by possession of the asset. Therefore, depreciated replacement cost, may be a suitable measurement model but other approaches may be used where more appropriate. *[FRS 102.27.20A]*.

4.8.14 Differences between fair value and value in use

Whilst value in use has some similarities to fair value, Section 2A does not apply to value in use, and there are a number of ways in which fair value is different to value in use. Fair value is a market-based measurement, not an entity-specific measurement, and therefore reflects the assumptions market participants would use when pricing the asset. In contrast, value in use is defined as the present value of the future cash flows expected to be derived from an asset or CGU and reflects the effects of factors that may be specific to the entity and not applicable to entities in general.

Whilst not set out in Section 27, IAS 36 gives a number of specific examples of factors that are excluded from fair value under IFRS to the extent that they would not be generally available to market participants. *[IAS 36.53A]*. As Section 2A also requires fair value to be determined from a market participant perspective, these examples would also be relevant to FRS 102 reporters:

- The additional value derived from the grouping of assets.
- Synergies between the asset being measured and other assets.
- Legal rights or legal restrictions that are specific only to the current owner of the asset.

And

- Tax benefits or tax burdens that are specific to the current owner of the asset.

By contrast, an entity calculating FVLCS includes cash flows that are not permitted in a VIU calculation but only to the extent that other market participants would consider them when evaluating the asset. For example, cash inflows and outflows relating to future capital expenditure could be included if they would be taken into account by market participants (see 4.8.2 above).

5 Impairment of goodwill

5.1 Goodwill and its allocation to CGUs

Goodwill, by itself, cannot be sold. Nor does it generate cash flows to an entity that are independent of other assets. As a consequence, the fair value of goodwill cannot be measured directly. Therefore, the recoverable amount of goodwill must be derived from measurement of the recoverable amount of the CGU(s) of which the goodwill is a part. [FRS 102.27.24].

Testing goodwill for impairment therefore requires it to be allocated to CGUs of the acquirer. This process is quite different to the process by which CGUs themselves are identified, as that depends on identifying the smallest group of assets generating largely independent cash inflows. The cash flows of the CGU, or those of a group of CGUs if appropriate, must be sufficient to support the carrying value both of the assets and any allocated goodwill.

For the purposes of impairment testing, goodwill acquired in a business combination must, from the acquisition date, be allocated to each of the acquirer's CGUs that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. [FRS 102.27.25].

Goodwill is allocated to CGUs from the acquisition date. There is no specific guidance in Section 27 on circumstances that might lead to a reallocation of goodwill between CGUs. Therefore, under the hierarchy in Section 10 on developing a relevant and reliable accounting policy entities may consider the requirements in IAS 36, which stipulate that the allocation of goodwill is not be revised unless the entity's operations are restructured in such a way as to alter the composition of one or more CGUs to which goodwill has been allocated.

5.1.1 Identifying synergies

Section 27 requires goodwill to be allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the combination and only to those CGUs. This is irrespective of whether other assets or liabilities of the acquiree are assigned to those CGUs. [FRS 102.27.25].

Operating synergies fall into two broad groups, those that improve margin (e.g., through cost savings and economies of scale) and those that give an opportunity for future growth (e.g., through the benefits of the combined talent and technology).

Illustration 5-1: Identifying synergies

In all of the following cases, the acquiring entity can identify the synergies and the CGUs that benefits from them. Goodwill will be allocated to the relevant CGUs.

- A mining entity (group) extracts a metal ore that does not have an active market until it has been through a smelting and refining process. The entity considers the CGU to comprise the smelter together with the individual mines. When the entity acquires a mine, the synergies relate to cost savings as the mine's fixed costs are already covered by the existing refining operations. Goodwill is therefore allocated to the CGU comprising the smelter, the existing mines and the newly acquired mine.
- An airline is subject to cost pressures common in the sector. It acquires another operation with similar international operations on the basis that it can reduce its workforce and asset base. It will combine its operational management, including its sales, reporting and human resources functions, into one head office and consolidate all aircraft maintenance in a single site that currently has capacity. These cost savings are the synergies of the business combination and goodwill would therefore be allocated to the CGUs that benefit from these cost savings.
- A global consumer products company purchases a company best-known for razors and razor blades. It has not previously manufactured razors although its 'grooming products' CGU does manufacture other shaving products. The acquirer expects that it will be able to increase sales of its shaving products through association with the target company's razors and through branding. No assets of the acquired business are allocated to the grooming products CGU, but this CGU will benefit from the synergies of the business combination and therefore goodwill from the acquisition will be allocated to it.

The process is further shown in the following Illustration which shows the differences for the purposes of testing impairment between the CGUs to which goodwill is allocated and the identification of CGUs.

Illustration 5-2: Allocating goodwill and identifying CGUs

Entity A operates three different types of fish restaurant: fifteen restaurants, twenty-five pubs that contain restaurants serving fish and forty fish bars. Each is separately branded, although the brand is clearly identified with the Entity A identity, e.g., the restaurant range is branded 'Fish by A'.

Entity A acquired Entity B, which had a similar range of restaurants and bars (thirty in total) although that entity had not applied any branding to the types of restaurants.

Entity A recognised goodwill on acquisition and determined that ten of Entity B's outlets were to be allocated and rebranded to each of its brands.

Each restaurant, pub or fish bar is a separate CGU because it has separately identifiable largely independent cash inflows.

Management notes that it manages the 'A' brand at group (entity) level. This may not be appropriate for testing goodwill as management monitors the business at a level which corresponds to the three individual brands (restaurants, pubs and fish bars) to which it has allocated the acquired outlets.

There are costs that cannot be clearly identified as relating to an individual restaurant, including marketing costs, sourcing of fish for the different brands and bulk purchasing. However, these costs are related to the brands and the branding is evidence that there are synergies at this level. Management concludes that it can allocate goodwill on a non-arbitrary basis and that it is appropriate to allocate goodwill to the three brands in order to test it for impairment. This does not prevent the separate outlets being identified as CGUs as Section 27 allows an apportionment of costs. The independence of cash inflows is decisive.

5.1.2 Measuring the goodwill allocated to CGUs or groups of CGUs

Section 27 does not provide any methods for allocating goodwill. This means that once the acquirer's CGUs or groups of CGUs that benefit from the synergies have been identified, as discussed in 5.1.1 above, the entity must use an appropriate methodology to allocate that goodwill between them.

Illustrations 5-1 and 5-2 provide simple examples of how an entity might allocate goodwill to CGUs:

Illustration 5-3: Allocating goodwill to CGUs - a simple example

On 1 January 20X0 Entity A acquired Entity B. As a consequence of the business combination, Entity B became a wholly owned subsidiary of entity A. Entities A and B each have one CGU. Goodwill of £1,000 arose from the business combination, all of which is attributable to synergies of the combination which are expected to arise in Entity B's CGU only.

For the purposes of impairment testing, £1,000 goodwill is allocated to Entity B's CGU. No goodwill is allocated to Entity A's CGU.

Illustration 5-4: Allocating goodwill to more than one CGU

The facts are the same as Illustration 5-1. However, in this example, 60 per cent of the goodwill is attributable to synergies of the combination that are expected to occur in Entity A's CGU. The rest of the goodwill is attributable to synergies in Entity B's CGU.

For the purposes of impairment testing, £600 goodwill is allocated to Entity A's CGU and £400 goodwill is allocated to Entity B's CGU.

The Illustrations above are fairly simple, and in practice entities would need to determine an allocation methodology in order to arrive at the 60 per cent allocation used in Illustration 5-4.

One allocation method which entities may use is a 'direct' method, which is based on the difference between the fair value of the net assets and the fair value of the acquired business (or portion thereof) to be assigned to the CGUs, thereby calculating goodwill directly by reference to the allocated net assets. However, this method will not allocate any goodwill to a CGU if no assets or liabilities are assigned to the CGU and, arguably, it will allocate too little goodwill to CGUs that benefit disproportionately because of synergies with the acquired business. A method that does not have these shortcomings is a 'with and without' method that requires the entity to calculate the fair value of the CGU or groups of CGUs that are expected to benefit before and after the acquisition; the difference represents the amount of goodwill to be allocated to that reporting unit. This will take account of buyer-specific synergies that relate to a CGU or group of CGUs. These methods are discussed in further detail in the EY publication, International GAAP®, together with illustrative examples.

In practice the allocation of goodwill to individual CGUs or groups of CGUs at the date of acquisition is likely to require significant judgement by management.

Where goodwill cannot be allocated to a single cash-generating unit on a non-arbitrary basis, then for the purpose of impairment testing, it may be possible to allocate it to a group of units. Where goodwill can be allocated on a non-arbitrary basis to a CGU grouping, an appropriate approach to the impairment test may be as follows:

- First, test individual CGUs of the CGU grouping without any allocation of goodwill.
And
- Second, test the group of CGUs to which goodwill has been allocated, including the allocated goodwill.

This approach is shown in Illustration 5-5:

Illustration 5-5: Two step approach for testing goodwill allocated to a group of CGUs

On 1 January 20X0 Group X acquired 100% of the ordinary share capital of Entity Z for £10,000. The identifiable net assets acquired had a fair value of £9,000 and therefore goodwill of £1,000 arose on the acquisition. That goodwill is amortised on a straight-line basis over 10 years. Entity Z comprises three CGUs, A, B and C. Management assesses that whilst it cannot allocate the goodwill arising to individual CGUs, it is attributable to synergies of the combination that are expected to occur in cash generating units A, B and C as a group.

On 31 December 20X2, as impairment indicators are present, Group X performs an impairment test on its goodwill. Group X has assessed that the fair value less costs to sell the CGUs is less than value in use, and therefore recoverable amount must be determined based on VIU. The carrying amount of the net assets in CGUs A, B and C and the associated goodwill and VIU of each CGU is shown in the following table:

Cash generating unit	A	B	C	Goodwill	Total
Carrying value	£175	£245	£210	£70	£700
Value in use	£200	£220	£230		£650

Step 1

Group X first assesses the individual CGUs for impairment, without any allocation of goodwill. This results in an impairment loss of £25 being recognised in respect of CGU B in order to reduce its carrying amount from £245 to its recoverable amount of £220.

Doing so reduces the total carrying amount of the group of CGUs, including goodwill, to £675, as shown below:

Cash generating unit	A	B	C	Goodwill	Total
Carrying value	£175	£220	£210	£70	£675
Value in use	£200	£220	£230		£650

Step 2

The second step involves the entity testing the group of CGUs to which goodwill has been allocated, including the allocated goodwill. As shown above, having booked the impairment of £25 in CGU B, the carrying value of the group of CGUs still exceeds its recoverable amount. Therefore, an impairment loss of £25 is recognised in respect of the goodwill reducing its carrying amount from £70 to £45. The total carrying amount of the group of CGUs including goodwill is reduced to £650.

In some cases, management may conclude that it is not possible to allocate goodwill on anything but an arbitrary basis. Section 27 addresses this issue by setting out a method which allows management to test the associated goodwill for impairment by splitting the entity into two parts. It is important to remember that the alternative method set out in below can only be used when goodwill cannot be allocated to CGUs on a non-arbitrary basis.

The requirement is that, if goodwill cannot be allocated to individual CGUs (or groups of CGUs) on a non-arbitrary basis, then for the purposes of testing goodwill the entity must test the impairment of goodwill by determining the recoverable amount of either:

- The acquired entity in its entirety, if the goodwill relates to an acquired entity that has not been integrated. Integrated means the acquired business has been restructured or dissolved into the reporting entity or other subsidiaries.
Or
- The entire group of entities, excluding any entities that have not been integrated, if the goodwill relates to an entity that has been integrated.

In applying this requirement, an entity will need to separate goodwill into goodwill relating to entities that have been integrated and goodwill relating to entities that have not been integrated. The entity must also follow the requirements for CGUs in this section when calculating the recoverable amount of, and allocating impairment losses and reversals to assets belonging to, the acquired entity or group of entities.

[FRS102.27.27].

It is not clear how often this method will be applied in practice as we would generally expect management to have a reasonable basis of allocating goodwill to individual CGUs or group of CGUs. The application of this is shown in the following Illustration.

Illustration 5-6: Non-allocated goodwill and integrated/non-integrated subsidiaries

Group A comprises a parent company and several subsidiaries. On 1 January 20X0 Group A acquired 100% of the ordinary share capital of Entity Z for £10,000. Goodwill of £1,000 arose in accounting for that business combination. That goodwill is amortised on a straight-line basis over 10 years.

At 31 December 20X0 the total carrying amount of goodwill after amortisation, and any impairment made in prior years, in Group A's consolidated financial statements is £3,900. This £3,900 includes goodwill from a number of business combinations including the acquisition of Entity Z.

On 31 December 20X0, as impairment indicators are present, Group A performs an impairment test on all of its goodwill. Management of Group A considers that its goodwill cannot be allocated to individual CGUs or groups of CGUs on a non-arbitrary basis. As a result, it must apply the alternative method set out in paragraph 27 of Section 27.

Assume that, at 31 December 20X0:

- The recoverable amount of Group A excluding Entity Z is £34,000.
- The recoverable amount of Entity Z is £10,500.
- The recoverable amount of Group A including Entity Z is £44,500.

Scenario 1 - Non-integrated subsidiary - Entity Z is engaged in dissimilar activities from the rest of Group A. Entity Z has therefore not been integrated into Group A.

At 31 December 20X0 the carrying amount of the net assets of Group A and Entity Z were as follows:

	Goodwill	Carrying amount (excluding Goodwill) ⁽¹⁾	Total
	£	£	£
Group A (excluding Z)	⁽²⁾ 3,000	30,000	33,000
Entity Z	⁽³⁾ 900	10,000	10,900
Group A	3,900	40,000	43,900

⁽¹⁾ After depreciation and amortisation

⁽²⁾ Goodwill relating to the acquisition of subsidiaries other than Entity Z.

⁽³⁾ Goodwill relating to the acquisition of Entity Z (after 1 year of amortisation).

Because Entity Z's activities are not integrated into Group A, in accordance with paragraph 27(a) of Section 27, the goodwill arising on Entity Z is tested separately from the goodwill relating to Group A's other business combinations. The impairment loss is calculated as follows:

Entity Z

	£
Carrying amount	10,900
Recoverable amount	10,500
Impairment	400

Group A

No impairment arises as the recoverable amount of Group A (excluding Entity Z) of £34,000 exceeds the carrying amount of Group A (excluding Entity Z) of £33,000.

Total impairment loss for Group A = £400.

Scenario 2 - Subsidiary is integrated - Entity Z has been integrated into Group A.

At 31 December 20X0 the carrying amount of the net assets of Group A are:

	Goodwill	Carrying amount ⁽¹⁾	Total
	£	£	£
Group A	⁽²⁾ 3,900	40,000	43,900

⁽¹⁾ After depreciation and amortisation

⁽²⁾ Goodwill relating to the acquisition of subsidiaries including the acquisition of Entity Z.

The goodwill arising on the acquisition of Entity Z is combined with the rest of the goodwill relating to Group A from the date of acquisition of Entity Z. No impairment arises, because the recoverable amount of the group as a whole of £44,500 exceeds the carrying amount of £43,900 (£3,900 goodwill plus £40,000 other assets at group carrying amounts).

As can be seen from the Illustration above, an incidental effect of this approach may be to reduce the incidence of write-downs, as the higher the level at which the goodwill is tested for impairment, the more likely that an impairment loss can be avoided. Judgement will be required in order to assess whether an arbitrary allocation of goodwill is genuinely all that is possible.

5.2 Impairment of assets and goodwill recognised on acquisition

There are a number of circumstances in which the fair value of assets or goodwill acquired as part of a business combination is measured at a higher amount through recognition of deferred tax or notional tax benefits. This raises the question of how to test for impairment and even whether there is, in fact, a 'day one' impairment in value. In other circumstances, deferred tax assets can or cannot be recognised as part of the fair value exercise and this, too, can affect subsequent impairment tests of the assets and goodwill acquired as part of the business combination.

The requirement of IAS 12 *Income Taxes* to recognise deferred tax on all temporary differences arising on net assets acquired in a business combination can have an impact on the amount of goodwill or negative goodwill recognised. In a business combination, there is no initial recognition exemption for deferred tax and the corresponding accounting entry for a deferred tax asset or liability forms part of the goodwill arising on the business combination.

Where an intangible asset, which was not recognised in the acquiree's financial statements, is acquired in a business combination and the intangible asset's tax base is zero, a deferred tax liability based on the fair value of the intangible asset and the prevailing tax rate will be recognised. [FRS 102.29.11]. The corresponding debit entry will increase goodwill. This then begs the question of how to consider this in the VIU when performing an impairment test on that goodwill and whether there could be an immediate impairment that would need to be recognised.

How we see it

In our view, a day one impairment does not arise purely because of recognised deferred tax liabilities in a business combination. To avoid an immediate impairment, goodwill would be reduced by the nominal versus fair value difference of the deferred tax liability when measuring any impairment. Alternatively, an entity could measure the recoverable amount based on fair value less costs of disposal.

Refer to the EY publication, International GAAP®, where this issue is discussed in detail together with Illustrations to further explain the issue.

5.3 Reallocating goodwill to CGUs

Section 27 does not provide any guidance on when goodwill must be reallocated between CGUs, or how such a reallocation must be performed. However, where an entity or group is restructured in a way that changes the composition of one or more CGUs to which goodwill has been allocated, it would generally seem appropriate to reallocate the goodwill to the units accordingly. Such a reallocation is explicitly required by paragraph 87 of IAS 36, and FRS 102 reporting entities may look to IFRS in developing a relevant and reliable accounting policy. As such, an acceptable method to make that reallocation might be to follow the approach set out in IAS 36, which requires the reallocation to be performed using a relative value approach. This is discussed further in the EY publication, International GAAP®.

5.4 Goodwill on non-controlling interests

As required by Section 19 *Business Combinations and Goodwill*, an acquirer must, at the acquisition date: [FRS 102.19.22]

- Recognise goodwill acquired in a business combination as an asset.
- And

- Initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with the various requirements for those assets, liabilities and contingent liabilities.

Non-controlling interests (NCI) are measured at the acquisition date at their proportionate share of the acquiree's identifiable net assets, which excludes goodwill. As a result, goodwill attributable to NCI is not recognised in the parent's consolidated financial statements. However, the recoverable amount of a CGU would be calculated for the CGU as a whole. This means that part of the recoverable amount of the CGU determined in accordance with Section 27 is attributable to the non-controlling interest in goodwill.

Therefore, for the purposes of impairment testing of a non-wholly owned CGU with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the NCI. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the CGU is impaired. [FRS 102.27.26].

How we see it

There is no specific guidance on how the gross up needs to be performed, but we expect the default method will be a simple mechanical gross up based on ownership percentages. This is shown in Illustration 5-4 below. However, in the absence of any guidance, we consider that an entity is not precluded from grossing up goodwill on a basis other than ownership percentages if to do so is reasonable.

Illustration 5-7: Notionally adjusting the carrying amount of goodwill for non-controlling interests

On 30 December 20X0 Entity A acquired 75% of Entity Z. As a consequence of the business combination, Entity Z become a subsidiary of Entity A. Entities A and Z each have one CGU. Goodwill of £750 arose from the business combination, all of which is attributable to synergies of the combination that are expected to occur only in Entity Z's CGU.

In the group's consolidated statement of financial position NCI is measured at their proportionate interest (25%) of the group carrying amount of Entity Z's net assets excluding goodwill.

If Entity Z's CGU was tested for impairment on 31 December 20X0, the £750 goodwill asset allocated to entity Z's CGU would, solely for the purpose of the impairment test at group level, be grossed up by £250 to £1,000 (i.e., it would be notionally increased to include goodwill attributable to the NCI's 25% interest in the CGU).

In the event of an impairment, the entity allocates the impairment loss as usual, first reducing the carrying amount of goodwill allocated to the CGU. However, because only the parent's goodwill is recognised, the impairment loss is apportioned between that attributable to the parent and that attributable to the NCI, with only the former being recognised.

Illustration 6-3 at 6.4 below shows an impairment calculation where goodwill has been notionally adjusted to take account of NCI. Additional guidance and Illustrations on this topic are also provided in the EY publication, International GAAP®.

6 Recognising impairment losses

If the carrying value of an individual asset or of a CGU is equal to or less than its calculated VIU, there is no impairment. On the other hand, an impairment loss must be recognised when the carrying amount of an asset or CGU exceeds its recoverable amount.

There are three scenarios: an impairment loss on an individual asset, an impairment loss on an individual CGU and an impairment loss on a group of CGUs. The last of these occurs where there are corporate assets (see 4.5.2 above) or goodwill (see 5.1.2 above) that have been allocated to a group of CGUs rather than to individual CGUs.

6.1 Recognising an impairment loss on an individual asset

For individual assets, Section 27 states: [FRS 102.27.5, FRS 102.27.6]

Extract from Section 27

5	If, and only if, the recoverable amount of an asset is less than its carrying amount, the entity shall reduce the carrying amount of the asset to its recoverable amount. That reduction is an impairment loss. Paragraphs 27.11 to 27.20A provide guidance on measuring recoverable amount.
6	An entity shall recognise an impairment loss immediately in profit or loss, unless the asset is carried at a revalued amount in accordance with another section of this FRS (for example, in accordance with the revaluation model in Section 17 Property, Plant and Equipment). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other section.

If there is an impairment loss on an asset that has not been revalued, it is recognised in profit or loss. An impairment loss on a revalued asset is first used to reduce the revaluation surplus for that asset. Only when the impairment loss exceeds the amount in the revaluation surplus for that same asset is any further impairment loss recognised in profit or loss. [FRS 102.17.15F, FRS 102.18.18H].

Any amounts written off a fixed asset must be shown as part of the accumulated depreciation or amortisation when an entity discloses the gross carrying amount and the accumulated depreciation or amortisation at the beginning and the end of the period. [FRS 102.17.31(d), FRS 102.18.27(c)]. In the reconciliations required by paragraph 31 of Section 17 and paragraph 27 of Section 18 any impairment recognised or reversed through profit and loss must be shown in a separate line item.

An impairment loss will reduce the depreciable amount of an asset and the revised amount will be depreciated or amortised prospectively over the remaining useful life. However, an entity ought also to review the useful life and residual value of its impaired asset as these may need to be revised. The circumstances that give rise to impairments frequently affect these as well. [FRS 102.27.10].

6.2 Recognising an impairment loss on a CGU

An impairment loss must be recognised for a CGU if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit. The impairment loss must be allocated to reduce the carrying amount of the assets of the unit in the following order: [FRS 102.27.21]

- First, to reduce the carrying amount of any goodwill allocated to the CGU.
And
- Then to the other assets of the unit *pro rata* on the basis of the carrying amount of each asset in the CGU.

This principle is shown in Illustration 6-1 below.

Illustration 6-1: Impairment loss for a CGU with goodwill - a simple example

On 31 December 20X0, Entity T acquires 100% of voting rights in Entity M for £10,000. Entity M has manufacturing plants in three countries, A, B and C, each of which is considered a CGU.

The fair value of identifiable assets in Entity M is £7,000 and goodwill of £3,000 arising on the acquisition has been allocated across the three CGUs A, B and C.

During 20X1, a new government is elected in Country A. It passed legislation that significantly restricts exports of the main product produced by Entity T and its subsidiaries (i.e., Group T). As a result, and for the foreseeable future, Group T's production in Country A will be cut by 40 percent. The significant export restriction and the resulting production decrease require Group T to estimate the recoverable amount of Country A's CGU at the end of 20X1.

Management estimates cash flow forecasts for Country A's operations and determines the CGU's recoverable amount to be £1,360. The carrying amounts of goodwill and identifiable assets of Country A are £800 and £1,833 respectively. The calculation and allocation of the impairment loss for Country A's CGU at the end of 20X1 is as follows:

	Carrying amount	Impairment ⁽¹⁾	Carrying amount after impairment
	£		£
Goodwill	800	(800)	-
Asset 1	500	(129)	371
Asset 2	457	(118)	339
Asset 3	876	(226)	650
Total identifiable assets	1,833	(473)	1,360
Total assets	2,633	(1,273)	1,360

⁽¹⁾ After impairing goodwill in full, the remaining impairment is allocated pro-rata to identifiable assets e.g., for Asset 1 this is $(500 \div 1,833) \times 473 = 129$.

The impairment loss is recorded first against the carrying amount of goodwill (£800) and next, pro-rata against the carrying amount of Country A's identifiable assets (£473).

However, an entity must not reduce the carrying amount of any asset in the CGU below the highest of:
[FRS 102.27.22]

- Its fair value less costs to sell (if determinable)
- Its value in use (if determinable)
- And
- Zero

Any excess amount of the impairment loss that cannot be allocated to an asset because of the restriction above needs to be allocated to the other assets of the unit *pro rata* on the basis of the carrying amount of those other assets. [FRS 102.27.23].

Illustration 6-2 below illustrates how this approach would be applied in practice.

Illustration 6-2: Impairment loss for a CGU with goodwill

An entity's CGU produces a product in a continuous process using three machines i.e., the output of Machine A is the input (raw material) for Machine B, the output of which is the input for Machine C. The output from Machine C is the entity's only marketable product.

After recognising depreciation and amortisation for the year ended 20X0 the carrying amount of the CGU containing Machines A, B and C including goodwill is £72,220. This can be broken down as £13,000 for Machine A, £29,250 for Machine B, £22,750 for Machine C and £7,220 for goodwill.

As there has been a significant downturn in the market for its products, the entity must conduct an impairment test on the associated CGU. The value in use of the CGU is calculated to be £55,000.

With a carrying value of £72,220 and a value in use of £55,000, this gives rise to an impairment loss of £17,220. The impairment loss is first allocated to the goodwill (£7,220) and then to the other assets of the CGU on a *pro rata* basis reflecting the carrying amount of each asset in the CGU.

Management have been able to determine the FVLCS of Machine A at £12,500. They have not been able to determine the FVLCS or VIU of any other individual asset within the CGU.

Absent the information about the FVLCS of Machine A, the remaining impairment loss of £10,000 (total impairment of £17,220 less £7,220 allocated to goodwill) would be allocated to Machines A, B and C on a *pro-rata* basis as follows:

	Carrying amount before impairment	Carrying amount in relation to CGU's carrying amount	Notional impairment allocation	Notional carrying amount after impairment
	£	%	£	£
Machine A	13,000	20	2,000	11,000
Machine B	29,250	45	4,500	24,750
Machine C	22,750	35	3,500	19,250
Total	65,000		10,000	55,000

However, this allocation would reduce the carrying amount of Machine A to £11,000, which is lower than its FVLCS of £12,500. Consequently, in accordance with paragraph 22(a) of Section 27, the impairment loss allocated to Machine A is limited to £500 (i.e., £13,000 carrying amount less £12,500 FVLCS). The remaining impairment loss of £1,500 (i.e., £2,000 less £500 allocated to Machine A) is allocated to Machines B and C on the basis of each machine's carrying amount in relation to the total carrying amount of the two machines as follows:

	Carrying amount after first impairment	Carrying amount in relation to CGU's carrying amount	Second impairment allocation
	£	%	£
Machine B	24,750	56.25	844
Machine C	19,250	43.75	656
Total	44,000		1,500

The total impairment loss allocated to each machine is shown below, together with the carrying amounts of Machines A, B and C immediately after recognising the impairment loss.

	Carrying amount before impairment	First impairment allocation	Second impairment allocation	Total impairment	Carrying amount after impairment
	£	£	£	£	£
Machine A	13,000	500	-	500	12,500
Machine B	29,250	4,500	844	5,344	23,906
Machine C	22,750	3,500	656	4,156	18,594
Goodwill	7,220	7,220	-	7,220	-
Total	72,220	15,720	1,500	17,220	55,000

In the above Illustration, the impairment loss is fully allocated across the assets of the CGU. However, as individual assets cannot be written down below the higher of their FVLCS and their VIU, this may not always be the case, thus an element of the impairment charge may not be recognised.

It must be noted that no impairment loss can be reflected against an individual asset if the CGU to which it belongs has not been impaired, even if its carrying value exceeds its FVLCS. This is explained in the following Illustration:

Illustration 6-3: Individually impaired assets within CGUs

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's FVLCS is less than its carrying amount. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Scenario 1: No commitment from management to replace the machine

In this scenario, there is no commitment from management to replace the machine, and approved budgets and forecasts do not include cash flows associated with the replacement of it. In such a situation, the recoverable amount of the machine alone cannot be estimated because its VIU is different from its FVLCS (because the entity is going to continue to use it) and can be determined only for the CGU to which it belongs (the production line).

As the production line is not impaired, no impairment loss is recognised for the machine. Nevertheless, the entity needs to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.

Scenario 2: Commitment of management to replace the machine and sell it in the near future

In this scenario, management has approved a plan to dispose of the machine in the near future, and the entity's budgets/forecasts reflect this commitment. Cash flows from continuing use of the machine until its disposal are estimated to be negligible. In such a situation, it can be demonstrated that the machine's VIU can be estimated to be close to its FVLCS (because the remaining cash flows associated with it are those arising from its disposal in the near future). Therefore, the recoverable amount of the machine can be determined, and no consideration needs to be given to the CGU (the production line) to which it belongs. As the machine's carrying amount exceeds its FVLCS, an impairment loss is recognised to write it down to FVLCS.

Note that it is assumed that the asset is still useable (otherwise it would not be contributing to the cash flows of the CGU at all and would have to be written off). If the asset is no longer part of the CGU, it will have to be tested for impairment on a stand-alone basis.

6.3 Recognising an impairment loss on a group of CGUs

It is important when applying the requirements above, that impairment testing is conducted in the right order. If there are indicators of impairment in connection with a CGU with which goodwill is associated, i.e., the CGU is part of a CGU group to which goodwill is allocated, the individual CGU must be tested and any necessary impairment loss taken, before the 'CGU group' goodwill is tested for impairment. These impairment losses and consequent reductions in carrying values are treated in exactly the same way as those for individual assets as explained at 6.1 above. An example of the application of this sequencing of impairment testing is provided in Illustration 5-5 above.

6.4 Recognising an impairment loss on a CGU with goodwill and non-controlling interests

As noted at 5.4 above, when impairment testing a non-wholly owned CGU with goodwill, the carrying amount of that unit must be notionally adjusted, before being compared with its recoverable amount, by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the NCI. [FRS 102.27.26].

If there is an impairment, the entity allocates the impairment loss as usual, first reducing the carrying amount of goodwill allocated to the CGU. However, because only the parent's goodwill is recognised, the impairment loss is apportioned between that attributable to the parent and that attributable to the NCI, with only the former being recognised.

If any impairment loss remains, it is allocated in the usual way to the other assets of the CGU *pro rata* on the basis of the carrying amount of each asset in the CGU.

These requirements are illustrated in the following Illustration.

Illustration 6-4: A CGU with goodwill and non-controlling interest

Entity X acquires an 80% ownership interest in Entity Y for £1,600 on 1 January 20X0. At that date, Entity Y's identifiable net assets have a fair value of £1,500. Entity X recognises in its consolidated financial statements:

- Goodwill of £400, being the difference between the cost of the business combination of £1,600 and acquirer's interest in the identifiable net assets of Entity Y of £1,200 (being 80% of £1,500).
- Entity Y's identifiable net assets at their fair value of £1,500.

And

- A non-controlling interest of £300, being the remaining 20% of Entity Y's identifiable net assets.

The group considers Entity Y to be a CGU and the full £400 of goodwill is allocated to that CGU. For simplicity, we ignore the amortisation of goodwill in this example.

At the end of 20X0, the carrying amount of Entity Y's identifiable assets (excluding goodwill) has reduced to £1,350 and Entity X determines that the recoverable amount of Entity Y is £1,000.

The carrying amount of Entity Y must be notionally adjusted to include goodwill attributable to the non-controlling interest, before being compared with the recoverable amount of £1,000. Goodwill attributable to Entity X's 80% interest in Entity Y at 31 December 20X0 is £400. Therefore, goodwill notionally attributable to the 20% non-controlling interest in Entity Y at the acquisition date is £100, being $£400 \times 20 \div 80$. Testing Entity Y for impairment at the end of 20X0 gives rise to an impairment loss of £850 calculated as follows:

	Identifiable		
	Goodwill	net assets	Total
	£	£	£
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interest	100	-	100
Notionally adjusted carrying amount	500	1,350	1,850
Recoverable amount			1,000
Impairment loss			850

The impairment loss of £850 is allocated to the assets in the CGU by first reducing the carrying amount of goodwill to zero. Therefore, £500 of the £850 impairment loss for Entity Y is allocated to the goodwill. However, because Entity X only holds a 80% ownership interest in Entity Y, it recognises only 80% of that goodwill impairment loss (i.e., £400). The remaining impairment loss of £350 is recognised by reducing the carrying amounts of Entity Y's identifiable assets, as follows:

	Identifiable		
	Goodwill	net assets	Total
	£	£	£
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	-	1,000	1,000

In total, Entity X recognises an impairment loss in the consolidated income statement of £750, of which £400 relates to the impairment of goodwill and £350 relates to the impairment of Entity Y's identifiable assets. Of the impairment loss of £350 relating to Entity Y's identifiable assets, £70 (i.e., 20% thereof) would be attributed to the non-controlling interest.

In this example the same result would have been achieved by just comparing the recoverable amount of £1,000 with the carrying amount of £1,750. However, what if the recoverable amount of the CGU had been greater than the carrying amount of the identifiable net assets prior to recognising the impairment loss?

Assume the same facts as above, except that at the end of 20X0, Entity X determines that the recoverable amount of Entity Y is £1,400. In this case, testing Entity Y for impairment at the end of 20X0 gives rise to an impairment loss of £450 calculated as follows:

	Identifiable		
	Goodwill	net assets	Total
	£	£	£
Carrying amount	400	1,350	1,750
Unrecognised non-controlling interest	100	-	100
Notionally adjusted carrying amount	500	1,350	1,850
Recoverable amount			1,400
Impairment loss			450

All of the impairment loss of £450 is allocated to the goodwill. However, Entity X recognises only 80% of that goodwill impairment loss (i.e., £360). This allocation of the impairment loss results in the following carrying amounts for Entity Y in the financial statements of Entity X at the end of 20X0:

	Identifiable		
	Goodwill	net assets	Total
	£	£	£
Carrying amount	400	1,350	1,750
Impairment loss	(360)	-	(360)
Carrying amount after impairment loss	40	1,350	1,390

Of the impairment loss of £360, none of it is attributable to the non-controlling interest since it all relates to the majority shareholder's goodwill.

In this case the total carrying amount of the identifiable net assets and the goodwill has not been reduced to the recoverable amount of £1,400, but is actually less than the recoverable amount. This is because the recoverable amount of goodwill relating to the non-controlling interest (20% of [£500 - £450]) is not recognised in the consolidated financial statements.

7 Reversal of an impairment loss

An impairment loss recognised for goodwill must not be reversed in a subsequent period. For all assets other than goodwill, if and only if the reasons for the impairment loss have ceased to apply, an impairment loss must be reversed in a subsequent period. [FRS 102.27.29].

An entity must assess at each reporting date whether there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. Indications that an impairment loss may have decreased or may no longer exist are generally the opposite of those discussed at 4.3 above. If any such indication exists, the entity must determine whether all or part of the prior impairment loss must be reversed.

The requirement that an impairment of assets other than goodwill be reversed “if and only if the reasons for the impairment loss have ceased to apply”, [FRS 102.27.29], places a restriction on when impairment losses are reversed. The ‘unwinding’ of the discount in a VIU calculation will increase the present value of future cash flows as they become closer, but Section 27 does not allow the mere passage of time to trigger the reversal of an impairment. In other words, the ‘service potential’ of the asset must genuinely improve if a reversal is to be recognised.

The procedure for making the determination of whether a prior impairment loss can be reversed will depend on whether the prior impairment loss on the asset was based on: [FRS 102.27.29]

- The recoverable amount of that individual asset.
- Or
- The recoverable amount of the cash-generating unit to which the asset belongs.

The process to be followed for the reversal of an impairment on an individual asset is discussed at 7.1 below and for a CGU at 7.2 below.

7.1 Reversal where recoverable amount was estimated for an individual impaired asset

When the prior impairment loss was based on the recoverable amount of the individual impaired asset, the following requirements apply: [FRS 102.27.30]

- (a) The entity must estimate the recoverable amount of the asset at the current reporting date.
- (b) If the estimated recoverable amount of the asset exceeds its carrying amount, the entity must increase the carrying amount to recoverable amount, subject to the limitation described in (c) below. That increase is a reversal of an impairment loss. The entity must recognise the reversal immediately in profit or loss unless the asset is carried at revalued amount in accordance with another section of FRS 102 (for example, the revaluation model in Section 17). Any reversal of an impairment loss of a revalued asset must be treated as a revaluation increase in accordance with the relevant section of FRS 102.
- (c) The reversal of an impairment loss must not increase the carrying amount of the asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years. This requirement is illustrated in Illustration 7-1 below.
- (d) After a reversal of an impairment loss is recognised, the entity must adjust the depreciation (amortisation) charge for the asset in future periods to allocate the asset’s revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Therefore, if there are indications that a previously recognised impairment loss has disappeared or reduced, it is necessary to determine the recoverable amount (i.e., the higher of FVLCS or VIU) so that the reversal can be quantified.

Illustration 7-1: Impairment reversal for an individually impaired asset

The facts are the same as in Illustration 4-6. During 20X4, it becomes apparent that the cheaper material used by Entity A’s competitor was not fit for purpose and their components need replacement after a year. Sales of Entity A’s product start to return to their previous levels. At 31 December 20X4 the machine has a carrying amount of £58,271. Management has reassessed the future cash flows based on changed circumstances since the end of 20X0 and determined VIU at the end of 20X4 to be £122,072. Management believes FVLCS is less than VIU.

At the end of 20X4, the machine's recoverable amount i.e., its VIU (£122,072) is higher than the machine's carrying amount before the recognition of any reversal of the impairment loss recognised in 20X0 (£58,271). It is an indication that the impairment loss recognised in 20X0 no longer exists or may have decreased.

End of 20X4	Machine
	£
Recoverable amount	122,072
Carrying amount before the reversal of the impairment loss recognised in 20X0	<u>58,271</u>
Difference	<u>63,801</u>

The difference is only an indication of the amount of the reversal because the reversal cannot increase the carrying amount of the asset above the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. At 31 December 20X4, the carrying amount that would have been determined, had no impairment loss been recognised for the asset in prior years, is £120,000 (cost £300,000 less accumulated depreciation £180,000). Thus £120,000 is the maximum carrying amount for the asset after the reversal of impairment.

The entity compares the carrying amount at 20X4 if no impairment loss had been recognised, with the carrying amount at 20X4 and determines that the maximum impairment reversal is £61,729.

End of 20X4	Machine
	£
Cost	300,000
Less notional depreciation since acquisition until 20X4	<u>(180,000)</u>
Notional carrying amount at 31/12/20X4 if no impairment loss had been recognised for the asset in 20X0	120,000
Less carrying amount at the year ended 31/12/20X4, before the reversal of the impairment loss recognised in prior reporting periods	<u>(58,271)</u>
Reversal of prior year's impairment loss	<u>61,729</u>

As a consequence of the reversal of part of the impairment loss recognised at 31 December 20X0, the carrying amount of the machine is £120,000 i.e., equal to the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. In subsequent periods, assuming that all variables remain the same as at the end of 20X4, the depreciable amount will be £120,000, so the depreciation charge will be £20,000 per annum (£120,000 depreciable amount depreciated over remaining 6 year remaining useful life).

7.2 Reversal when recoverable amount was estimated for a cash-generating unit

When the original impairment loss was based on the recoverable amount of the cash-generating unit to which the asset, including goodwill belongs, the following requirements apply: [FRS 102.27.31]

- (a) The entity must estimate the recoverable amount of that cash-generating unit at the current reporting date.
- (b) If the estimated recoverable amount of the cash-generating unit exceeds its carrying amount, that excess is a reversal of an impairment loss. The entity must allocate the amount of that reversal to the assets of the unit, except for goodwill, *pro rata* with the carrying amounts of those assets subject to the limitation described in (c) below. Those increases in carrying amounts must be treated as reversals of impairment losses and recognised immediately in profit or loss unless the asset is carried at revalued amount in accordance with another section of this FRS (for example, the revaluation model in Section 17). Any reversal of an impairment loss of a revalued asset must be treated as a revaluation increase in accordance with the relevant section of this FRS.
- (c) In allocating a reversal of an impairment loss for a cash-generating unit, the reversal must not increase the carrying amount of any asset above the lower of:
 - (i) Its recoverable amount.
 - And
 - (ii) The carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

- (d) Any excess amount of the reversal of the impairment loss that cannot be allocated to an asset because of the restriction in (c) above must be allocated *pro rata* to the other assets of the cash-generating unit.
- (e) After a reversal of an impairment loss is recognised, if applicable, the entity must adjust the depreciation (amortisation) charge for each asset in the cash-generating unit in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

The above requirements are illustrated in the Illustration below.

Illustration 7-2: Impairment reversal for a cash generating unit

The facts are the same as those in Illustration 6-1. In 20X3 the government is still in office in Country A but the business situation is improving. The effects of the export laws on Entity T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase. This favourable change requires Entity T to re-estimate the recoverable amount of the CGU for the net assets of the Country A operations. Management estimates that the recoverable amount of the Country A CGU is now £2,010. Management are unable to estimate the FVLCS or VIU of any individual asset within the CGU. To calculate the reversal of the impairment loss, Entity T compares the recoverable amount and the net carrying amount of Country A's CGU.

	Goodwill	Identifiable assets	Total
	£	£	£
Historical cost	1,000	2,000	3,000
Accumulated amortisation/depreciation ¹	(200)	(167)	(367)
Accumulated impairment loss	(800)	(473)	(1,273)
Carrying amount after impairment loss at 31/12/20X1	-	1,360	1,360
20X2 and 20X3			
Depreciation (2 years) ²	-	(247)	(247)
Carrying amount before impairment reversal	-	1,113	1,113

¹ Goodwill was being amortised over a period of five years ($£1000 \div 5 \text{ years} = £200$), while the identifiable assets were deemed to have a useful life of 12 years ($£2000 \div 12 \text{ years} = £166.70$ depreciation per year).

² Two years of depreciation based on carrying amount of £1,360 at 1/1/20X4 and remaining useful life of 11 years ($(£1,360 \div 11 \text{ years} = £123.6 \text{ per year}) \times 2 \text{ years} = £247$).

Comparing this with the recoverable amount of the CGU:

End of 20X3	CGU A
	£
Recoverable amount	2,010
Carrying amount before the reversal of the impairment loss recognised in 20X1	(1,113)
Difference	897

The difference is only an indication of the amount of the possible reversal because of the restriction in paragraph 31(b) of Section 27, which requires that any impairment reversal can only be applied to assets of the unit other than goodwill, and is subject to the limitation that the reversal cannot increase the carrying amount of any asset above the lower of its recoverable amount and the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods. As can be seen below, this results in the impairment reversal being restricted to £387.

	Identifiable assets
	£
Carrying amount of identifiable assets before impairment reversal	1,113
Carrying amount assuming no prior period impairment ¹	1,500
Impairment reversal applied to assets	387

¹ Identifiable assets continue to be depreciated over their 12 year useful life @£166.70 per year ((£2000 ÷ 12 years = £166.70 per year) × 3 years) = £500. Gives carrying amount of £2000 less depreciation of £500 = £1,500).

Note: if management were able to estimate the recoverable amount for any of the individual identifiable assets then these amounts (if lower) would be used in restricting the impairment reversal.

7.3 Reversals of impairments - revalued assets

If an asset is recognised at a revalued amount under another standard, any reversal of an impairment loss must be treated as a revaluation increase under that other standard. Thus, a reversal of an impairment loss on a revalued asset is credited to other comprehensive income. [FRS 102.27.30, FRS 102.27.31]. However, under the revaluation models in Section 17, Section 18 and Section 20, to the extent that an impairment loss on the same revalued asset was previously recognised as an expense in the income statement, a reversal of that impairment loss is recognised as income in the income statement. [FRS 102.17.15E, FRS 102.18.18G, FRS 102.9.26, FRS 102.20.61].

As with assets carried at cost, after a reversal of an impairment loss is recognised on a revalued asset, the depreciation charge must be adjusted in future periods to allocate the asset's revised carrying amount, less any residual value, on a systematic basis over its remaining useful life. [FRS 102.27.30(d), FRS 102.27.31(e)].

8 Subgroup and separate financial statement issues

The application of Section 27 in group situations is not always straight forward and can give rise to a number of challenging questions. We explore some of these questions in the following sections, including:

- How to identify CGUs and relevant cash flows in the financial statements of an individual entity within a group, the consolidated financial statements of a subgroup, or when impairment testing equity accounted investments or those carried at cost.

And

- Whether the cash flows mentioned above need to be on an arm's length basis, i.e., at fair value, and the extent the restrictions imposed by Section 27 need to be applied.

Note that we have used the term 'individual financial statements' for any stand-alone financial statements that apply FRS 102. The term 'individual financial statements' includes separate financial statements, individual financial statements for subsidiary companies with no investments and, for a subsidiary that does not have any subsidiaries, unconsolidated financial statements whose associates and joint ventures are accounted for using the equity method.

8.1 VIU: intra-group transactions (transfer pricing)

When required by Section 27, an impairment test is performed to:

- Equity accounted investments.
- Investments in subsidiaries, associates or joint ventures carried at cost in the separate financial statements of the parent.

Or

- Assets/CGUs in an individual group company's or subgroup's financial statements.

When performing those impairment tests, the key questions are how to determine the cash flows for intra-group transactions and whether those cash flows need to be on an arm's length basis.

Individual group companies or subgroups may not have truly independent cash flows because of the way in which groups allocate activities between group entities. Transactions between a parent entity and its subsidiaries, between subsidiaries within a group or between subsidiaries/parents and investments in associates and joint ventures can be carried out at terms that differ from an arm's length basis. Entities can benefit from transactions entered into by others that are not reflected in their financial statements, e.g., management and other facilities provided by another group company, or can incur those expenses on their behalf without recharge.

In the context of impairment testing, this means that an entity needs to consider whether the relevant cash flows are those actually generated by the asset (investment in subsidiary, joint venture, associate or individual asset or CGU) or those that it could generate on an arm's length basis. Section 27 gives no clear answer to this question. There are two broad approaches, either:

- The cash flows must take into consideration the manner in which the group has organised its activities and make notional adjustments to reflect arm's length amounts.

Or

- The VIU must be based on the cash flows directly generated under current arrangements, e.g., those received and receivable.

In the UK, we typically expect the former approach to be more common, as it reflects the value of the subsidiary to the parent without an arbitrary overlay of internal transfer pricing.

Calculating the notional adjustments is not always straightforward in practice, as it can be difficult to allocate arm's length prices in intra-group arrangements where there is often a 'bundle' of goods and services and where some transactions do not have commercial equivalents. When making these adjustments, one method that can work in practice is to start from the VIU of the CGU in the consolidated financial statements, of which the subsidiary being tested for impairment is a part, and allocate it to the various subsidiaries. Doing so reflects the arm's length prices of inputs and outputs, and therefore the substitution of transfer prices. This, however, is not a straightforward exercise. It is essential to avoid the following potential pitfalls:

- Taking account of a notional increase in income or VIU to one subsidiary but neglecting to reflect the notional increase in costs or loss of VIU to another.

- Including benefits or costs that cannot be converted into cash flows to the entity. This can be particularly problematic when testing goodwill, including the carrying value of investments when the purchase price reflects goodwill on acquisition. Most would consider this a constraint on the cash flows reflected in this impairment test. This can be revealed if there is a major difference between the subsidiary-based and CGU-based recoverable amount as there could be cash flows or synergies elsewhere in the group that cannot be reasonably attributed to the subsidiary or subgroup in question.
- As explained further in 8.4.2.B below, the entity's investment reflects the net assets of the subsidiary while the CGU reflects the assets and liabilities on a gross basis, so appropriate adjustments to any VIU calculated for the purposes of a CGU at the consolidated level will have to be made in order to arrive at the VIU for an investment.

Whilst in the UK we typically expect entities to apply an approach that involves making notional adjustments to reflect arm's length amounts, it is acknowledged that one may argue against making notional adjustments due to the lack of guidance in Section 27.

How we see it

As Section 27 is silent on how to treat intra-group transactions in a VIU calculation it is important for an entity to disclose sufficient information to enable users of financial statements to understand which approach was applied and how this impacted the entity's financial statements. These disclosures may include a description of the entity's facts and circumstances, how the approach was applied, the basis for selecting an approach and the impact on the financial statements.

8.2 Testing goodwill for impairment in a group company's or subgroup's financial statements

When individual financial statements or the consolidated financial statements of a subgroup include goodwill, impairment testing of assets at the level of that entity or subgroup will be required when indicators are present. Along with the question of whether intra-group cash flows need to be on an arm's length basis for impairment testing purposes (as discussed in 8.1 above), another question which may arise is how to treat synergies arising outside of the reporting entity/subgroup.

If goodwill is being tested in the consolidated financial statements of a subgroup or individual financial statements, it is possible that the synergies that gave rise to the goodwill are in another part of the larger group because the subgroup is part of a CGU containing other subsidiary companies. It is possible that some synergies such as economies of scale cannot be translated into cash flows to the entity or subgroup in question. Although there is no impairment at the level of the CGU in the group consolidated financial statements, it is possible that the entity cannot avoid writing down the goodwill in the individual financial statements or consolidated financial statements of a subgroup statements.

How we see it

In our view, it is not appropriate to consider synergies arising outside the individual financial statements or consolidated financial statements of a subgroup when testing impairment in the individual financial statements or consolidated financial statements of a subgroup unless these synergies are available to market participants and therefore are built into the FVLCS. Whether this impairment loss needs to be recorded in the statement of profit or loss or whether it is appropriate to treat it as an equity transaction in the form of a distribution to the parent is a matter of judgement.

8.3 Intra-group transfer of investments in subsidiaries

A common form of group reorganisation involves the transfer of the entire business of a subsidiary to another subsidiary of the same parent. These transactions often take place at the book value of the transferor's assets rather than at fair value. If the original carrying value was a purchase price that included an element of goodwill, the remaining 'shell', i.e., an entity that no longer has any trade or activities, can have a carrying value in the parent company's statement of financial position in excess of its net worth/recoverable amount. It could be argued that as the subsidiary is now a shell with no possibility in its current state of generating sufficient profits to support its value, a loss must be recognised by the parent in its separate financial statements to reduce its investment in the shell company to its net worth/recoverable amount. However, the transfer of part of the group's business from one controlled entity to another has no substance from the perspective of the group and will have no effect in the consolidated accounts. There has also been no loss overall to the parent as a result of this reorganisation as the loss in net worth/recoverable amount in one subsidiary results in an increase in the net worth/recoverable amount in the other subsidiary.

How we see it

In our view, where part of the group's business has been transferred from one controlled entity to another such that the parent company has suffered no real loss, it is appropriate for the parent to reallocate an appropriate amount of its investment in the transferor company to its investment in the receiving company. The parent company's total investment in its subsidiaries remains the same.

This concept is discussed further, together with an Illustration in Chapter 22 at 5.4.3.A.

It must be noted that there are also legal considerations when an entity sells an asset (or a group of assets and liabilities, for example, a business) to another group company for an amount that is less than its fair value (including for nil consideration). In such instances, the entity is making a transfer at undervalue because it is not receiving an arm's length consideration. Therefore, the entity must consider whether it is making a distribution under Part 23 of the CA 2006 and whether it has sufficient distributable reserves to do so. Distributions in kind (meaning distributions arising on the sale or transfer of a non-cash asset) are specifically addressed in s845 and s846 of Part 23. This is particularly relevant when the transaction involves a transfer of value from a group entity to its direct or indirect parent/owner or to a fellow subsidiary. An example of a transfer of value by the transferor (the selling entity) is a hive up or hive across in which the consideration received by the entity is less than the fair value of the trade and assets sold. An example of a transfer of value by the transferee (the purchasing entity) is a hive down or hive across in which the consideration paid by the entity exceeds the fair value of the trade and assets purchased. This issue is also discussed further in Chapter 22 at 5.4.1.

8.4 Investments in subsidiaries, associates and joint ventures

Investments in subsidiaries, associates and joint ventures carried at cost in separate financial statements of the parent and equity accounted investments are within the scope of Section 27.

However, Section 9 also permits entities to account for investments in subsidiaries, associates and joint ventures in separate financial statements at fair value with changes in fair value recognised in other comprehensive income (or profit or loss) in accordance with Section 27 or at fair value with changes in fair value recognised in profit or loss. [FRS 102.9.26].

The recoverable amount for investments carried at cost is the higher of FVLCS and VIU. Specific questions around FVLCS are dealt with in 8.4.1 below. Challenges in respect of VIU for investments carried at cost are dealt with in 8.4.2 below.

It is important to note that testing an investment in an associate or joint venture carried under the equity method using Section 14 in group financial statements cannot always provide assurance about the recoverability of the cost of shares in the investor's separate financial statements, if they are carried at cost. Accounting for the group's share of losses can take the equity interest below cost and an impairment test could reveal no need for an impairment loss in the consolidated financial statements. This does not necessarily provide any assurance about the (higher) carrying value of the shares in the separate financial statements.

8.4.1 Fair value less costs to sell (FVLCS) for investments in subsidiaries, associates and joint ventures

In order to establish FVLCS an entity must apply Section 2A's requirements as outlined in 4.7 above and described in detail in Chapter 10.

Section 2A states that the best evidence of fair value is an unadjusted quoted price for an identical or comparable asset or liability in an active market at the measurement date. As such, if an entity holds a position in a single asset or liability that is traded in an active market, one would typically expect fair value to be measured at that price, without adjustment. Under IFRS 13, there is an explicit requirement to measure such an asset or liability based on the product of the quoted price for the individual asset or liability and the quantity held ($P \times Q$).

However, when an entity holds an investment in a subsidiary, joint venture or associate the question arises as to what the unit of account is, the individual shares or the investment as a whole, and whether it would be appropriate to include a control premium when determining fair value provided that market participants take this into consideration when pricing the asset. This has led to some diversity of views amongst IFRS reporters as to whether such an investment must be measured at $P \times Q$, or whether, instead, the fair value must include an adjustment (e.g., a control premium). FRS 102 requires that the best evidence of fair value is a quoted price for an identical asset in an active market. This is similar to that in IFRS 13, and therefore similar questions may arise under FRS 102. However, FRS 102 does not reproduce the additional guidance contained in IFRS 13 that the fair value of a portfolio of financial instruments must be measured as $P \times Q$.

How we see it

Given that PxQ guidance is not contained in FRS 102, in our view, the use of PxQ is not required unless an entity uses the requirements and guidance of adopted IFRS in setting an accounting policy as permitted by paragraph 10.6 of FRS 102. This matter is discussed further in Chapter 10 at 4.10.1 and the EY publication, International GAAP®.

Unlike investments with quoted prices, discussed above, there are less issues if FVLCS is used to determine the recoverable amount of an asset that does not have a quoted price in an active market and is either:

- An investment in a subsidiary, joint venture or associate.

Or

- A CGU comprising the investment's underlying assets.

Using FVLCS can avoid some of the complexities of determining appropriate cash flows related to transfer pricing and other intra-group transaction issues, described in 8.1 above and 8.4.2 below.

8.4.2 VIU for investments in subsidiaries, associates and joint ventures

Unlike most other assets, an investment in a subsidiary, joint venture or associate can be viewed as either:

- An individual asset that can generate income, e.g., in the form of dividends.

Or

- As an asset that represents the underlying assets and liabilities that are under the control of the subsidiary, joint venture or the associate.

Reflecting these two ways in which an investment can be viewed, that there are broadly two approaches in testing for impairment:

- To focus on the investment as a single asset, and estimate its VIU based on the cash flows the parent receives (dividends and ultimate disposal proceeds).

Or

- To focus on the underlying assets of the investment and estimate its VIU based on the cash flows generated by these assets through the investee's operations (and if applicable, the ultimate disposal of the investee).

Using appropriate assumptions, both methods give the same result. These two approaches are considered at 8.4.2.A and 8.4.2.B below respectively. Whichever view is taken, the entity needs to ensure that the cash flows are appropriate (see 8.1 above in respect of considerations around intra-group transfer pricing). We note that, when testing subsidiaries for impairment in particular, the second approach is the more common in practice.

It is important to note that, whether an entity calculates VIU using its share of the present value of estimated cash flows of the underlying assets or the dividends expected to be received, it is necessary to adjust them to reflect Section 27 restrictions, e.g., those in respect of improvements, enhancements and restructuring (see 4.8.2 above), growth (see 4.8.1 above) and discount rates (see 4.8.12 above). It can be a practical challenge to obtain sufficiently detailed information to make such adjustments for investments in entities that are not controlled by the parent, in which case it is possible that the entity needs to use FVLCS to establish the recoverable amount.

8.4.2.A VIU of investments in subsidiaries, associates and joint ventures using dividend discount models

One approach to determining the VIU of the equity accounted interest is to base it on the present value of the estimated future cash flows expected to arise from dividends to be received from the investment. This type of approach is referred to as a dividend discount model (DDM). DDMs are financial models frequently used by financial institutions to value shares at the discounted value of future dividend payments. These models value a company on the basis of future cash flows that are expected to be distributed to the shareholders in compliance with the capital requirements provided by law, discounted at a rate expressing the cost and risk of capital. By analogy this approach can be used to calculate the VIU for investments in subsidiaries, associates and joint ventures carried at cost in the separate financial statements of a parent and for equity accounted investments.

It must be noted that in order to use a DDM for calculating VIU, Section 27's requirements (including the various restrictions referred to at 8.4.2 above) must be reflected in the future dividends calculated for use in the model.

8.4.2.B VIU of investments in subsidiaries, associates and joint ventures based on cash flows generated by underlying assets

When testing investments in subsidiaries, associates and joint ventures based on cash flows generated by underlying assets, entities need to ensure that the cash flows are appropriate (see 8.1 above in respect of intra-group transfer pricing) and that the restrictions of Section 27 are appropriately applied (see 8.4.2 above).

If an entity is testing its investments in subsidiaries, associates and joint ventures for impairment can demonstrate that the investment contains one or more CGUs in their entirety, then it can in some circumstances be able to use the results of the group impairment tests of the underlying CGUs to test the investment for impairment. If the aggregate VIU (or FVLCS) of the CGU(s) is not less than the carrying value of the investment, this can be an indication that the investment is not impaired.

However, it is critical to note that the entity's investment reflects the net assets of the subsidiary, associates or joint venture while the CGU reflects the assets and liabilities on a gross basis, so appropriate adjustments will have to be made. For example, any VIU calculated for a CGU is unlikely to include any adjustments for debt held by that CGU, because liabilities are typically excluded from the carrying value of a CGU. In contrast, the carrying value of an investment inherently includes any debt the entity holds and therefore, in order to achieve consistency, the VIU must also be adjusted for that debt. There may also be other balances such as financial assets, working capital, pensions and other provisions which warrant closer attention. In addition, when it comes to investments in associates and joint ventures, an investor with a minority holding will need to assess the impact of holding a minority stake without control.

Illustration 8-1 below is a simple example illustrating the requirement to make appropriate adjustments where group level testing has been used as a start point:

Illustration 8-1: Impairment testing of investment in subsidiary

Entity A is a parent company with three wholly owned subsidiaries: Entity X, Entity Y and Entity Z. The three subsidiaries operate autonomously and do not transact with one another. Entity A prepares consolidated financial statements, and the three subsidiaries each represent separate CGUs for the purposes of its group level impairment testing.

At 31 December 20X0, there are indicators of impairment of CGU X, and therefore the group calculates the VIU of the CGU*. CGU X has an external loan whose carrying value is £750 (with £750 also being materially consistent with the loan's fair value). However, in accordance with the requirements of Section 27, this loan is excluded from the carrying value of CGU X, and financing cash flows are excluded from the VIU calculation when testing the CGU at group. Based on the group level impairment testing, the VIU of CGU X is determined to be £1,500.

For the purposes of Entity A's parent company financial statements, it notes that the impairment indicator relating to CGU X is also an impairment indicator in respect of its investment in Entity X. The carrying value of Entity A's investment in Entity X is £1,000.

In this case, Entity A can leverage the group level impairment testing, because the investment contains the tested CGU in its entirety. However, the cash flows of CGU X cannot all be extracted by Entity A as dividends because Entity X also has a loan. Therefore, the present value of expected cash flows from Entity X's cash flows must be reduced by the fair value of outstanding debt, in order to determine the net amount available to Entity A as an equity investor. Therefore, the outcome of Entity A's impairment test on its equity investment in Entity X is as follows:

	£
Value-in-use of CGU X	1,500
Fair value of debt held by Entity X	(750)
Recoverable amount of Entity X	<u>750</u>
Carrying value of Entity X before impairment	<u>1,000</u>
Impairment loss	<u>(250)</u>

In this example such adjustments would also be required if the debt held by Entity X was payable to its parent or to a fellow subsidiary, as the same principle applies - not all cash flows generated by Entity X are available to Entity A as equity holder.

If the debt was payable to Entity A, Entity A would also need to perform a separate impairment test in respect of the receivable due from Entity X.

* For simplicity in this example, it is assumed that at the year end, working capital for CGU X is insignificant and that in addition, the CGU does not have other complexities such as pensions or provisions to consider.

The example above is relatively simplistic and it is not always so straightforward in practice. There are particular problems if the asset (the investment) and the underlying CGU are not the same.

8.5 Impairment of assets of a subsidiary which is part of a larger CGU

The identification of a group's CGUs may not be consistent with the legal structure of the group, such that the activities of an individual subsidiary may form part of a larger CGU or group of CGUs in the group. When this is the case the cash flows attributable to an individual subsidiary may appear not to support the carrying value of that entity's assets, while from a group perspective no impairment is identified as the subsidiary forms part of a larger profitable CGU or group of CGUs.

An example of this would be where TopCo A has a single direct investment in MidCo B. MidCo B owns OpCo's D to F. In the group accounts, D, E and F form a group of CGUs to which goodwill has been allocated, and the group of CGUs as a whole is highly profitable. However, despite operating on an arm's length basis, the legal entity, OpCo F, is loss making. As a result, the cash flows for OpCo F may not support the carrying value of MidCo B's investment in F, and an impairment may need to be recognised by MidCo. However, from the perspective of the consolidated accounts, the group of CGUs is profitable and therefore no impairment of goodwill is required at that level. In addition, in TopCo's separate financial statements there may be no impairment of its investment in MidCo, as the positive cash flows which can be derived from OpCo's D and E may be sufficient to recover the carrying value of that investment.

However, it must be noted that although goodwill is not impaired in the consolidated accounts in this scenario, if OpCo F corresponds to a CGU in the group accounts, the impairment of MidCo's investment in F may be an indicator of impairment of CGU F itself, which would need to be considered for the purposes of the consolidated accounts (see 6.3 above).

This illustrates that, as a result of the different levels at which impairment testing is performed, impairment losses in individual subsidiaries' financial statements may not follow the losses recognised in the consolidated financial statements.

Even if the CGU and investment coincide, it is possible that the shares have been acquired in a business combination. It is quite possible that the synergies that gave rise to goodwill on acquisition are in another part of the group not controlled by the intermediate parent in question. In such a case it could be that an entity is not able to use the result of the group impairment test and so would have to calculate the recoverable amount of the investment.

9 Disclosures

An entity must disclose the following for each class of assets indicated in the paragraph below:

[FRS 102.27.32]

- The amount of impairment losses recognised in profit or loss during the period and the line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which those impairment losses are included.
- And
- The amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) in the statement of comprehensive income (or in the income statement, if presented) in which those impairment losses are reversed.

The information above is required for each of the following classes of asset: [FRS 102.27.33]

- Inventories
- Property, plant and equipment (including investment property accounted for by the cost method)
- Right-of-use assets
- Goodwill
- Intangible assets other than goodwill
- Investments in associates
- And
- Investments in joint ventures

An entity must also disclose a description of the events and circumstances that led to the recognition or reversal of the impairment loss. [FRS 102.27.33A].

9.1 Companies Act disclosure requirements

Schedule 1 of the *Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*, (SI 2008/410) (the Regulations), requires provisions for diminution in value to be made in respect of any fixed asset if the reduction in value is expected to be permanent. Where the reasons for the provision have ceased to apply, the provision must be written back to the extent that it is no longer necessary. In either case, amounts not shown in the profit and loss account must be disclosed in the notes to the accounts. [1 Sch 19].

Accounts prepared under FRS 102 are 'Companies Act accounts' (as opposed to 'IAS accounts') under Company Law, and are subject to all of the requirements set out in the Regulations. Entities subject to Schedule 1 to the Regulations have a choice of formats for the presentation of their financial statements. These choices are as follows:

- Apply one of the two statutory formats set out in Section B of Part 1 of Schedule 1 to the Regulations.
- Or
- Applying paragraph 1A(2) of Schedule 1 to the Regulations and use the 'adapted' formats as set out in Section 5 - *Statement of Comprehensive Income and Income Statement*. 'Adapted' formats are similar to IAS 1 formats used by IFRS reporters.

Under Format 2 of Schedule 1 to the Regulations, where expenses are classified by nature, there is a specific line item, 7(a), headed 'Depreciation and other amounts written off tangible and intangible fixed assets' where impairment losses must be shown. Under Format 1, where expenses are classified by function, impairment losses are generally shown in the same category of expense as depreciation of the relevant asset, with the amount of depreciation and other amounts written off tangible and intangible assets disclosed in a note to the accounts.

Under the adapted format, an entity must present an analysis of expenses, either in the income statement or the notes, equivalent to what would have been presented had the profit and loss account format not been adapted. [FRS 102.5.5B].

Under both the statutory and adapted formats, FRS 102 requires entities to present additional line items, headings and subtotals in the income statement when such presentation is relevant to an understanding of the entity's financial performance. [FRS 102.5.9]. Therefore, in practice, we would not anticipate differences in the level of information given about impairment charges whether entities apply the statutory or adapted formats for the income statement.

The Regulations also require certain information to supplement the balance sheet. In respect of fixed assets, this includes:

- The cumulative amount of provisions for depreciation or diminution in value as at the beginning of the financial year and at the balance sheet date.
- The amount of any such provisions made in respect of the financial year.
- The amount of any adjustments made in respect of any such provisions during that year in consequence of the disposal of any assets.

And

- The amount of any other adjustments made in respect of any such provisions during that year.

[1 Sch 51(3)].

The statutory disclosures overlap with disclosures in FRS 102 of depreciation, amortisation and impairment charges (see above at 8, Chapter 20 at 3.10 and Chapter 21 at 3.4.2). *[FRS 102.17.31, FRS 102.18.27(e), FRS 102.27.32, FRS 102.27.33].*

9 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for impairments are set out below.

	FRS 102	IFRS
Timing of impairment tests	Impairment testing required only when indicators of impairment exist.	Mandatory annual testing for goodwill and indefinite lived intangibles.
Assets held for service potential	Possible to use depreciated replacement cost as a measurement model.	No specific guidance
Guidance on inputs to VIU calculations	Guidance on inputs to VIU calculations is provided but is less extensive than IFRS. Section 27 does not give any further guidance (beyond providing a definition) on the identification of CGUs for impairment testing purposes.	Guidance provided on identifying CGUs, allocating goodwill to those CGUs, estimating cash flows and discount rates and treatment of corporate assets.
Allocation of goodwill to CGUs for purposes of impairment testing	Allocated to each of the acquirer's CGUs that are expected to benefit from the acquisition, whether or not the acquiree's other assets or liabilities are allocated to those units. If unable to allocate to CGUs non-arbitrarily, can test based on simplified split between integrated and non-integrated entities.	Allocated to each of the acquirer's CGUs that are expected to benefit from the acquisition, whether or not the acquiree's other assets or liabilities are allocated to those units. Each CGU or group of CGUs to which goodwill is allocated must represent the lowest level at which goodwill is monitored and cannot be larger than an IFRS 8 <i>Operating Segments</i> operating segment before aggregation.
Disclosures	Limited to amount of impairment losses recognised/reversed and circumstances leading to it.	Extensive additional disclosures required in respect of goodwill/indefinite lived intangibles even where no impairment recognised - includes amounts of goodwill/indefinite lived intangibles allocated to particular CGUs, key assumptions, period over which cash flows projected, growth rates and discount rates applied and further detail where a reasonably possible change in a key assumption could give rise to an impairment.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

carrying amount	The amount at which an asset or liability is recognised in the statement of financial position.
cash-generating unit	The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
depreciated replacement cost	The most economic cost required for the entity to replace the service potential of an asset (including the amount that the entity will receive from its disposal at the end of its useful life) at the reporting date.
fair value less costs to sell	The amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable willing parties, less the costs of disposal.
impairment loss	The amount by which the carrying amount of an asset exceeds: (a) in the case of inventories, its selling price less costs to complete and sell; or (b) in the case of other assets, its recoverable amount.
recoverable amount	The higher of an asset's (or cash-generating unit's) fair value less costs to sell and its value in use.
service potential	The capacity to provide services that contribute to achieving an entity's objectives. Service potential enables an entity to achieve its objectives without necessarily generating net cash inflows.
value in use	The present value of the future cash flows expected to be derived from an asset or cash-generating unit.
value in use (in respect of assets held for their service potential)	When the future economic benefits of an asset are not primarily dependent on the asset's ability to generate net cash inflows, value in use (in respect of assets held for their service potential) is the present value to the entity of the asset's remaining service potential if it continues to be used, plus the net amount that the entity will receive from its disposal at the end of its useful life.

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Chapter 30

Employee benefits

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Overview

Employee benefits typically form a very significant part of any entity's costs and can take many varied forms. These are covered in two separate sections of FRS 102, Section 28 *Employee Benefits* ('Section 28') and Section 26 *Share-based Payment* ('Section 26'). Section 28 deals with all employee benefits not in the scope of Section 26.

Many issues in accounting for employee benefits can be straight forward, such as the allocation of wages paid to an accounting period. In contrast, accounting for the costs of post-employment and other long-term benefits in the financial statements of employers presents a more difficult challenge. The amounts involved are large, the timescale is long, the estimation process is complex and involves many areas of uncertainty for which assumptions must be made. Section 28 includes limited guidance on the recognition of pension surpluses, which further increases the level of judgements preparers of financial statements must make in determining appropriate accounting for employee benefits.

What you need to know

- The general recognition principle for all employee benefits, including a post-employment benefit plan, is to recognise an expense (unless another section of FRS 102 requires it to be recognised as the cost of an asset) alongside a corresponding asset or liability. The expense is recognised when the employees have become entitled to the benefit as a result of services rendered to the entity.
- Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on their principal terms and conditions.
- The application of Section 28, particularly for defined benefit plans, can be complicated and require significant estimates (i.e., actuarial assumptions) to be made.
- Section 28 requires the cost of a defined benefit plan to be recognised as follows:
 - The change in the net defined benefit liability arising from employee service rendered during the period in profit or loss.
 - Net interest on the defined benefit liability during the reporting period in profit or loss.
 - The cost of plan introductions, benefit changes, curtailments and settlements in profit or loss. And
 - Remeasurement of the net defined liability in other comprehensive income.
- Judgements might need to be made around various requirements of the standard, such as whether the entity is able to recover a surplus, and the date of modification or settlement of a plan.
- In group plans (defined benefit plan that shares risks between entities under common control), an individual entity must recognise their share of the scheme measured as either their contractually agreed share or their contribution payable.

1 Introduction

This chapter deals with Section 28. In March 2018 and September 2024, the FRC published amendments to FRS 102 which resulted in minor changes to this section. In May 2019, the FRC published an amendment to FRS 102 specifically related to multi-employer defined benefit plans setting out clear requirements to address the transition from defined contribution accounting to defined benefit accounting for a multi-employer defined benefit plan. All of these amendments are included in this chapter.

2 Comparison between Section 28 and IFRS

The key differences between Section 28 of FRS 102 and IAS 19 *Employee Benefits* are detailed below.

2.1 Past service costs

IAS 19 defines past service cost as “the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by a plan).” [IAS 19.8]. FRS 102 does not use the term past service cost, but still requires the cost of plan introductions, benefit changes, curtailments and settlements to be recorded in profit or loss. [FRS 102.28.23(c)]. As both FRS 102 and IAS 19 require a charge to the profit and loss account the only difference is concerned with terminology within disclosures (see 4.1.4 below).

2.2 Recognition of a defined benefit plan surplus

FRS 102 requires that an entity must recognise a defined benefit plan surplus as an asset only to the extent that it is able to recover the surplus either through reduced contributions in the future or through refunds from the plan. [FRS 102.28.22]. FRS 102 does not elaborate on how these reduced future contributions or refunds are quantified.

The lack of guidance provided by FRS 102 will lead to management being required to make a judgement on the amount of a defined benefit pension surplus to be recognised. When making this judgement, FRS 102 states that management may consider the requirements and guidance in adopted IFRS dealing with similar or related issues, as discussed in Chapter 9 at 3.1. [FRS 102.10.6]. The requirements of IFRIC 14 *IAS 19 – The Limited on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* are discussed in further detail at 3.5.7 below. The treatment of pension surpluses was also dealt with under previous UK GAAP which had a strict requirement that the amount to be recovered from refunds of the scheme must only reflect those that have been agreed by the pension scheme trustees at the balance sheet date, [FRS 17.42]. This has led to a diversity in practice under FRS 102.

2.3 Liability for deficit funding requirements

For entities already recognising assets or liabilities for defined benefit plans in accordance with FRS 102, no additional liabilities are recognised in respect of an agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions). This is a difference with IFRS which requires a liability to be recognised where deficit funding contributions are not recoverable in the future. This is discussed further at 3.5.7 below.

The requirements of IFRIC 14 are discussed where relevant in the remaining sections of this chapter.

2.4 Attributing benefit to years of service

IAS 19 requires benefits to be attributed to the periods in which the obligation to provide post-employment benefits arises. In applying the projected unit credit method, IAS 19 normally requires benefits to be attributed to periods of service under the plan's benefit formula, however if an employee's service in later years will lead to a materially higher level of benefit the benefit must be attributed on a straight-line basis from: [IAS 19.70]

- The date when service by the employee first leads to benefits under the plan.
Until
- The date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

FRS 102 also notes that the present value of an entity's obligations under defined benefit plans must include the effects of benefit formulas that give employees greater benefits for later years of service, [FRS 102.28.16], but does not state that this must be attributed on a straight-line basis. Given the GAAP hierarchy in Section 10 *Accounting Policies, Estimates and Errors* we would expect users to follow the principles in IAS 19, but they are not required to do so.

2.5 Calculation of service cost and net interest following a plan amendment, curtailment or settlement

In February 2018, amendments were issued to IAS 19 which address the accounting when a plan amendment, curtailment or settlement occurs during the reporting period. This guidance has not been replicated in FRS 102. However, given that the standard is silent in this area users of FRS 102 may, under the GAAP hierarchy, turn to IAS 19 for further guidance.

IAS 19 clarifies that the current service cost in the period following a plan amendment, curtailment or settlement must be calculated using the actuarial assumptions used to measure the net defined benefit liability (asset). [IAS 19.122A]. The net interest following a plan amendment or curtailment must be measured using the net defined benefit liability/(asset) after the plan amendment or curtailment and the discount rate used to remeasure the net defined liability/(asset). [IAS 19.123A].

Accounting for plan amendments, curtailments and settlements is discussed further at 3.5.6 below.

2.6 Presentation

Part 1 of Schedule 1 to the Regulations provides a choice of either two statutory formats or the adapted formats for the balance sheet. This is discussed further in Chapter 6 at 3.

The statutory formats of *the Large and Medium-sized companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410) ('The Regulations'), presentation under FRS 102 differ from that required by IAS 1 *Presentation of Financial Statements*. The Regulations show pension deficits as the first line item within provisions, and pension surpluses are presented in the same place as pension deficits (i.e., after accruals and deferred income) under format 1 of the Regulations, but after prepayments and accrued income under format 2 of the Regulations. FRS 17 *Retirement benefits* required defined benefit pension assets or liabilities to be presented after accruals and deferred income, but before capital and reserves. [FRS 17.47]. This presentation was based on an interpretation of law. [FRS 17 Appendix II.6]. As a result, there is likely to be divergence in practice in the presentation of defined benefit pension surpluses and deficits under FRS 102. This is further discussed at 3.5.9 below.

2.7 Accounting for multi-employer defined benefit plans when sufficient information becomes available

A multi-employer plan must be classified as either a defined contribution plan or a defined benefit plan on the basis of the terms of the plan, including any constructive obligation. [FRS 102.28.11] However, if sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, the entity must account for the plan as if it were a defined contribution plan. [FRS 102.28.11A]. Subsequently, if sufficient information becomes available to use defined benefit accounting, then an entity must apply defined benefit accounting from the date that is the later of the first day for which sufficient information to use defined benefit accounting becomes available, and the first day of the current reporting period (comparative information is not restated). [FRS 102.28.11B(a), FRS 102.28.11C]. The difference between the carrying value of any liability recognised under the previous defined contribution accounting and the net defined benefit liability or surplus, must be recognised as a separate item in other comprehensive income. [FRS 102.28.11B(b)].

IAS 19 does not address the accounting treatment required if sufficient information becomes available for a multi-employer plan which has previously been accounted for as a defined contribution scheme. Therefore, given the lack of guidance, there are two possible approaches that entities may take to account for this:

- Record an immediate charge/credit to profit and loss equal to the deficit/surplus.
- Or
- Record an actuarial gain or loss in other comprehensive income.

3 The requirements of Section 28 for employee benefits

3.1 Scope and general recognition principles

Section 28 is not restricted to pensions and other post-employment benefits, but addresses all forms of consideration given by an employer in exchange for services rendered by employees or for the termination of employment (except for share-based payment transactions which are dealt with by Section 26 and discussed in Chapter 28 of this publication). [FRS 102.28.1]. In particular Section 28 covers:

- Short-term employee benefits, which are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the reporting period in which the employees render the related service. The accounting for these is discussed at 3.2 below.
- Post-employment benefits, which are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. The accounting for these is discussed at 3.3 to 3.6 and 3.9 below.
- Other long-term employee benefits, which are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits. The accounting for these is discussed at 3.7 below.
- Termination benefits, which are employee benefits provided in exchange for the termination of an employee's employment as a result of either:
 - the entity's decision to terminate an employee's employment before the normal retirement date. Or
 - an employee's decision to accept voluntary redundancy in exchange for those benefits. The accounting for these is discussed at 3.8 below.

The standard does not define the term 'employee'. Similarly, the Companies Act 2006 does not define the term 'employees' in a specific way, only stating that the calculation of the average number of employees would include the number of persons employed under contracts of service by the company. [s382(6)(a)]. Reference to contracts of service would exclude self-employed people such as contractors or consultants. (See Chapter 6 and 7.7). In looking for guidance over what is meant by 'employee' users may turn to IAS 19. Despite there being no direct definition of 'employee' in IAS 19 either, the standard does state that, "An employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis" and that employees include "directors and other management personnel". [IAS 19.7]. It is clear from these references that the term is intended to apply widely.

How we see it

Although neither the Companies Act 2006, FRS 102 nor IAS 19 defines the term 'employee' we believe it applies to anyone who is in substance an employee which will be a matter of judgement considering all the facts and circumstances.

Careful consideration is required to determine which section applies in specific circumstances, and it is possible that a single arrangement could have elements of both an employee benefit and a share-based payment. An example of benefits which could be under the scope of either Section 28 or Section 26 is a cash bonus dependent on share performance (see Chapter 28 at 3.4.4). Cash settled awards based on an entity's enterprise value would be under the scope of Section 28 if the enterprise value used in the calculation did not represent the fair value of the entity's equity instruments (see Chapter 28 at 3.4.5). Cash bonuses could also be within the scope of both Section 28 or Section 26 if they require a mandatory investment of part of the bonus into shares (see Chapter 28 at 16.1). The cash element paid would fall within the scope of Section 28, whereas any bonus which results in a required or discretionary investment in shares would come under the scope of Section 26. Each element of a bonus would be under the scope of one of these sections, but not both sections.

As discussed in Chapter 22 at 2.5.3, contingent payments to selling shareholders in a business combination may be accounted for as remuneration dependent on the nature of the arrangement. Where accounted for as remuneration they will fall under the scope of Section 28 (or Section 26 if they represent a share-based payment transaction).

This chapter addresses only the accounting by employers and excludes from its scope reporting by employee benefit plans themselves. These are dealt with in FRS 102 Section 34 *Specialised Activities*. [FRS 102.34.34]. The specialist nature of reporting by employee benefit plans puts them beyond the scope of this book.

The general recognition principle for all employee benefits is that an entity must recognise the cost of employee benefits to which its employees have become entitled as a result of service rendered to the entity during the period:

- As a liability, after deducting amounts that have been paid either directly to the employees or as a contribution to an employee benefit fund. If the amount paid exceeds the obligation arising from service before the reporting date, an entity must recognise that excess as an asset to the extent that the prepayment will lead to a reduction in future payments or a cash refund.
- And
- An expense, unless another section of the FRS requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment. [FRS 102.28.3].

An employee benefit fund may have been set up as an intermediary payment arrangement. Contributions made to the fund need to be accounted for in accordance with paragraphs 9.33 to 9.38 of FRS 102. This means that when the employer is a sponsoring employer of the fund, the assets and liabilities of the fund will be accounted for by the sponsoring employer as an extension of its own business. As a consequence, the payments to the employee benefit fund do not extinguish the liability of the employer. [FRS 102.28.3(a)]. Accounting for intermediate payment arrangement is discussed in Chapter 28 at 13.3. A pension plan is independent of the employer and is therefore not accounted for as an extension of the employer's business.

3.1.1 Employee benefits settled by a shareholder or another group entity

In some circumstances, employee benefits could be settled by a party other than the entity to which services were rendered by employees. Examples would include a shareholder or another entity in a group of entities under common control.

Except for accounting for defined benefit plans under common control, Section 28 is silent on whether, and if so how, an entity receiving employee services in this way must account for them. Section 26, on the other hand, devotes quite some detail to this topic for employee services within its scope.

An entity could make reference to the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* (discussed in Chapter 9 at 3.1) when deciding on an accounting policy under Section 28.

How we see it

Accordingly, in developing an accounting policy for employee benefits settled by a party other than the entity to which services were rendered by employees the provisions of Section 26 could be applied by analogy to transactions within the scope of Section 28. That accounting policy should be applied consistently to similar transactions.

The relevant requirements of Section 26 are discussed in Chapter 28 at 3.2.1 and 13.3.

3.2 Short-term employee benefits

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service. The following are examples of short-term employee benefits: [FRS 102.28.4]

- Wages, salaries and social security contributions
- Paid annual leave and paid sick leave
- Profit-sharing and bonuses
- And
- Non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees

Accounting for short-term employee benefits is relatively straight forward as no discounting is required due to their short-term nature. An entity must recognise the undiscounted amount expected to be paid in respect of short-term benefits attributable to services that have been rendered in the period as an expense or as part of the cost of an asset where required by another section of FRS 102. [FRS 102.28.5]. As detailed in the general recognition principles at 3.1 above, any amount of the expense which has not been paid at the reporting date must be recognised as a liability.

Short-term compensated absences occur where the employee does not provide services to the employer, but benefits continue to accrue. This may be made for various reasons including absences for annual leave and sick leave. Short-term compensated absences can either be accumulating or non-accumulating absences. Accumulating absences are those that can be carried forward and used in future periods if the entitlement in the current period is not used in full. An entity must recognise the expected cost of accumulating compensated absences when the employees render service that increases their entitlement to future compensated absences. The amount recognised will be the undiscounted additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of reporting period. This liability must be presented on the balance sheet as falling due within one year at the reporting date. [FRS 102.28.6].

An example of an accumulating compensated absence is holiday not taken in the current year which can be carried forward.

Illustration 3-1: Accumulating compensated absences

An entity has 100 employees, who are each entitled to 25 working days of paid holiday for each year. Unused holiday may be carried forward for one calendar year. Holiday is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X6, the average unused entitlement is two days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than 25 days of paid holiday in 20X7, and that the remaining eight employees will take an average of 26 and a half days each.

The entity expects that it will pay an additional 12 days of holiday pay as a result of the unused entitlement that has accumulated at 31 December 20X6 (one and a half days each, for eight employees). Therefore, the entity recognises a liability equal to 12 days of holiday pay.

Non-accumulating absences are those where there is no entitlement to carry forward unused amounts/days. An entity must record the cost of these absences when they occur at the undiscounted amount of salaries and wages paid or payable for the period of absence. [FRS 102.28.7]. Examples of non-accumulating compensating absences include sick leave (to the extent that unused past entitlement cannot be carried forward), maternity or paternity leave, furlough periods and paid absences for jury or military service.

In applying the general recognition criteria to profit-sharing and bonus payments, an entity must recognise the expected cost of profit-sharing and bonus payments when, and only when: [FRS 102.28.8]

- The entity has a present legal or constructive obligation to make such payments as a result of past events (this means that the entity has no realistic alternative but to make the payments).

And

- A reliable estimate of the obligation can be made.

A legal obligation may not always be present, however an entity's past practice in paying profit-sharing or bonuses may have established a constructive obligation, requiring the cost to be recognised.

Cost is not defined in Section 28 and therefore the accounting for such benefits could vary depending on any other sections involved in the recognition of the transaction.

Section 28 provides no guidance on how to determine whether an estimate may be reliable. Reliability is defined in FRS 102, Appendix I as "The quality of information that makes it free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent". [FRS 102 Appendix I]. Free from error means there are no errors or omissions in the description of the events, and the process used to produce the reported information has been selected and applied with no errors. In this context, free from error does not mean perfectly accurate in all respects. [FRS 102.2.18]. In looking for guidance over what is meant by a 'reliable estimate' in the context of Section 28 users may turn to IAS 19. This standard states that a reliable estimate of a constructive or legal obligation under a profit-sharing or bonus plan can usually be made when, and only when: [IAS 19.22]

- The formal terms of the plan contain a formula for determining the amount of the benefit.
- The entity determines the amounts to be paid before the financial statements are authorised for issue.

Or

- Past practice gives clear evidence of the amount of the entity's constructive obligation.

It is worth noting that the paragraph above from IAS 19 deals only with the measurement of the provision and not the point of recognition.

Illustration 3-2: Profit sharing and bonus plans

A profit-sharing plan requires an entity to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of profit. The entity estimates that staff turnover will reduce the payments to 2.5% of profit.

The entity recognises a liability and an expense of 2.5% of profit.

Profit-sharing and bonus plans must only be accounted for as short-term benefits when they are expected to be wholly settled within twelve months from the end of the reporting period. Plans which are expected to be settled over a longer period must be accounted for as other long-term benefits, which are discussed at 3.7 below.

3.3 Post-employment benefits: distinction between defined contribution plans and defined benefit plans

Post-employment benefits are defined as employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. [FRS 102 Appendix I]. They include, for example:

- Retirement benefits, such as pensions.
And
- Other post-employment benefits, such as post-employment life insurance and post-employment medical care. [FRS 102.28.9].

Arrangements whereby an entity provides post-employment benefits are post-employment benefit plans as defined in Appendix I. Section 28 applies to all post-employment benefit plans, whether or not they involve the establishment of a separate legal entity to receive contributions or pay benefits. In some cases, these arrangements are imposed by law rather than by the action of the entity. In some cases, these arrangements arise from actions of the entity even in the absence of a formal documented plan.

[FRS 102.28.9].

3.3.1 Distinction between defined contribution plans and defined benefit plans

Section 28 draws the natural, but important, distinction between defined contribution plans and defined benefit plans. The determination is made based on the economic substance of the plan as derived from its principal terms and conditions. The approach it takes is to define defined contribution plans, with defined benefit plans being the default category if a post-employment benefit plan is deemed not to be a defined contribution plan. These definitions are stated in Appendix I. Guidance is also provided explaining how to apply the requirements to insured benefits, multi-employer plans (including state plans) and group plans.

Extract from FRS 102

28.10 Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and has no legal or constructive obligation to pay further contributions or to make direct benefit payments to employees if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurer, together with investment returns arising from the contributions.

Defined benefit plans are post-employment benefit plans other than defined contribution plans. Under defined benefit plans, the entity's obligation is to provide the agreed benefits to current and former employees, and actuarial risk (that benefits will cost more or less than expected) and investment risk (that returns on assets set aside to fund the benefits will differ from expectations) are borne, in substance, by the entity. If actuarial or investment experience is worse than expected, the entity's obligation may be increased, and vice versa if actuarial or investment experience is better than expected. [FRS 102.28.10]

The most significant difference between defined contribution and defined benefit plans is that, under a defined benefit plan some actuarial risk or investment risk falls on the employer. Consequently, because the employer is in substance underwriting the actuarial and investment risks associated with the plan, the expense recognised for a defined benefit plan is not necessarily the amount of the contributions due for the period. In contrast the benefits received by the employee from a defined contribution plan are determined by contributions paid (both by the employer and employee) to the benefit plan or insurance company, together with investment returns, and therefore actuarial and investment risk fall in substance on the employee. Hence, the expense of a defined contribution plan is the contributions due for the period from the employer.

Under defined benefit plans the employer's obligation is not limited to the amount that it agrees to contribute to the fund. Rather, the employer is obliged (legally or constructively) to provide the agreed benefits to current and former employees.

An employer's obligation may be increased by a constructive obligation such as the historical practice of discretionary pension increases going beyond the formal terms of the plan or statutory minimum increases.

3.3.2 Multi-employer and state plans

Multi-employer plans, other than state plans, are defined contribution plans or defined benefit plans that:

- Pool assets contributed by various entities that are not under common control.
- And
- Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees. *[FRS 102 Appendix I]*.

In the UK these are typically industry wide schemes. They exclude group administration plans, which simply pool the assets of more than one employer under common control, for investment purposes and the reduction of administrative and investment costs. Group administration plans keep the claims of different employers segregated for the sole benefit of their own employees. The accounting for these plans is dealt with at 3.9 below.

A multi-employer plan must be classified as either a defined contribution plan or a defined benefit plan in accordance with its terms, including any constructive obligation that goes beyond the formal terms of the plan, in the normal way (see 3.3.1 above). However, if sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, the entity must account for the plan as if it were a defined contribution plan and make relevant disclosures (see 4.1.3 below).

[FRS 102.28.11].

In the UK the Pensions Act 2004 requires that where a defined benefit plan is underfunded (i.e., it does not have sufficient assets to cover its obligations), the trustees must establish a recovery plan which confirms how the Statutory Funding Objective must be met and the period over which this is to be met. This recovery plan will detail the contributions to be made by each participating employer. From this agreement it may be possible to establish sufficient information to allow defined benefit accounting as the schedule of deficit funding contributions provides information on how the deficit will be funded by each of the participating employers, and hence their share of assets and liabilities.

Where an entity participates in a defined benefit plan which is a multi-employer plan, and this plan is accounted for as a defined contribution plan, if the entity has entered into an agreement with the multi-employer plan that determines how the entity will fund a deficit, the entity must recognise a liability for the contributions payable that arise from this agreement (to the extent they are related to the deficit). The resulting expense is recognised in profit or loss. *[FRS 102.28.11A]*.

Subsequently, if sufficient information becomes available to use defined benefit accounting, an entity must apply defined benefit accounting from the relevant date which is the date that is the later of the first day for which sufficient information to use defined benefit accounting becomes available, and the first day of the current reporting period (comparative information is not restated). *[FRS 102.28.11B(a), [FRS 102.28.11C]*. Defined benefit accounting is dealt with at 3.5 below. The difference between the carrying value of any liability recognised under the previous defined contribution accounting and the net defined benefit liability or surplus, must be recognised as a separate item in other comprehensive income. *[FRS 102.28.11B(b)]* For the avoidance of doubt, the difference calculated excludes the impact of any plan changes, curtailments or settlements occurring at the relevant date, which are accounted for in accordance with paragraphs 28.21 and 28.21A of FRS 102 (see 3.5.6 below). *[FRS 102.28.11D]*.

A state plan is an employee benefit plan established by legislation to cover all entities (or all other entities in a particular category, for example a specific industry) and operated by national or local government or by another body (for example an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity. *[FRS 102 Appendix I]*. A state plan must be accounted for in the same way as a multi-employer plan. *[FRS 102.28.11]*.

3.3.3 Insured benefits

One factor that can complicate making the distinction between defined benefit and defined contribution plans is the use of external insurers.

Section 28 helps users to make this distinction by stating that where insurance premiums are paid to fund post-employment benefits, the employer must treat the plan as a defined contribution plan unless it has (either directly or indirectly through the plan) a legal or constructive obligation to:

- Pay the employee benefits directly when they fall due.
- Or
- Pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the employer has retained such a legal or constructive obligation it must treat the plan as a defined benefit plan. A constructive obligation could arise indirectly through the plan, through the mechanism for setting future premiums, or through a related party relationship with the insurer. *[FRS 102.28.12]*.

If a plan involving insurance is determined to be a defined benefit plan, the insurance policies will represent plan assets which are discussed at 3.5.3 below.

3.4 Defined contribution plans

3.4.1 General

Accounting for defined contribution plans is straightforward under Section 28 as a reporting entity's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to be made in order to measure the obligation or the expense and there is no possibility of any actuarial gain or loss to the reporting entity. Moreover, the obligations to pay contributions are measured on an undiscounted basis, except where they are not expected to be settled wholly before twelve months after the end of the period in which the employees render the related service. Where discounting is required, the discount rate must be determined in the same way as for defined benefit plans, which is discussed at 3.5.2.B below. *[FRS 102.28.13A]*. In general, though, it would seem unlikely for a defined contribution scheme to be structured with such a long delay between the employee service and the employer contribution.

Section 28 requires that, when an employee has rendered service during a period, the employer must recognise the contribution payable to a defined contribution plan in exchange for that service:

[FRS 102.28.13]

- As a liability, after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, the excess must be recognised as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.
- As an expense, unless another section of the FRS requires the cost to be recognised as part of the cost of an asset such as inventories or property, plant and equipment. See Chapters 16 and 20 respectively.

As discussed at 3.3.2 above, Section 28 requires multi-employer defined benefit plans to be accounted for as defined contribution plans in certain circumstances. It is clear that contractual arrangements to make contributions to fund a deficit must be fully provided for (on a discounted basis) even if they are to be paid over an extended period. The unwinding of any discount is recognised as a finance cost in profit or loss.

[FRS 102.18.13A].

3.5 Defined benefit plans

Accounting for defined benefit plans is complex because actuarial assumptions are required to measure both the obligation and the expense, and there is a possibility of actuarial gains and losses. Moreover, because the obligations are settled many years after the employees render the related service, the obligations are measured on a discounted basis.

3.5.1 Recognition

In applying the general recognition principle (see 3.1 above) to defined benefit plans, an entity is required to recognise: [FRS 102.28.14]

- A liability for its obligations under the defined benefit plans net of plan assets - its 'net defined benefit liability'.

And

- The change in that liability during the period as the cost of its defined benefit plans during the period.

Guidance on how to account for these is covered below.

3.5.2 Measurement of plan liabilities

Extract from FRS 102

Post-employment benefits: Defined benefit plans

Measurement of the net defined benefit liability

28.15 An entity shall measure the net defined benefit liability for its obligations under defined benefit plans at the net total of the following amounts:

- (a) the present value of its obligations under defined benefit plans (its defined benefit obligation) at the reporting date (paragraphs 28.16 to 28.21A provide guidance for measuring this obligation); minus
- (b) the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled. Section 2A Fair Value Measurement provides guidance on determining the fair values of those plan assets, except that, if the asset is an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the plan, the fair value of the asset is deemed to be the present value of the related obligation.

3.5.2.A Legal and constructive obligations

The present value of an entity's obligations under defined benefit plans at the reporting date must reflect the estimated amount of benefit that employees have earned in return for their service in the current and prior periods, including benefits that are not yet vested (see below) and the effects of benefit formulas that give employees greater benefits for later years of service. This requires the entity to determine how much benefit is attributable to the current and prior periods on the basis of the plans benefit formula and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that influence the cost of the benefit. The actuarial assumptions must be unbiased (neither imprudent nor excessively conservative), mutually compatible, and selected to lead to the best estimate of the future cash flows that will arise under the plan. [FRS 102.28.16].

Although Section 28 does not use the term 'attribution of benefit to years of service', the fact that it states that defined benefit obligations must reflect the estimated amount of benefit that employees have earned in return for their service, including benefits that are not yet vested, and it requires the effects of benefit formulas that give employees greater benefits for later years of service to be taken into account essentially has the same meaning. In doing this, the projected unit credit method is required to be used (see 3.5.2.C below). However, Section 28 does not provide detail on how greater benefits for later years of service must be taken into account, therefore users of FRS 102 may under the GAAP hierarchy in Section 10 *Accounting Policies, Estimates and Errors* turn to IAS 19 for further guidance. IAS 19 requires that when an employee's service in later years will lead to a materially higher level of benefit, the benefit must be attributed on a straight line basis from: [IAS 19.70]

- The date when service by the employee first leads to benefits under the plan.
Until
- The date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

This requirement is considered necessary because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

The employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they have not yet vested). Employee service before the vesting date gives rise to a constructive obligation because, at each successive reporting date, the amount of future service that an employee will have to render before being entitled to the benefit is reduced. When calculating its defined benefit obligation (attributing benefits to years of service) an entity must consider the probability that some employees may not satisfy the vesting requirements (i.e., leave before retirement age). Similarly, although some post-employment benefits (such as post-employment medical benefits) become payable only if a specified event occurs when an employee is no longer employed (such as illness), the obligation is created when the employee renders the service that provides entitlement to the benefit, if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation but does not determine whether the obligation exists. [FRS 102.28.26].

It is sometimes the case where the plan rules include an automatic exit event, where the entity's involvement in the plan will cease, which cannot be unilaterally avoided by the entity. On occurrence of the exit event, the entity will extinguish its obligation under the plan by the payment of an agreed amount through giving up plan assets. We believe the consequences of this must be included within the calculation of the defined benefit obligation as the best estimate of the ultimate cost to the company, and that this must not be treated as a settlement. An example of this is in relation to Local Government Pension Schemes (LGPS) in England and Wales. The Local Government Pension Scheme Regulations 2013, Regulation 64, explains that an entity becomes 'an exiting employer' when its last member ceases to be active (such as through retirement) and the scheme is closed to new members. As an exiting employer the entity is either liable to pay an exit payment or entitled to receive an exit credit determined by an actuarial valuation obtained at the exit date. The calculation of the defined benefit obligation would be based on cash flows paid to members (i.e., benefit payments) until the expected exit event plus any transfer of assets at the date of the exit event as required under the plan rules.

3.5.2.B Discount rate

Due to the long timescales involved, post-employment benefit obligations are required to be discounted. The rate used must be determined 'by reference to' the market yield (at the end of the reporting period) on high quality corporate bonds of currency and term consistent with liabilities. In countries where there is no deep market in such bonds, the entity must use the market yields on national government bonds instead. [FRS 102.28.17].

FRS 102 does not explain what is meant by 'high quality'. In practice it is considered to mean bonds rated AA or higher by Standard and Poor's, or an equivalent rating from another rating agency.

3.5.2.C Actuarial methodology

An entity is required to use the projected unit credit method to measure its defined benefit obligation and the related expense. It is defined as an actuarial valuation method that sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. [FRS 102 Appendix I]. If defined benefits are based on future salaries, the projected unit method requires an entity to measure its defined benefit obligations on a basis that reflects estimated future salary increases. In addition, the projected unit credit method requires an entity to make various actuarial assumptions in measuring the defined benefit obligation, including discount rates, employee turnover, mortality and (for defined benefit medical plans) medical cost trend rates. [FRS 102.28.18].

As detailed above, this method uses both the vested and non-vested benefits.

IAS 19 provides a simple example of the projected unit credit method: [IAS 19.68]

Illustration 3-3: The projected unit credit method

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in year 1 is 10,000 and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per year. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Year	1	2	3	4	5
Benefit attributed to:					
- prior years	0	131	262	393	524
- current year (1% of final salary)	131	131	131	131	131
- current and prior years	131	262	393	524	655
Opening Obligation	-	89	196	324	476
Interest at 10%	-	9	20	33	48
Current Service Cost	89	98	108	119	131
Closing Obligation	89	196	324	476	655

Note:

- The Opening Obligation is the present value of benefit attributed to prior years.
- The Current Service Cost is the present value of benefit attributed to the current year.
- The Closing Obligation is the present value of benefit attributed to current and prior years.

As can be seen in this simple example, the projected unit credit method also produces a figure for current service cost and interest cost (and, although not illustrated here, would where appropriate produce a figure for past service cost). These cost components are discussed at 3.5.10 below.

The underlying workings relevant to the above are as follows:

Final salary at year 5 (10,000 compounded at 7%)	$10,000 \times (1 + 0.07)^4 = 13,100$
1% of final salary attributed to each year	131
Expected final benefit	$5 \text{ years} \times 1\% \times 131,000 = 655$
Current service cost, being present value of 131 discounted at 10%: e.g.,	
Year 1	$131 \times (1 + 0.1)^{-4} = 89$
Year 2	$131 \times (1 + 0.1)^{-3} = 98$
Closing obligation, being years served multiplied by present value of 131: e.g.,	
Year 3	$3 \text{ years} \times 131 \times (1 + 0.1)^{-2} = 324$

3.5.2.D Actuarial assumptions

As noted above, the projected unit credit method requires an entity to make various actuarial assumptions in measuring the defined benefit obligation. These are defined as an entity's unbiased and mutually compatible best estimates of the demographic and financial variables that will determine the ultimate cost of providing post-employment benefits. [FRS 102 Appendix I].

Demographic assumptions concern the future characteristics of current and former employees (and their dependents) who are eligible for benefits and deal with matters such as:

- Mortality, both during and after employment.
 - Rates of employee turnover, disability and early retirement.
 - The proportion of plan members with dependents who will be eligible for benefits.
- And
- Claim rates under medical plans.

Financial assumptions deal with items such as:

- The discount rate (see 3.5.2.B above).
- Future salary and benefit levels, excluding the cost of benefits that will be met by the employees.

- In the case of medical benefits, future medical costs including claim handling costs.
And
- Price inflation.

The actuarial assumptions must be unbiased (neither imprudent nor excessively conservative), mutually compatible, and selected to lead to the best estimate of the future cash flows that will arise under the plan. [FRS 102.28.16].

In periods of rising inflation this may have a significant impact on the measurement of the defined benefit obligation as this will often be linked to future salary increases, future benefit increases and future medical costs due to either contractual or constructive obligations (for example, through a history of benefit payments to former employees being based on inflation even though there is no legal obligation to do so). Payment options selected by employees on retirement may also change where annuities are linked to fixed annual increases which become lower than expected inflation.

When the level of defined benefits payable by a scheme are reduced for the amounts that will be paid to employees under government-sponsored benefits, an entity must measure its defined benefit obligations on a basis that reflects the benefits payable under the plans, but only if: [FRS 102.28.27]

- Those plans were enacted before the reporting date.
Or
- Past history, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.

3.5.2.E Frequency of valuations and use of an independent actuary

An entity must measure its defined benefit obligation and plan assets at the reporting date. [FRS 102.28.15]. An entity is not required to engage an independent actuary to perform the comprehensive actuarial valuation needed to calculate the defined benefit obligation, nor does it require that a comprehensive valuation to be performed annually. If the principal actuarial assumptions have not changed significantly in periods between the comprehensive actuarial valuations, the defined benefit obligation can be measured by adjusting the prior period measurement for changes in employee demographics such as employee numbers or salary levels. [FRS 102.28.20].

In practice we expect that most entities will engage an independent actuary to perform the comprehensive actuarial valuation given its complexity.

3.5.3 Measurement of plan assets

Plan assets are required to be measured at fair value at the reporting date, except that if an asset is an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the plan, the fair value of the asset is deemed to be the present value of the related obligation. Section 2A *Fair Value Measurement* provides guidance on determining fair value measurement of assets. See Chapter 10. [FRS 102.28.15(b)].

Plan assets are defined as comprising: [FRS 102 Appendix I]

- Assets held by a long-term employee benefit fund.
And
- Qualifying insurance policies.

Assets held by a long-term employee benefit fund are an asset (other than non-transferable financial instruments issued by the reporting entity) that: [FRS 102 Appendix I]

- Is held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits.
And
- Is available to be used only to pay or fund employee benefits, is not available to the reporting entity's own creditors (even in bankruptcy) and cannot be returned to the reporting entity, unless either:
 - The remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity.
Or
 - The assets are returned to the reporting entity to reimburse it for employee benefits already paid.

Qualifying insurance policies are defined as an insurance policy issued by an insurer that is not a related party of the reporting entity, if the proceeds of the policy: *[FRS 102 Appendix I]*

- Can be used only to pay or fund employee benefits under a defined benefit plan.
- And
- Are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity unless either:
 - The proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations.
- Or
- The proceeds are returned to the reporting entity to reimburse it for employee benefits already paid.

A footnote to the definition clarifies that an insurance policy is not necessarily an insurance contract. Qualifying insurance policies are accounted for as plan assets; however, Section 28 provides no guidance on accounting for other insurance policies which do not meet the definition of a qualifying insurance policy. Under IAS 19 these are accounted for as reimbursement rights (providing the criteria for recognition as reimbursement rights are met). See 3.5.4 below.

3.5.4 Reimbursement rights

Some employers could have in place arrangements to fund defined benefit obligations which do not meet the definition of qualifying insurance policies, but which do provide for another party to reimburse some, or all of the expenditure required to settle a defined benefit obligation. In such cases, the expected receipts under the arrangement are not classified as plan assets.

Section 28 states that when an entity is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, the entity must recognise its right to the reimbursement as a separate asset, which must be treated the same way as other plan assets (i.e., measured at fair value). The cost of a defined benefit plan recognised in accordance with paragraph 28.23 (i.e., service cost, net interest and the cost of plan introductions, benefit changes, curtailments and settlements) could be presented net of the amounts relating to changes in the carrying amount of the right to reimbursement. *[FRS 102.28.28]*.

3.5.5 Longevity swaps

A longevity swap transfers, from a pension scheme to an external party, the risk of members living longer (or shorter) than expected.

Longevity swaps are not specifically dealt with in FRS 102. Therefore, we would expect users to turn to discussions held by the IFRS IC on the subject.

The IFRS IC was asked in August 2014 to clarify the measurement of longevity swaps held by an entity's defined benefit plan, and in particular discussed whether an entity must:

- (a) Account for a longevity swap as a single instrument and measure its fair value as part of plan assets (discussed at 3.5.3 above) with changes in fair value being recorded in other comprehensive income.

Or

- (b) Split longevity swaps into two components.

The two components in (b) would be a 'fixed leg' and a 'variable leg'. As the variable leg exactly matches some or all of the defined benefit obligation it would represent a qualifying insurance policy and be measured at the present value of the related obligation (discussed at 3.3.3 above). The fixed leg comprises a series of fixed payments to be made in return for the receipt of the variable leg receipts. In other words, a longevity swap could be considered to be economically equivalent to the purchase of qualifying insurance (commonly called a 'buy-in') but with the premium paid over a period of time rather than at inception.

The likely effect of disaggregating a longevity swap in this way would be to recognise a remeasurement loss at inception very similar to that for a buy-in (discussed at 3.5.6 below). Conversely, considering the swap as a single instrument measured at fair value would likely have no initial effect as typically its fair value would be zero (that is, a premium neither received nor paid).

If the two legs were to be considered separately, an appropriate accounting policy would need to be applied to the fixed leg. Two possibilities were discussed by the IFRS IC as follows. The fixed leg would initially be measured at fair value with subsequent accounting either:

- If treated as part of plan assets, at fair value with interest reported in profit or loss and other changes being included in other comprehensive income (discussed at 3.5.3 above).
- Or
- If treated as a financial liability, at amortised cost using the effective interest rate method with interest recognised in profit and loss and no other remeasurements.

The IFRS IC noted that when such transactions take place, the predominant practice is to account for a longevity swap as a single instrument and measure it at fair value as part of plan assets.

The IFRS IC decided not to add this issue to its agenda as it did not expect diversity to develop in the application of IAS 19.²³³

How we see it

Given that the IFRS IC decided not to add this to its agenda we believe that either of the accounting options detailed above (i.e., accounting for the swap as either a single instrument or as two components) would be acceptable. An entity must develop an accounting policy after consideration of these options and apply this consistently where there are similar facts and circumstances.

3.5.6 Plan introductions, changes, curtailments and settlements

If a defined benefit plan has been introduced or the benefits have changed in the current period, the entity must increase/(decrease) its net defined benefit liability to reflect the change and recognise the increase/(decrease) as an expense/(income) in profit or loss in the current period. [FRS 102.28.21].

The point in time at which a plan amendment occurs will often be a matter of fact based on the legal entitlements of plan members. Judgement could be required, based on individual facts and circumstances, particularly if the benefits concerned constitute constructive, as opposed to legal, obligations (see 3.5.2.A above).

Sometimes, benefit plans are amended in such a way as to allow members a choice, for a limited period, between two or more benefit arrangements. In such cases, a plan amendment occurs (and a positive or negative past service cost will be recognised) on the date at which the new arrangement comes into existence (legally or constructively) and not at the later date by which members are required to make their choice. This could mean that the initial accounting for the plan amendment will require estimates to be made of the choices which members will make. However, if it is known at the time the relevant financial statements are prepared, what choices members have made (for example, because the 'window' for making selections closes before the financial statements are authorised for issue) this definitive data would remove the need for estimation. Any subsequent changes in estimates in the following years resulting from the confirmation process would be a change in estimate and recognised as a remeasurement gain or loss.

Where a defined benefit plan has been curtailed (i.e., the benefits or group of covered employees are reduced) or settled (i.e., the relevant part of the employer's obligation is completely discharged) in the current period, the defined benefit obligation must be decreased or eliminated and the resulting gain or loss recognised in profit and loss in the current reporting period. [FRS 102.28.21A]. This gain or loss must be disclosed separately as part of the reconciliation of the defined benefit obligation along with the expense/(income) arising from plan introductions and changes. [FRS 102.28.41(f)(iv)]. See 4.1.4 below for further details on disclosure requirements.

An employer could acquire an insurance policy to fund all or some of the employee benefits relating to employee service in the current and prior periods (referred to as a buy-in arrangement). The acquisition of such a policy is not a settlement if the employer retains a legal or constructive obligation to pay further amounts if the insurer does not pay the employee benefits specified in the insurance policy. However, the acquisition of an insurance policy will mean that the entity has an asset which it must measure at fair value. As discussed at 3.5.3 above, certain insurance policies are valued at an amount equal to the present value of the defined benefit obligation they match. The cost of buying such a policy will typically greatly exceed its subsequent carrying amount as the discount rate used by the insurance company will be lower than that used in an FRS 102 valuation. This raises the question of how to treat the resultant loss.

²³³ [IFRIC Update](#), March 2015, available on the IFRS Foundation's website.

How we see it

In our view, a loss arising on purchase of an insurance policy is an actuarial loss as it results from exchanging one plan asset for another, which is recognised in other comprehensive income, unless in substance the acquisition of the qualifying insurance policy is a settlement of the plan.

The plan assets and plan liabilities would remain to be recorded on the statement of financial position until such time as the settlement had occurred and the entity no longer had any obligations under the plan.

3.5.7 Restriction on plan assets

In practice, defined benefit pension plans tend to be funded on a more prudent basis than would be the case if the surplus or deficit was measured in accordance with FRS 102. This is due to the discount rate used for funding purposes typically being lower than that specified by Section 28. For this reason, an FRS 102 valuation could result in a pension asset (surplus), when for funding purposes there is a deficit. A surplus may also arise in economic conditions where discount rates are increased, and therefore the defined benefit obligation decreases, without a corresponding impact on the fair value of plan assets.

FRS 102 states that if the present value of the defined benefit obligation at the reporting date is less than the fair value of plan assets at that date, the plan has a surplus. It goes on to observe that an entity must recognise a plan surplus as a defined benefit asset only to the extent that it is able to recover the surplus either through reduced contributions in the future or through refunds from the plan. [FRS 102.28.22].

No further explanation is given of the meaning of 'reduced contributions in the future or through refunds from the plan'. This lack of guidance will require management to exercise judgement in developing and applying an accounting policy to determine the amount of any defined benefit pension surplus that can be recognised. In making such a judgement, management must refer to and consider the definition of an asset, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2 *Concepts and Pervasive Principles* (see Chapter 4).

In exercising judgement when developing and applying an accounting policy when FRS 102 does not specifically address a transaction, other event or condition, management may also consider the requirements and guidance in adopted IFRS dealing with similar or related issues (see Chapter 9 at 3.1).

Due to the problems encountered in practice in applying the asset ceiling test in IAS 19, the IFRS IC issued IFRIC 14 in 2007. IFRIC 14 addresses the issues of:

- When refunds or reductions in future contributions must be regarded as available in accordance with the definition of the asset ceiling in IAS 19.8.
- How a minimum funding requirement might affect the availability of reductions in future contributions. And
- When a minimum funding requirement might give rise to a liability.

FRS 102 does not include the requirements of IFRIC 14. However, paragraph 15A of Section 28 states that "Where an entity has measured its defined benefit obligation using the projected unit credit method (including the use of appropriate actuarial assumptions), as set out in paragraph 28.18, it must not recognise any additional liabilities to reflect differences from these assumptions and those used for the most recent actuarial valuation of the plan for funding purposes. For the avoidance of doubt, no additional liabilities must be recognised in respect of an agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions)." [FRS 102.28.15A]. This means that entities turning to IFRIC 14 (or any other methodology) under the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* must not recognise a liability for a minimum funding requirement.

3.5.7.A IFRIC 14 - General requirements concerning the limit on a defined benefit asset

IFRIC 14 clarifies that economic benefits, in the form of refunds or reduced future contributions, are available if they can be realised at some point during the life of the plan or when plan liabilities are settled. In particular, such an economic benefit could be available even if it is not realisable immediately at the end of the reporting period. [IFRIC 14.8]. Furthermore, the benefit available does not depend on how the entity intends to use the surplus. The entity must determine the maximum economic benefit available from refunds and reductions in future contributions that are mutually exclusive. [IFRIC 14.9].

3.5.7.B Economic benefit available through a refund

IFRIC 14 observes that an unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period. However, if the right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within an entity's control, the entity does not have an unconditional right and must not recognise the asset. [IFRIC 14.12]. Furthermore, the interpretation states that benefits are available as a refund only if the entity has an unconditional right to the refund: [IFRIC 14.11, IFRIC 14.12]

- During the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund.
Or
- Assuming the gradual settlement of the plan liabilities over time until all members have left the plan.
Or
- Assuming the full settlement of the plan liabilities in a single event (i.e., as a plan wind up).

The economic benefit available as a refund must be measured as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs. For example, if a refund would be subject to a tax other than income tax of the reporting entity it must be measured net of tax. [IFRIC 14.13].

In measuring the amount of a refund available when the plan is wound up (third bullet point above), the costs to the plan of settling the plan liabilities and making the refund must be included. For example, a deduction must be made for professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind up. [IFRIC 14.14].

Another relatively common situation in the UK is for pension schemes to have a defined benefit section and a defined contribution section. Trustees may be empowered under the trust deed to use any surplus arising on the defined benefit section in paying up contributions to the defined contribution section. Whilst this is equivalent to obtaining a refund for accounting purposes, it may not be regarded as an 'authorised payment' for tax purposes. Therefore, where an entity is recognising a surplus on a defined benefit section on the basis that it could be refunded through a transfer to a defined contribution section of the same plan, there may be no need to provide for the effect of a refund tax.

It is usually the case that the trustees of a pension fund are independent of the entity. Trustees may have a variety of powers to influence a surplus in a plan. For example:

- Setting the investment strategy whereby assets with lower risk and lower return would erode a surplus over time; or the purchase of assets in the form of insurance policies matching all or some of the cash outflows of the plan.
Or
- Full or partial settlement of liabilities; or the improvement of benefits under the plan.

IFRIC 14 makes it clear that for future benefit improvements made by the employer and actuarial gains and losses, the existence of an asset at the end of the reporting period is not affected by possible future changes to the amount of the surplus. If future events occur that change the amount of the surplus, their effects are recognised when they occur. [IFRIC 14.BC10].

IFRIC 14 is also clear that if the right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events that are not wholly within an entity's control, the entity does not have an unconditional right and must not recognise a surplus. [IFRIC 14.11, IFRIC 14.12].

However, neither IAS 19 nor IFRIC 14 address the question of whether the entity's right to a refund of a surplus which depends on the occurrence or non-occurrence of uncertain future events means that no surplus is recognised in any scenario where trustees have the power to 'spend' a surplus.

In June 2018 the IASB published an exposure draft of proposed amendments to IAS 19 and IFRIC 14 which addressed whether other parties' (for example pension trustees) power to enhance benefits for plan members or wind up a plan affected the availability of a refund.

This exposure draft was issued as a response to two requests to the IFRS IC, suggesting that there is diversity in practice in this area. In the Basis for conclusions on the exposure draft, the IASB noted that IFRIC 14.BC10 had not specifically addressed the circumstances in which trustees have such unconditional powers. The exposure draft proposed that the amount of the surplus that the entity recognised as an asset on the basis of a future refund must not include amounts that other parties can use for other purposes that affect the benefits for plan members, for example by enhancing those benefits without the entity's consent. In February 2022, the IASB decided to remove this project from its work plan after concluding that the prospects for progress were limited.²³⁴

How we see it

In our view, as IFRS is silent on the circumstances in which trustees have unconditional powers, entities applying IFRIC 14 via the FRS 102 accounting hierarchy have an accounting policy choice as to how unconditional rights by trustees to 'spend' any current surplus are taken into account in the recognition of any existing IAS 19 surplus, to be applied consistently to similar facts and circumstances, and disclosed where material.

If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity must make no adjustment for the time value of money, even if the refund is realisable only at a future date. [IFRIC 14.15].

There is currently diversity in practice under IFRS in relation to accounting for costs associated with a pension plan. When a UK pension scheme makes a refund (known in tax law as 'an authorised surplus payment') to an employer, the refund gives rise to a liability for the pension scheme to pay a tax of 25% of the amount refunded (a 'refund tax'). As above, IFRIC 14 requires that taxes other than income taxes must be deducted from the measurement of the refund. [IFRIC 14.13].

Where the refund tax is not considered to be an income tax of the sponsoring employer (based on the fact that it is not charged to the employer and does not appear in the employer's tax calculation) and an entity has a surplus on a scheme (measured under FRS 102 or IAS 19) that is recognised on the basis of a potential refund, IFRIC 14 requires the surplus to be restricted to the net of tax amount (i.e., 75% of the gross surplus is recognised).

Where the refund tax is considered to be an income tax (based on the refund tax being economically an income tax of the employer in the sense that it has the effect of claiming back tax relief given to the employer on contributions to the scheme), this will not be deducted in measuring the refund. Instead, deferred tax must be measured based on management's actual expectation of the manner of recovery of the asset, which may be different to the conclusion reached in respect of the recognition of a pension asset which will be based on the ability to recover the asset. The measurement of deferred tax assets and liabilities is discussed in detail in Chapter 31 at 7.4. If a pension asset is expected to be recovered by way of a refund, then the rate of refund tax (currently 25%) must be used to measure the deferred tax asset arising. If however, the pension asset is expected to be recovered in another way such as through reductions in future contributions or the 'spending' of the asset (see below) the deferred tax asset will be measured at the substantively enacted rate of tax expected to apply when the asset reverses.

We note that both of the above approaches are seen in practice.

3.5.7.C Economic benefit available through reduced future contributions where there is no minimum funding requirement

IFRIC 14 addresses, separately, cases where there are minimum funding requirements for contributions relating to future service, and cases where there are no such funding requirements.

This section deals with the situation where there are no such funding requirements. The implications of future service minimum funding requirements are discussed at 3.5.7.D below.

IFRIC 14 requires that the economic benefit available by way of reduced future contributions be determined as the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity. The future service cost to the entity excludes amounts that will be borne by employees. [IFRIC 14.16].

²³⁴ [IASB Update](#), February 2022, available on the IFRS Foundation's website.

Future service costs must be determined using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by FRS 102/IAS 19. Accordingly, no future changes to the benefits to be provided by a plan must be assumed until the plan is amended, and a stable workforce in the future must be assumed unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce must include the reduction. The present value of the future service cost must be determined using the same discount rate as that used in the calculation of the defined benefit obligation (discount rates are discussed at 3.5.2.B above). [IFRIC 14.17].

3.5.7.D The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

IFRIC 14 defines minimum funding requirements as “any requirements to fund a post-employment or other long-term defined benefit plan”. [IFRIC 14.5]. This is clearly quite a wide definition encompassing more than just statutory regimes.

Some minimum funding arrangements require periodic reappraisal (for example, every three years). Should such an arrangement cover a longer period, all payments over this longer period constitute the minimum funding requirement, not just the three years until the next reappraisal. In its March 2015 meeting the IFRS IC, following a request for clarification, discussed whether an entity should assume that the minimum funding requirement for contributions to cover future services (see below) would continue over the estimated life of the pension plan. In its July 2015 agenda decision, the IFRS IC noted that the entity should assume a continuation of existing funding principles because:²³⁵

- For any factors not specified by the minimum funding basis (for example, the period to continue the plan is not specified by the existing funding principles), the assumptions for determining future service costs and those used to estimate the future minimum funding requirement contributions for future service must be consistent. This is because the Interpretation requires an entity to use assumptions that are consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period. [IFRIC 14.17, IFRIC 14.21].
- The estimate should not include changes to the funding principles to determine contributions for future service, if such changes require future negotiations with pension trustees. [IFRIC 14.21, IFRIC 14.BC30].

In the UK, we have observed that for a number of public sector bodies, the life of the defined benefit plan is expected to be indefinite. In line with the agenda decision, it is reasonable to assume minimum funding requirements will continue indefinitely.

The Interpretation requires any minimum funding requirement at a given date to be analysed into contributions that are required to cover: [IFRIC 14.18]

- Any existing shortfall for past service on the minimum funding basis. These contributions do not affect future contributions for future service.
- And
- Future service.

If there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the sum of: [IFRIC 14.20]

- (a) Any amount that reduces future minimum funding requirement contributions for future service because the entity made a pre-payment (that is, it paid the amount before being required to do so).
- And
- (b) The estimated future service cost in each period less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no pre-payment as described in (a).

The future minimum funding contributions required in respect of future service should be calculated:

- Taking into account the effect of any existing surplus on the minimum funding requirement basis but excluding the pre-payment discussed in (a) immediately above.
- Using assumptions consistent with the minimum funding requirement basis. For any factors not specified by the minimum funding requirement, the assumptions used should be consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by IAS 19.

²³⁵ [IFRIC Update](#), July 2015, available on the IFRS Foundation's website.

- Including any changes expected as a result of the entity paying the minimum contributions when they are due.
- And
- Excluding the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period.

[IFRIC 14.21].

If the future minimum funding contribution required in respect of future service exceeds the future IAS 19 service cost in any given period, the present value of that excess reduces the amount of the asset available as a reduction in future contributions. However, the amount of the asset available as a reduction in future contributions can never be less than zero. [IFRIC 14.22].

The mechanics of the above requirements are illustrated in the following two examples based on the illustrative examples accompanying IFRIC 14. [IFRIC 14.IE9-IE27].

Illustration 3-4: Deficit-clearing future minimum funding requirements when refunds are not available

An entity has a funding level on the minimum funding requirement basis (which is measured on a different basis from that required under IAS 19) of 95% in Plan C. Under the minimum funding requirements, the entity is required to pay contributions to increase the funding level to 100% over the next three years. The contributions are required to make good the deficit on the minimum funding requirement basis (shortfall) and to cover future service.

Plan C also has an IAS 19 surplus at the end of the reporting period of £50m, which cannot be refunded to the entity under any circumstances. There are no unrecognised amounts.

The nominal amounts of the minimum funding contribution requirements in respect of the shortfall and the future IAS 19 service cost for the next three years are set out below.

	Total minimum funding contribution requirement	Minimum contributions required to make good the shortfall	Minimum contributions required to cover future accrual
Year	£ m	£ m	£ m
1	135	120	15
2	125	112	13
3	115	104	11

The entity's present obligation in respect of services already received includes the contributions required to make good the shortfall but does not include the minimum contributions required to cover future service.

The present value of the entity's obligation, assuming a discount rate of 6% per year, is approximately £300m, calculated as follows:

$$£120m \div (1.06) + £112m \div (1.06)^2 + £104m \div (1.06)^3$$

When these contributions are paid into the plan, the IAS 19 surplus (i.e., the fair value of assets less the present value of the defined benefit obligation) would, other things being equal, increase from £50m to £350m. However, the surplus is not refundable although an asset may be available as a future contribution reduction.

As noted above, the economic benefit available as a reduction in future contributions is the present value of:

- The future service cost in each year to the entity
- Less
- Any minimum funding contribution requirements in respect of the future accrual of benefits in that year over the expected life of the plan.

The amounts available as a future contribution reduction are set out below.

	IAS 19 service cost	Minimum contributions required to cover future accrual	Amount available as contribution reduction
Year	£ m	£ m	£ m
1	13	15	(2)
2	13	13	0
3	13	11	2
4+	13	9	4

Assuming a discount rate of 6%, the economic benefit available as a future contribution reduction is therefore equal to:

$$£(2)m \div (1.06) + £0m \div (1.06)^2 + £2m \div (1.06)^3 + £4m \div (1.06)^4 + £34m \div (1.06)^5 + £4m \div (1.06)^6 \dots = £56m.$$

The asset available from future contribution reductions is accordingly limited to £56m.

Illustration 3-5: Effect of a prepayment when a minimum funding requirement exceeds the expected future service charge

An entity is required to fund Plan D so that no deficit arises on the minimum funding basis. The entity is required to pay minimum funding requirement contributions to cover the service cost in each period determined on the minimum funding basis.

Plan D has an IAS 19 surplus of £35m at the beginning of 20X6. This example assumes that the discount rate is 0%, and that the plan cannot refund the surplus to the entity under any circumstances but can use the surplus for reductions of future contributions.

The minimum contributions required to cover future service are £15m for each of the next five years. The expected IAS 19 service cost is £10m in each year.

The entity makes a prepayment of £30m at the beginning of 20X6 in respect of years 20X6 and 20X7, increasing its surplus at the beginning of 20X6 to £65. That prepayment reduces the future contributions it expects to make in the following two years, as follows:

Minimum funding requirement contribution:			
	IAS 19 service cost	Before pre-payment	After pre-payment
Year	£ m	£ m	£ m
20X6	10	15	0
20X7	10	15	0
20X8	10	15	15
20X9	10	15	15
20X0	10	15	15
Total	50	75	45

At the beginning of 20X6, the economic benefit available as a reduction in future contributions is the sum of:

- £30m, being the prepayment of the minimum funding requirement contributions.
And
- Nil. The estimated minimum funding requirement contributions required for future service would be £75m if there was no prepayment. Those contributions exceed the estimated future service cost (£50m); therefore, the entity cannot use any part of the surplus of £35m.

Assuming a discount rate of 0%, the present value of the economic benefit available as a reduction in future contributions is equal to £30. Accordingly, the entity recognises an asset of £30m (because this is lower than the IAS 19 surplus of £65m).

Two points worth noting in Illustration 3-5 above are as follows. The first is that, if IFRIC 14 did not allow the recognition of such prepayments, the full surplus of £65m would have been written off. The second is that, in the fact pattern of the question, it is unnecessary to know that the surplus before the prepayment was £35m. This is because any surplus (other than the prepayment of MFR) would not be recognised because refunds are not available and future MFR exceeds future service costs.

3.5.8 Tax on defined benefit pension plans

The presentation of income and deferred tax on defined benefit pension schemes along with tax on a pension surplus are discussed in Chapter 31 at 9.4.

3.5.9 Presentation of the net defined benefit liability/asset

FRS 102 requires that an entity present a statement of financial position in accordance with one of the formats prescribed by the Regulations, or using one of the 'adapted formats' (see Chapter 6). The Regulations show pension deficits as the first line item in provisions and pension surpluses either in the same place as a pension deficit under Format 1 of the Regulations, or after prepayments and accrued income under Format 2 of the Regulations. Under previous UK GAAP, FRS 17 required defined benefit pension assets or liabilities to be presented, net of deferred tax, after accruals and deferred income, but before capital and reserves (see 2.6 above). The presentation under FRS 17, which was based on an interpretation of company law, could also be used under FRS 102 as it does not conflict with the Companies Act with the exception that any related deferred tax must not be offset against the pension balance. As a result, there is likely to be divergence in practice in the presentation of defined benefit pension surpluses and deficits under FRS 102.

Where the 'adapted formats' are used, neither FRS 102 nor IFRS specify where in the statement of financial position a net asset or a net liability in respect of a defined benefit plan must be presented, nor whether such balances must be shown separately on the face of the statement of financial position or only in the notes. This is left to the judgement of the reporting entity, but FRS 102 requires additional line items, headings and subtotals where relevant to an understanding of the entity's financial position. [FRS 102.4.3]. Classification of post-employment benefit assets and liabilities as current or non-current is discussed in Chapter 6 at 4.1.1.D.

The cost of a defined benefit plan would be included within administration expenses in the income statement, and net interest either within interest receivable and similar income or interest payable and similar charges dependent on whether net interest was an income or expense.

Where an entity has more than one defined benefit pension plan it is possible that it may have a plan with a surplus and another with a deficit. As Section 28 does not deal directly with the presentation of pension plans in the statement of financial position, users are required to look to other sections of FRS 102 which deal with the issue. FRS 102 states that an entity must not offset assets and liabilities unless required or permitted by an FRS. [FRS 102.2.96]. Therefore, defined benefit pension surpluses and deficits arising from different defined benefit schemes must be presented separately on the face of the statement of financial position.

3.5.10 Treatment of defined benefit plans in profit and loss, and other comprehensive income.

Section 28 requires the cost of a defined benefit plan to be recognised as follows:

- The change in the net defined benefit liability arising from employee service rendered during the reporting period in profit or loss.
 - Net interest on the defined benefit liability during the reporting period in profit or loss (see 3.5.10.A below).
 - The cost of plan introductions, benefit changes, curtailments and settlements in profit or loss (see 3.5.6 above).
- And
- Remeasurement of the net defined benefit liability in other comprehensive income (see 3.5.10.B below).

Where another section of FRS 102 requires part or all of a cost of employee benefits to be recognised as part of the cost of an asset such as inventories or plant, property and equipment that cost is not recognised in profit or loss. See Chapters 16 and 20 respectively. [FRS 102.28.3(b)].

Some defined benefit plans require employees or third parties to contribute to the cost of the plan. Contributions by employees reduce the cost of benefits to the entity. [FRS 102.28.23].

3.5.10.A Net interest

The net interest on the net defined benefit liability is determined by multiplying the net defined benefit liability by the discount rate (see 3.5.2.B above), both as determined at the start of the reporting period, taking into account any changes in the net defined liability during the period as a result of contributions and benefit payments. [FRS 102.28.24].

IAS 19 clarifies that net interest must be determined for the remainder of the period after a plan amendment, curtailment or settlement using:

- The net defined benefit liability (asset) reflecting the benefits offered under the plan and the plan assets after that event.

And

- The discount rate used to remeasure that net defined benefit liability (asset). [IAS 19.123A].

Although these amendments have not been reproduced in FRS 102, users may turn to IAS 19 for guidance in this regard and calculate the net interest after significant changes using the net defined benefit liability after the event and possibly the discount rate used to remeasure that net defined benefit liability, as well as applying this guidance for other significant changes in the net defined benefit liability, for example settlements and curtailments.

As the net item in the statement of financial position is comprised of two or three separate components (the defined benefit obligation, plan assets and the asset restriction, if any), the net interest is made up of interest unwinding on each of these components. [FRS 102.28.24A]. Although, for the purposes of presentation in profit or loss, net interest is a single net amount.

Interest on plan assets calculated as described above will not, other than by coincidence, be the same as the actual return on plan assets. The difference is a remeasurement which is recognised in other comprehensive income. [FRS 102.28.24B].

3.5.10.B Remeasurements

Remeasurements of the net defined benefit liability (asset) comprise:

- Actuarial gains and losses.
- The return on plan assets, excluding amounts included in net interest on the net defined benefit liability and after deducting the costs of managing the plan assets.

And

- Any change in the amount of a defined benefit plan surplus that is not recoverable (in accordance with paragraph 28.22), excluding amounts included in net interest on the net defined benefit liability.

[FRS 102.28.25].

Remeasurements of the net defined benefit liability are recognised in other comprehensive income and are not reclassified to profit or loss in a subsequent period. [FRS 102.28.25A].

Actuarial gains and losses are changes in the present value of defined benefit obligation resulting from: experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and the effects of changes in actuarial assumptions. [FRS 102 Appendix I].

3.6 Costs of administering employee benefit plans

Some employee benefit plans incur costs as part of delivering employee benefits. These costs are generally more significant for post-retirement benefits such as pensions. Examples of costs would include actuarial valuations, government levies, audits and the costs of managing any plan assets.

FRS 102 does not include any guidance on accounting for these costs. As noted at 2.2 above entities may refer to IAS 19 using the GAAP hierarchy in Section 10 *Accounting Policies, Estimates and Errors*.

IAS 19 deals with some costs but is silent on others.

The following costs are required to be factored into the measurement of the defined benefit obligation:

- In the case of medical benefits, future medical costs, including claim handling costs (i.e., the costs that will be incurred in processing and resolving claims, including legal and adjuster's fees)

And

- Taxes payable by the plan on contributions relating to service before the reporting date or on benefits resulting from that service. [IAS 19.76(b)].

The following costs (and no others) are deducted from the return on plan assets:

- The costs of managing the plan assets

And

- Any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation. [IAS 19.130].

As discussed at 3.5.10 above, net interest on the net liability or asset is reported in the profit or loss. This is a wholly computed amount which is uninfluenced by actual asset returns; the difference between actual asset returns and the credit element of the net interest amount forms part of remeasurements reported in other comprehensive income.

So, although not expressed in these terms, costs of administering plan assets and the tax mentioned above are under IAS 19, reported in other comprehensive income.

Both Section 28 and IAS 19 do not address the treatment of any other costs of administering employee benefit plans. However, the Basis for conclusions of IAS 19 contains the following: “the Board decided that an entity should recognise administration costs when the administration services are provided. This practical expedient avoids the need to attribute costs between current and past service and future service”. [IAS 19.BC127]. The IASB may well have taken that decision, however it was not articulated in the practical expedient in the standard.

How we see it

In our view, recognising administration costs when the administration services are provided is an acceptable way to account for costs not dealt with in the standard. However other approaches could be acceptable, for example, in relation to closed schemes as discussed below. Once an accounting policy has been determined it must be applied consistently to similar facts and circumstances.

FRS 102 allows only specific items to be presented in other comprehensive income. [FRS 102.5.5A]. Costs of administering employee benefit plans are not required or permitted to be recognised in other comprehensive income and therefore must be presented within profit or loss.

One alternative to simple accruals accounting as costs are incurred could be relevant to closed plans, where employees are no longer exchanging services for defined benefits. In this situation, it is clear that any and all future costs of administering the plan relate to past periods and no attribution is necessary. An entity with such an arrangement could select a policy of full provision of all costs of ‘running-off’ the plan, which must be applied consistently to similar facts and circumstances.

3.7 Other long-term employee benefits

3.7.1 Meaning of other long-term benefits

Other long-term employee benefits include items such as the following, if they are not expected to be wholly settled within 12 months after the end of the annual reporting period in which the employees have rendered the related service: [FRS 102.28.29]

- Long-term paid absences such as long-service or sabbatical leave.
- Other long-service benefits.
- Long-term disability benefits.
- Profit-sharing and bonuses.
- And
- Deferred remuneration.

3.7.2 Recognition and measurement

For other long-term benefits a simplified version of the accounting treatment required in respect of defined benefit plans (which is discussed in detail at 3.5 above) is required. The amount recognised as a liability for other long-term employee benefits must be the net total, at the end of the reporting period, of the present value of the defined benefit obligation and the fair value of plan assets (if any) out of which the obligations are to be settled directly. The net change in the liability during the period must be recognised in profit or loss, except to the extent that FRS 102 requires or permits their inclusion in the cost of an asset, such as inventory or property, plant and equipment. [FRS 102.28.30]. See Chapters 16 and 20.

In other words, all assets, liabilities, income and expenditure relating to such benefits must be accounted for in the same way as those relating to a defined benefit plan (see 3.5 above), except that remeasurements are recognised in profit or loss (and not in other comprehensive income).

Illustration 3-6: Long-term benefits

An employee is entitled to receive a bonus of £100,000 in five years’ time, provided they continue to stay employed by the entity for this period. It is assumed that the employee will remain in employment for the entire five-year period.

In this example, the cost must be spread over the five-year period using the attribution of benefit method described in 3.5.2.C above.

3.7.3 Long-term benefits contingent on a future event

It could be the case that a long-term benefit becomes payable only on the occurrence of an uncertain future event, for example an initial public offering of an entity's shares (IPO) or an exit event, financial KPIs such as revenue or non-financial KPIs such as the number of new customers or retail outlets opened in a period. Such events are binary in nature and would result in payment either to no employees with entitlements under the plan or to all such employees.

As discussed at 3.7.2 above, the projected unit credit method is applied to long-term employee benefits, [FRS 102.28.30], however the key question that arises is whether the accounting should reflect the single best estimate of the outcome; or, the expected value - that is, a weighted average of possible outcomes. Paragraph 26 of Section 28 states that "the probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists". This sets out the requirement that probability affects measurement. The manner in which probability affects measurement is dealt with in the definition of actuarial assumptions which requires that these are a best estimate of the ultimate cost of providing benefits. [FRS 102 Appendix I].

How we see it

We believe that the best estimate of the outcome of an uncertain event must be used when accounting for long-term employee benefits where the outcome is binary.

Therefore, where the outcome is binary, if the future event on which the long-term benefit is contingent is not probable, the liability must be measured at nil. When the contingent event is or becomes probable (that is, more likely than not) the actuarial assumption used in applying the projected unit credit method must reflect the full benefits which would be payable upon the occurrence of the event. The result of revising the actuarial assumptions will result in a remeasurement gain or loss being recognised in profit and loss in the year of the change. For example, consider a long-term employee benefit vesting over a five-year period in which the liability was measured based on the projected unit credit method at the end of the first and second year as the contingent event was determined to be probable. If the contingent event becomes no longer probable during the third year, then the liability at the end of year three will be nil and the previous liability recognised in years one and two will be released to the profit and loss account. For an additional example, consider a long-term employee benefit contingent on a future event such as an IPO, where an employee will receive a payment if (and only if) the employing entity becomes listed on a stock exchange within five years. In each of the first two years it was considered probable that the listing would take place in five years from the granting of the benefit and the benefit be paid on that date. Accordingly, the liability was measured using the projected unit credit method at the end of the first and second year with the discounted present value of 20% of the payment attributed to each year for service provided by the employee. If the listing becomes no longer probable during the third year, then the liability at the end of year three will be nil and the previous liability recognised in years one and two will be released to the profit and loss account.

3.8 Termination benefits

Termination benefits occur when an entity is committed, by legislation, by contractual or other agreements with employees or their representatives or by a constructive obligation based on business practice, custom or desire to act equitably, to make payments (or to provide other benefits) to employees when it terminates their employment. [FRS 102.28.31]. Rather than being earned through providing services to an entity, termination benefits arise as a result of an event such as a decision to reduce the size of the workforce.

Termination benefits are required to be recognised by an entity as an expense in profit or loss immediately, as they do not provide an entity with future economic benefits. [FRS 102.28.32].

Termination benefits must be recognised as a liability and an expense only when the entity is demonstrably committed either: [FRS 102.28.34]

- To terminate the employment of an employee or group of employees before the normal retirement age.
Or
- To provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.

An entity becomes demonstrably committed to a termination only when it has a detailed formal plan for the termination and is without realistic possibility of withdrawal from the plan. [FRS 102.28.35]. Section 21 *Provisions and Contingencies* states that a restructuring, which may include termination benefits, gives rise to a constructive obligation only when an entity has a detailed formal plan which identifies at least: [FRS 102.21.11C]

- The business or part of a business concerned.
 - The principal locations affected.
 - The location, function, and approximate number of employees who will be compensated for terminating their services.
 - The expenditures that will be undertaken.
- And
- When the plan will be implemented.

Additionally, the entity must have raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

When an entity recognises termination benefits, it could also have to account for a plan amendment or a curtailment of other employee benefits. [FRS 102.28.33].

An entity is required to measure termination benefits at the best estimate of the amount that would be required to settle the obligation at the reporting date. If an offer was made to encourage voluntary redundancy, the measurement of termination benefits must be based on the number of employees expected to accept the offer. [FRS 102.28.36].

Where termination benefits are not due to be settled wholly within 12 months after the end of the reporting period, they must be discounted to their present value using the methodology and discount rate specified as for defined benefit pension schemes (see 3.5.2.B above). [FRS 102.28.37].

Some employers will pay 'stay bonuses' to encourage employees who have been told that they will be made redundant to continue to work for the employer for a further period of time (for example to complete a project). These bonuses are not termination benefits as the individuals are still employed by the entity and the expense does not meet the definition of a termination benefit (see above), and therefore the cost of the stay bonus must be recognised over the period in which the employee is working to earn this bonus.

3.9 Group plans

When an entity participates in a defined benefit plan that shares risks between entities under common control (a group plan), it is required to obtain information about the plan as a whole measured in accordance with FRS 102, on the basis of assumptions that apply to the plan as a whole. If there is a contractual agreement or stated policy for charging the net defined benefit cost of a defined benefit plan as a whole to individual group entities, then the entity is required to recognise the net defined benefit cost based on this allocation in its individual financial statements. [FRS 102.28.38].

If there is no contractual agreement or stated policy for charging the net defined benefit cost to individual group entities, the net defined benefit cost of a defined benefit plan must be recognised in the individual financial statements of the group entity which is the sponsoring employer for the plan. The other group entities must recognise a cost equal to their contribution payable for the period in their individual financial statements. [FRS 102.28.38].

As the net defined benefit cost is calculated by reference to both the defined benefit obligation and the fair value of plan assets, recognising a net defined benefit cost requires the recognition of a corresponding net benefit asset or liability in the individual financial statements of any group entity recognising a net defined benefit cost. [FRS 102.28.38].

3.10 Death-in service benefits

The provision of death-in service benefits is a common part of employment packages (either as part of a defined benefit plan or on a stand-alone basis). Unfortunately, no guidance is provided by FRS 102 or IAS 19 on how to account for such benefits. An appropriate approach could be that:

- Death in service benefits provided as part of a defined benefit post-employment plan are factored into the actuarial valuation. In this case any insurance cover must be accounted for in accordance with the normal rules of IAS 19 i.e., the fair value of the asset is deemed to be the present value of the related obligation. An important point here is that insurance policies for death in service benefits typically cover only one year and hence will have a low or negligible value. As a result, it will not be the case that the insurance asset is equal and opposite to the defined benefit obligation.
- Other death in service benefits which are externally insured are accounted for by expensing the premiums as they become payable.

And

- Other death in service benefits which are not externally insured are provided for as deaths in service occur.

An alternative approach could be to view death in service benefits as being similar to disability benefits. The accounting for disability benefits under IAS 19 is as follows:

- Where a long-term disability benefit depends on the length of service of the employee, an obligation arises as the employee renders service, which is to be measured according to the probability that payment will be required and the length of time for which payment is expected to be made.
- If however, the level of benefit is the same for all disabled employees regardless of years of service, the expected cost is recognised only when an event causing a disability occurs. [IAS 19.157].

How we see it

Given the lack of explicit guidance on death-in-service benefits in FRS 102 and IAS 19, it seems likely that practice will be mixed.

4 Disclosures required by Section 28 including related UK company law

4.1 Section 28 Disclosures

In addition to the disclosures required by Section 28, consideration should also be given to the disclosures required in Section 8 *Notes to the Financial Statements* to disclose:

- Material accounting policy information).
- And
- The judgements made by management, in applying the accounting policies, that have the most significant effect on the amounts recognised in the financial statements.
- As well as
- Assumptions concerning the future and other key sources of estimation uncertainty. [FRS 102.8.5, FRS 102.8.6, FRS 102.8.7].

4.1.1 Disclosures about short-term employee benefits

Section 28 does not require any specific disclosures about short-term employee benefits, [FRS 102.28.39], but preparers of financial statements must also consider the requirements of Section 33 *Related Party Disclosures* discussed in Chapter 35 at 4.

4.1.2 Disclosures about other long-term benefits

For each category of other long-term benefits that it provides to its employees, an entity must disclose the nature of the benefit, the amount of its obligation and the extent of funding at the reporting date. [FRS 102.28.42].

4.1.3 Disclosures about defined contribution plans

An entity is required to disclose the amount recognised in profit or loss as an expense for defined contribution plans. [FRS 102.28.40].

When a multi-employer plan is treated as a defined contribution plan because sufficient information is not available to use defined benefit accounting (see 3.3.2 above) entities must: [FRS 102.28.40A]

- Disclose the fact that it is a defined benefit plan and the reason why it is being accounted for as a defined contribution plan, along with any available information about the plan's surplus or deficit and the implications, if any, for the entity.
- Include a description of the extent to which the entity can be liable to the plan for other entities' obligations under the terms and conditions of the multi-employer plan.
- And
- Disclose how any liability recognised as a result of the entity entering into an agreement to fund a deficit (see 3.3.2 above) has been determined.

4.1.4 Disclosures about defined benefit plans

As discussed at 3.5.9 above, FRS 102 requires that the statement of financial position and income statement must be presented in accordance with The Large and Medium sized companies and Groups (Accounts and Reports) Regulations 2008 or the 'adapted formats'.

4.1.4.A General disclosures

An entity is required to disclose the following information about defined benefit plans (except for multi-employer defined benefit plans that are treated as defined contribution plans - see 3.3.2 above). If an entity has more than one defined benefit plan, these disclosures could be made in aggregate, separately for each plan, or in such groupings as considered to be the most useful:

- A general description of the type of plan, including funding policy. This includes the amount and timing of the future payments to be made by the entity under any agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions).

- The date of the most recent comprehensive actuarial valuation and, if it was not as of the reporting date, a description of the adjustments that were made to measure the defined benefit obligation at the reporting date.
- A reconciliation of opening and closing balances for each of the following:
 - The net defined benefit obligation.
 - The fair value of the plan assets.
 - And
 - Any reimbursement right recognised as an asset.
- Each of the reconciliations above must show each of the following, if applicable:
 - The change in the net defined benefit liability arising from employee service rendered during the period.
 - Interest income or expense.
 - Remeasurements of the defined benefit liability, showing separately actuarial gains and losses and the return on plan assets less amounts included in interest income/expense above.
 - Plan introductions, changes, curtailments and settlements.
 - Contributions to the plan.
 - Payments from the plan.
 - The effect of changes in foreign exchange rates.
 - And
 - The effect of business combinations and disposals.
- For each major class of plan assets, which must include but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major class constitutes of the fair value of the total plan assets at the reporting date.
- The amounts included in the fair value of plan assets for:
 - Each class of the entity's own financial instruments.
 - And
 - Any property occupied by, or other assets used by, the entity.
- The return on plan assets.
- The principal actuarial assumptions used, including when applicable:
 - The discount rates.
 - The expected rate(s) of salary increases.
 - Medical cost trend rates.
 - And
 - Any other material actuarial assumptions used.
- When applicable, the basis used to determine the limit on recognising a plan surplus (see 3.5.7 above).

The reconciliations above need not be presented for prior periods. [FRS 102.28.41].

FRS 102 sets out that the objective of financial statements, "...is to provide financial information about the entity that is useful for decision-making by a wide range of users who are not in a position to demand reports tailored to meet their particular information needs". An example of a disclosure that is not specifically listed in Section 28, but which may be required to meet the overall objective of financial statements is the remeasurement gain or loss arising on the acquisition of a qualifying insurance policy (or buy-in arrangement) which has been recognised in other comprehensive income.

4.1.4.B Disclosures for plans which share risks between entities under common control

If an entity participates in a defined benefit plan that shares risks between entities under common control (see 3.9 above) it is required to disclose the following information:

- The contractual agreement or stated policy for charging the cost of a defined benefit plan or the fact that there is no policy.
- The policy for determining the contribution to be paid by the entity.
- And
- If the entity accounts for an allocation of the net defined benefit cost, all the information required in 4.1.4.A above.

If the entity accounts for the contributions payable for the period, the following information is also required:

- A general description of the type of plan, including funding policy.
- The date of the most recent comprehensive actuarial valuation and, if it was not as of the reporting date, a description of the adjustments that were made to measure the defined benefit obligation at the reporting date.
- For each major class of plan assets, which must include but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major class constitutes of the fair value of the total plan assets at the reporting date.

And

- The amounts included in the fair value of plan assets for:
 - Each class of the entity's own financial instruments.
- And
- Any property occupied by, or other assets used by, the entity.

This information can be disclosed by cross-reference to disclosures in another group entity's financial statements if: the group entity's financial statements separately identify and disclose the information required about the plan; and that group entity's financial statements are available to users of the financial statements on the same terms as the financial statements of the entity and at the same time as, or earlier than, the financial statements of the entity. [FRS 102.28.41A].

4.1.5 Disclosures about termination benefits

For each category of termination benefits provided to employees the following must be disclosed:

[FRS 102.28.43]

- The nature of the benefit.
 - The accounting policy.
- And
- The amount of its obligation and the extent of funding at the reporting date.

When there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists. Section 21 *Provisions and Contingencies* requires the disclosure of contingent liabilities unless the possibility of an outflow in settlement is remote (see Chapter 24 at 4.2). [FRS 102.28.44].

4.2 UK Companies Act disclosures

The Companies Act does not require any specific disclosure requirements for employee benefits, however there are numerous disclosure requirements for salaries, pensions and other benefits payable to directors. These requirements are within Schedule 5 to the Large and Medium sized Companies and Groups (Accounts and Reports) Regulations 2008. In addition, s411 of the Companies Act requires the disclosure of other pension costs as part of the disclosure of staff costs. See Chapter 6 at 7.7.

5 Summary of GAAP differences

The following table shows the key differences between IFRS and FRS 102.

	FRS 102	IFRS
Pension surpluses/asset ceilings	FRS 102 states that a defined benefit asset can be recognised only to the extent that an entity is able to recover the pension surplus either through reduced contributions in the future or through refunds in the plan. No further guidance is provided and therefore an entity must develop an accounting policy to determine the extent of any pension surplus that can be recognised.	Similar to FRS 102, IAS 19 allows the recognition of a defined benefit asset and restricts its recognition to the lower of the pension surplus and an asset ceiling. The asset ceiling is the present value of benefits available via a reduction in future contributions or a refund. However, IFRIC 14 provides detailed guidance on how to calculate the present value of benefits available and the impact of any minimum funding requirement.
Liability for deficit funding requirements	Under FRS 102, no additional liabilities can be recognised in respect of an agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions).	IFRIC 14 requires a liability to be recorded to the extent that deficit funding contributions payable will not be available after they are paid into the plan.
Attributing benefit to years of service	The present value of a net defined benefit obligation must include the effects of benefit formulas that give employees greater benefits for later years of service. No further guidance is given on how to assess the effect.	If an employee's service in later years will lead to a materially higher level of benefit, the benefit must be attributed on a straight-line basis from the date when service by the employee first leads to benefits under the plan until the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.
Calculation of service cost and net interest following a plan amendment, curtailment or settlement during a reporting period	Silent on the issue.	IAS 19 clarifies that the current service cost in the period following a plan amendment, curtailment or settlement must be calculated using the actuarial assumptions used for the remeasurement. The net interest following a plan amendment or curtailment must be measured using the net defined benefit liability/(asset) after the plan amendment or curtailment and the discount rate used to remeasure the net defined liability/(asset).
Calculation of gain or loss on settlement	Silent on the issue.	IAS 19 clarifies that the effect of the asset ceiling must not be considered in determining any gain or loss as a result of a plan amendment, curtailment or settlement.

	FRS 102	IFRS
Accounting for multi-employer defined benefit plans when sufficient information becomes available	Any difference on the recognition of a net defined benefit liability when applying defined benefit accounting for the first time is recognised in other comprehensive income.	IAS 19 does not address the accounting when sufficient information becomes available for defined benefit accounting to be applied to a multi-employer scheme for the first time. Our view is that there are two approaches in accounting for the difference recognised as a net defined benefit obligation being: ▪ An immediate charge/credit to profit or loss. OR ▪ An actuarial gain or loss recognised in other comprehensive income.
Presentation	FRS 102 requires primary statements to be presented in accordance with one of the formats prescribed by the Regulations, or using one of the 'adapted formats', which can result in presentation in various places on the Balance Sheet (except that deferred tax cannot be offset against the gross pension deficit or surplus).	Follow the general requirements of IAS 1 for the presentation on the statement of financial position.
Disclosure	FRS 102 does not include a disclosure objective and has fewer specific disclosure requirements. For example, sensitivity analysis is not listed as a disclosure requirement.	IAS 19 has a disclosure objective for information in respect of defined benefit schemes along with considerations in order to meet this objective.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

accumulating compensated absences	Compensated absences that are carried forward and can be used in future periods if the current period's entitlement is not used in full.
actuarial assumptions	An entity's unbiased and mutually compatible best estimates of the demographic and financial variables that will determine the ultimate cost of providing post-employment benefits.
actuarial gains and losses	Changes in the present value of the defined benefit obligation resulting from: (a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and (b) the effects of changes in actuarial assumptions
asset held by a long-term employee benefit fund	An asset (other than non-transferable financial instruments issued by the reporting entity) that: (a) is held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and (b) is available to be used only to pay or fund employee benefits, is not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either: (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.
constructive obligation	An obligation that derives from an entity's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
defined benefit obligation (present value of)	The present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.
defined benefit plans	Post-employment benefit plans other than defined contribution plans.
defined contribution plans	Post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and has no legal or constructive obligation to pay further contributions or to make direct benefit payments to employees if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods
employee benefits	All forms of consideration given by an entity in exchange for service rendered by employees.
funding (of post-employment benefits)	Contributions by an entity, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting entity and from which the employee benefits are paid

multi-employer (benefit) plans	Defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that: (a) pool the assets contributed by various entities that are not under common control, and (b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned
net defined benefit liability	The present value of the defined benefit obligation at the reporting date minus the fair value at the reporting date of plan assets (if any) out of which the obligations are to be settled.
plan assets (of an employee benefit plan)	Plan assets (of an employee benefit plan) are: (a) assets held by a long-term employee benefit fund; and (b) qualifying insurance policies.
post-employment benefits	Employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.
post-employment benefit plans	Formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.
projected unit credit method	An actuarial valuation method that sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method).
qualifying insurance policies	An insurance policy issued by an insurer that is not a related party of the reporting entity, if the proceeds of the policy: (a) can be used only to pay or fund employee benefits under a defined benefit plan; and (b) are not available to the reporting entity's own creditors (even in bankruptcy) and cannot be paid to the reporting entity, unless either: (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or (ii) the proceeds are returned to the reporting entity to reimburse it for employee benefits already paid
retirement benefit plan	Arrangements whereby an entity provides benefits for employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practice.
state (employee benefit) plan	Employee benefit plans established by legislation to cover all entities (or all entities in a particular category, for example a specific industry) and operated by national, regional or local government or by another body (for example an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting entity.
termination benefits	Employee benefits provided in exchange for the termination of an employee's employment as a result of either: (a) an entity's decision to terminate an employee's employment before the normal retirement date; or (b) an employee's decision to accept voluntary redundancy in exchange for those benefits.

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Chapter 31

Income tax

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Overview

This chapter deals with the requirements of Section 29 *Income Tax*. Section 29 applies to income tax and value added tax and other similar taxes which are not income taxes. [FRS 102.29.2].

What you need to know

The overall requirements of Section 29 can be summarised as follows:

- Determine whether a tax is an 'income tax' (see 3 below).
- Recognise income tax due or receivable in respect of the current and prior periods (current tax), measured using enacted or substantively enacted legislation (see 5 below), and having regard to any uncertain tax treatments (see 5 below).
- Determine whether there are timing differences that arise from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements (see 6 below).
- Determine whether there are unrelieved tax losses or other deferred tax assets (see 6 below).
- Determine whether Section 29 prohibits or restricts recognition of deferred tax assets (see 6 below).
- Do not recognise deferred taxes on permanent differences except for those arising from a business combination accounted for by applying the purchase method (see 6 below).
- Allocate any income tax charge or credit for the period to profit or loss, other comprehensive income or equity as appropriate (see 9 below).
- Present income tax in the financial statements as required by Section 29 (see 11 below).
- Disclose information required by Section 29 (see 12 below).

1 Introduction

Section 29 not only applies to accounting for income tax, but also to value added tax (VAT) and other similar sales taxes which are not income taxes, [FRS 102.29.2], as discussed at 4 below. Section 29 also covers specific provisions in relation to withholding tax on dividend income (see 8.1.2 below).

Income tax as described in Section 29 comprises:

- Current tax.
- And
- Deferred tax including deferred tax in respect of assets (other than goodwill) and liabilities recognised as a result of a business combination. [FRS 102.29.2].

An entity is required to recognise the current and future tax consequences of transactions and other events that have been recognised in the financial statements. Current tax is the amount of income tax payable (refundable) in respect of the taxable profit (tax loss) for the current period or past reporting periods. Deferred tax represents the income tax payable (recoverable) in respect of the taxable profit (tax loss) for future reporting periods as a result of past transactions or events. [FRS 102 Appendix I].

The requirements applicable to business combinations are discussed at 6.6 below.

Section 29 includes a mandatory exception from recognising and disclosing deferred tax assets and liabilities related to Pillar Two income tax. [FRS 102.29.2B]. Requirements relating to Pillar Two income tax is discussed in 3.7 below.

1.1 Allocation of tax income and expense between periods

The most significant accounting question which arises in relation to taxation is how to allocate tax expense (income) between accounting periods. The particular period in which transactions are recognised in the financial statements is determined by FRS 102's accounting framework. However, the timing of the recognition of transactions for the purposes of measuring the taxable profit is governed by tax law, which sometimes prescribes an accounting treatment different from that used in the financial statements. The generally accepted view is that it is necessary for the financial statements to seek some reconciliation between these different treatments.

The objective of Section 29 is to reflect the tax consequences of transactions that are recognised in the financial statements following FRS 102. Broadly speaking, the tax consequences that are legal assets or liabilities at the reporting date are referred to as current tax. The other tax consequences, which are expected to become or form part of legal assets or liabilities in a future period, are referred to as deferred tax.

This is shown in Illustration 1-1, and the further discussion at 1.1.1 to 1.1.2 below.

Illustration 1-1: PP&E attracting tax deductions in advance of accounting depreciation

An item of equipment is purchased on 1 January 20X3 for £50,000 and is estimated to have a useful life of five years, at the end of which it will be scrapped. The estimated residual amount is zero and this estimate does not change over the life of the equipment. The depreciation charge will therefore be £10,000 per year for five years.

The applicable corporate tax rate is 30%. No tax deductions are given for depreciation charged in the financial statements. Instead, the cost of the asset may be deducted from taxes payable in the year that the asset is purchased. The entity's profit before tax, after deducting the depreciation charge, for each of the five years ended 31 December 20X3 to 31 December 20X7 is £100,000. All components of pre-tax profit, other than the accounting depreciation, are taxable or tax-deductible.

The entity's tax computations for each year would show the following:

£s	20X3	20X4	20X5	20X6	20X7
Accounting profit	100,000	100,000	100,000	100,000	100,000
Accounting depreciation	10,000	10,000	10,000	10,000	10,000
Tax depreciation	(50,000)	-	-	-	-
Taxable profit	60,000	110,000	110,000	110,000	110,000
Tax payable @ 30%	18,000	33,000	33,000	33,000	33,000

1.1.1 No provision for deferred tax ('flow through')

If the entity in Illustration 1-1 above were to account only for the tax legally due in respect of each year ('current tax'), it would report the amounts in the table below in profit or loss. Accounting for current tax only is generally known as the 'flow through' method.

£s	20X3	20X4	20X5	20X6	20X7	Total
Profit before tax	100,000	100,000	100,000	100,000	100,000	500,000
Current tax	18,000	33,000	33,000	33,000	33,000	150,000
Profit after tax	82,000	67,000	67,000	67,000	67,000	350,000
Effective tax rate (%)	18	33	33	33	33	30

The 'effective tax rate' in the last row of the table above is the ratio, expressed as a percentage, of the tax expense to the profit before tax in the financial statements. As can be seen from the table above, over the full five-year life of the asset, the entity pays tax at the statutory rate of 30% on its total profits of £500,000, but with considerable variation in the effective rate in individual accounting periods.

The generally held view is that simply to account for the tax legally payable as above is distortive, and the tax must therefore be allocated between periods. Under Section 29 this allocation is achieved by means of deferred taxation (see 1.1.2 below).

1.1.2 Provision for deferred tax (the timing difference approach)

The approach required by Section 29 is known as the 'timing difference' approach, which seeks to measure the impact on future tax payments of the cumulative difference, as at the reporting date, between income or expenditure in the financial statements and the amounts recognised for the same income or expense in the tax computation. This is shown in Illustration 1-1 above in the case of depreciation. Such differences are known as 'timing differences'. Timing differences are said to 'originate' in those periods in which the cumulative difference between book and tax income (expense) increases and to 'reverse' in those periods in which that cumulative difference decreases. In Illustration 1-1 above, the differences originate and reverse as follows:

£s	20X3	20X4	20X5	20X6	20X7
Accounting depreciation	10,000	10,000	10,000	10,000	10,000
Tax depreciation	(50,000)	-	-	-	-
(Origination)/reversal	(40,000)	10,000	10,000	10,000	10,000
Cumulative ¹	(40,000)	(30,000)	(20,000)	(10,000)	-

As discussed in more detail at 7 below, Section 29 requires an entity to recognise a liability for deferred tax on the timing difference arising between book and tax depreciation, as follows.

£s	20X3	20X4	20X5	20X6	20X7
Cumulative difference (per table above)	(40,000)	(30,000)	(20,000)	(10,000)	-
Deferred tax liability ¹	(12,000)	(9,000)	(6,000)	(3,000)	-
Movement in deferred tax in period	12,000	(3,000)	(3,000)	(3,000)	(3,000)

1 Cumulative timing difference multiplied by the tax rate of 30%. As discussed at 7 below, Section 29 requires deferred tax to be measured by reference to the tax rates and laws expected to apply when the timing differences will reverse.

The deferred tax liability is recognised in the statement of financial position and any movement in the deferred tax liability during the period is recognised as deferred tax income or expense in profit or loss, with the following impact:

£s	20X3	20X4	20X5	20X6	20X7	Total
Profit before tax	100,000	100,000	100,000	100,000	100,000	500,000
Current tax (at 1.1 above)	18,000	33,000	33,000	33,000	33,000	150,000
Deferred tax	12,000	(3,000)	(3,000)	(3,000)	(3,000)	-
Total tax	30,000	30,000	30,000	30,000	30,000	150,000
Profit after tax	70,000	70,000	70,000	70,000	70,000	350,000
Effective tax rate (%)	30	30	30	30	30	30

It can be seen that the effect of accounting for deferred tax is to present an effective tax rate of 30% in profit or loss for each period.

1.2 Permanent differences

Some differences between an entity's taxable profit and accounting profit arise not because the same items are recognised in taxable profit and accounting profit in different periods (i.e. timing differences), but because certain types of income and expenses are non-taxable or disallowable, or because certain tax charges or allowances are greater or smaller than the corresponding income or expense recognised in accounting profit. For example:

- An item of PP&E is depreciated but its cost is not deductible for tax purposes other than on sale. An example in the UK would be an industrial building. Any depreciation of such an asset recognised for accounting purposes is a permanent difference.
- In the UK a company may obtain a tax deduction for a share-based payment transaction based on its value at vesting or exercise, which is typically higher than its value at grant on which the expense in the financial statements is based. Any excess of the tax deduction over the expense recognised in the financial statements is a permanent difference.

As discussed further at 6.5 below, Section 29 requires that deferred tax is not recognised on permanent differences, except for differences arising on the initial accounting for a business combination accounted for by applying the purchase method. [FRS 102.29.10].

2 Comparison between Section 29 and IAS 12

2.1 Withholding taxes on dividends and VAT and other sales taxes

The requirements of Section 29 in relation to withholding taxes on dividends (see 8.1.2 below) are not all reflected in IAS 12 *Income Taxes*, which refers only to withholding taxes payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity. Practice related to presentation of withholding taxes from dividend income is diverse under IFRS where in some cases such income is measured gross and in other cases net of withholding taxes.

IAS 12, unlike Section 29, does not include VAT and other similar sales taxes in its scope (see section 4 below).

2.2 Current tax and deferred tax

The requirements of Section 29 and IAS 12 in respect of the recognition and measurement of current tax are essentially the same.

As regards deferred tax, Section 29 adopts a 'timing difference' approach, except when the entity initially recognises assets and liabilities acquired in a business combination accounted for by applying the purchase method (where the treatment is largely the same as IFRS). Timing differences are differences between taxable profits and total comprehensive income as stated in the financial statements. They arise from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements. [FRS 102.29.6].

IAS 12 applies a 'temporary difference' approach, whereby deferred tax is recognised on the difference between the carrying amount of an asset or liability and the amount at which that asset or liability is assessed for tax purposes (referred to as its 'tax base'). However, there are some exceptions to this, most notably the initial recognition exception, whereby no deferred tax is recorded on a difference between the carrying amount of an asset or liability and its tax base where that difference arose on the initial recognition of the asset or liability in a transaction which is not a business combination, at the time of the transaction affects neither accounting profit nor taxable profit or tax loss and at the time of the transaction does not give rise to equal taxable and deductible temporary differences (such as leases and decommissioning obligations that lead to the recognition of an asset and a liability). No such exemption is necessary under a 'timing differences' approach as no timing differences arise on the initial recognition of an asset. [FRS 102.BC.B29.5].

Whilst FRS 102 is based on a 'timing differences' approach, it was considered important to maintain consistency with IFRS on the recognition of deferred tax arising from a business combination. Accordingly, in Section 29, the timing difference approach is supplemented with a requirement to recognise deferred tax on business combinations. [FRS 102.BC.B29.6].

Having supplemented the 'timing differences' approach with a requirement to recognise deferred tax on business combinations, the main distinction between Section 29 and IFRS is that IAS 12 requires deferred tax to be recognised on any difference between the carrying amount of an asset or liability and its tax base that arises after the initial recognition of the asset or liability. Section 29 would prohibit the recognition of such differences that are not the result of timing differences. For example, no deferred tax is recognised under Section 29 when: [FRS 102.BC.B29.7]

- The tax base (the tax-deductible amount) of an asset is amended, such as when the legislation changes the amount of future tax relief relating to the asset (see 6.5 below).
- And
- The tax deduction (or estimated future deduction) for share-based payment exceeds the cumulative amount of the related remuneration expense (see 8 below).

3 Scope of Section 29

Section 29 applies not only to income tax, but also includes specific provisions in relation to withholding taxes on dividend income (see 8.1.2 below) and on accounting for VAT and other similar sales taxes that are not income taxes (see 4 below). [FRS 102.29.2].

No transitional reliefs are given for first-time adopters of FRS 102 in respect to the application of Section 29. Accordingly, on transition to FRS 102 entities must apply the requirements of Section 29 on a fully retrospective basis. In particular, deferred tax will arise as a result of the following:

- Past revaluations of property, plant and equipment and investment properties (see Chapter 37 at 3.4.3.C).
 - Accounting for business combinations before the date of transition (see Chapter 37 at 5.2.1 and 5.2.2).
- And
- The application of transitional reliefs, such as the use of fair value or a previous revaluation as the deemed cost of certain assets (see Chapter 37 at 5.5.4).

In addition, the transition to FRS 102 can have direct implications for an entity's corporation tax position in the UK. In some cases, a current tax liability arises in the year of transition and in others the liability is spread over a period of up to 10 years. Such deferral of the liability to corporation tax can either be automatic or require an election to be made and will require deferred tax to be recognised as at the date of transition to FRS 102 to the extent that this creates a timing difference under Section 29. Entities must refer to relevant guidance issued by HM Revenue & Customs and take professional advice as appropriate.²³⁶

3.1 What is an 'income tax'?

Section 29 applies to income tax. [FRS 102.29.2(a)]. Income tax as defined in FRS 102 Appendix I includes:

- All domestic and foreign taxes that are based on taxable profit.
- And
- Taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.

This definition is somewhat circular, since 'taxable profit' is, in turn, defined in terms of profits "upon which income taxes are payable".

UK corporation tax is an 'income tax' as defined, since it takes as its starting point the totality of a reporting entity's accounting profits. However, both the UK and overseas jurisdictions raise 'taxes' on sub-components of net profit. These include:

- Sales taxes
 - Goods and services taxes
 - Value added taxes
 - Levies on the sale or extraction of minerals and other natural resources
 - Taxes on certain goods as they reach a given state of production or are moved from one location to another
- And
- Taxes on gross production margins

Taxes that are simply collected by the entity from one third party (generally a customer or employee) on behalf of another third party (generally local or national government) are not 'income taxes' for the purposes of Section 29. This view is supported by the requirement of Section 23 *Revenue from Contracts with Customers* that the transaction price excludes amounts collected on behalf of third parties for example some sales taxes, [FRS 102.23.41], (and therefore, by implication, are not an expense of the entity either).

In cases where taxes as noted above are a liability of the entity, they may often have some characteristics both of production or sales taxes (in that they are payable at a particular stage in the production or extraction process and may well be allowed as an expense in arriving at the tax on net profits) and of income taxes (in that they may be determined after deduction of certain allowable expenditure). This can make the classification of such taxes (as income taxes or not) difficult. In this regard, the IFRS Interpretation Committee (IFRS IC) made certain observations that is, in the context of Section 29, described below.

²³⁶ FRS 102 Overview Paper – Tax Implications, H M Customs & Excise, updated 14 October 2016.

Frequently asked questions

Question 3-1: Which taxes are in the scope of Section 29?

The definition of 'income tax' in Section 29 (i.e., taxes that are based on taxable profit) implies that:

- Not all taxes are within the scope of Section 29.
But
- Because taxable profit is not the same as accounting profit, taxes do not need to be based on a figure that is exactly accounting profit to be within the scope of Section 29.

The latter point is also implied by the requirement in Section 29 to disclose a reconciliation of the tax expense (income) included in profit or loss and the profit or loss before tax on ordinary activities multiplied by the applicable rate - see 12 below. [FRS 102.29.27(b)]. Further, the term 'taxable profit' implies a notion of a net rather than gross amount, and that any taxes that are not in the scope of Section 29 are in likely to be in scope of Section 21 *Provisions and Contingencies* (see Chapter 24).

The observations noted above reinforce the difficulty of formulating a single view as to the treatment of taxes. The appropriate treatment will need to be addressed on a case-by-case basis depending on the particular terms of the tax concerned and the entity's own circumstances.

How we see it

Where a tax is levied on multiple components of net income, we believe it is more likely that the tax must be viewed as substantially a tax on income and therefore subject to Section 29.

Even where such taxes are not income taxes, if they are deductible against current or future income taxes, they may nevertheless give rise to tax assets which fall within the scope of Section 29.

3.1.1 Levies

A number of jurisdictions, including the UK, charge levies in relation to certain activities or on certain types of entity, particularly those in the financial services sector. In many cases the levies are expressed as a percentage of a measure of revenue or net assets, or some component(s) of revenue or net assets, at a particular date. Such levies are not income taxes and must be accounted for in accordance with Section 21 (see Chapter 24).

3.1.2 Tonnage tax

In the UK, entities that operate qualifying vessels that are 'strategically and commercially managed in the UK', can take advantage of the tonnage tax regime. The tonnage tax regime differs from the main corporation tax system in a number of key respects, the most significant from an accounting point of view being that an entity in the tonnage tax regime is not assessed to tax on the basis of its reported profits from qualifying activities. Instead, its corporate tax liability is determined by reference to the qualifying tonnage of qualifying vessels. For this reason, it is not an income tax as defined in Section 29. Another feature of the tonnage tax regime is that a qualifying entity does not receive capital allowances for the cost of its ships.

The accounting implications for vessels taken into the tonnage tax regime are discussed at 6.3.1 below.

3.1.3 Hybrid taxes (including minimum taxes)

The term 'hybrid taxes' is applied to arrangements in which:

- (a) An entity's liability to tax is assessed on both a measure of its taxable profits and a non-profit measure.
Or

- (b) The amount of tax to be paid in any period depends on the interaction between those two measures.

Examples of non-profit measures would include amounts based on particular types of revenue, on components of the statement of financial position, such as total equity, net assets or net debt, or to a non-financial measure such as physical output. Tax authorities might require entities to use the alternative measures to determine a minimum amount of tax to be paid in any period. Hybrid taxes do not include arrangements where an entity can elect to operate within one of a number of alternative tax regimes, for example to choose to be assessed on the basis of its taxable profits, or to have its profits exempt from tax and instead be assessed according to a non-profit measure such as revenue, net assets or physical output.

In this case there is no interaction between taxable profits and the non-profit measure in determining the actual tax to be paid in a given period.

Such 'hybrid taxes' (where the tax to be paid depends on the interaction of a profit and a non-profit measure) raise the issue of how they must be accounted for. Does Section 29 apply simply because one of the measures referred to in the tax legislation is based on taxable profits, or must a determination be made based on an assessment of which measure is most likely to influence the actual amount of tax to be incurred by the entity? Alternatively, should the tax charge be bifurcated between the component based on profits and the component based on another measure, with the former accounted as an income tax and the other as a levy under Section 21? This section considers one such arrangement seen in practice as described at 3.1.4 below.

3.1.4 Tax is based on revenues, unless a profit measure gives a lower result

As businesses have increasingly operated across international boundaries, national governments have sought to evolve their tax systems to ensure that the profit of a multinational group is taxed in the countries in which it creates value. As a result, individual governments are introducing taxes based primarily on measures of revenue earned in their jurisdiction by these businesses such as the Digital Services Tax (DST) introduced in the UK. For example, the tax might be levied on revenues above a certain threshold, or an entity might be permitted to elect to be taxed on its profits from that activity if it has a presence in the jurisdiction and it can show that a measure based on profits would give rise to a lower liability.

This is shown in the following Illustration.

Illustration 3-1: Tax based on revenues, unless a profit measure gives a lower result

A government introduces a tax on the revenues of certain digital businesses. A charge of 2% is levied on the digital revenues earned from customers in that country above an annual threshold. Where the local revenues received in connection with digital services activities exceed the annual threshold, the entity must submit DST returns to the local tax authority and will have to pay DST. No tax is payable for revenues up to the annual threshold.

Because the entities subject to this tax often have little or no physical presence in the country in question, DST normally applies at the rate of 2% on local digital services revenues above the annual threshold. However, an entity can elect to calculate its tax liability using an alternative basis. The alternative basis gives rise to a lower DST liability for entities making a loss or operating at a low margin on their local digital services activity.

This election is voluntary, applies for one year, and entities must make or renew the election at the time they submit their tax return for the period they wish to calculate their DST liability using the alternative method. Under the alternative basis, the DST is calculated by reference to the operating margin of the local digital services activity at a rate of 80% of that margin. In cases where the local digital services activity is loss making and the alternative basis is being applied, no DST needs to be paid on revenues attributable to that activity, but at the same time no relief is given in respect of those losses. That is, the DST is set at zero for the current period, but no losses are carried forward or back into other accounting periods.

How should entities account for this tax?

How we see it

In these circumstances we believe that this type of arrangement must be treated wholly as a non-income tax outside the scope of Section 29. In our view, it would not be appropriate to account for the tax as a non-income tax in those years when tax is paid on digital services revenues, and as an income tax when an election is taken to apply the alternative basis, using a measure of profit. It would also be inappropriate to try to bifurcate the tax between a component based on revenue and a component based on the alternative profit measure regardless of whether the election is taken. Such bifurcation is only effective where the tax liability is the higher of one measure or another.

The nature of the arrangement in the Illustration 3-1 above, in both design and operation, is a revenue-based tax that would fall outside the scope of Section 29. The tax is designed to achieve a higher level of tax for entities that do not have a physical presence in the country in which revenues are generated; and in most cases it is this basis that will determine the amount of tax payable. The election to apply the alternative basis represents a relief for those particular entities with a low operating margin in the local jurisdiction (for example because they have a physical presence, employ staff or have other activities that would attract a liability to local taxes). In the Illustration above, only if the entity's operating margin were below 2.5% ($2\% \div 0.8$) would the alternative basis give rise to a lower charge than the levy on revenue.

Governments are also co-operating internationally to establish ways to ensure that the profits of multinational groups are taxed appropriately. An example of such international co-operation and the accounting challenges it presents is discussed in 3.7 below.

3.2 Withholding and similar taxes

As discussed at 3.1 above, Section 29 includes in its scope those taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity. [FRS 102 Appendix I]. FRS 102 also sets specific requirements in relation to withholding taxes on income from entities other than a subsidiary, associate or joint venture.

The rationale for the treatment as income taxes of taxes payable by a subsidiary, associate or joint arrangement on distributions to the investor is discussed further at 8.1 below. Essentially, however, the reason for considering withholding taxes within the scope of income tax accounting derives from the accounting treatment of the investments themselves. The accounting treatment for such investments - whether by consolidation or the equity method - results in the investor recognising profit that may be taxed twice: once as it is earned by the investee entity concerned, and again as that entity distributes the profit as dividends to the investor. Section 29 ensures that the financial statements reflect both tax consequences consistently.

Accounting for income tax withheld on outgoing and incoming dividends is discussed in 8.1 below.

3.2.1 Withholding taxes on royalty payments

Governments often require deduction of tax at source on payments other than dividends, particularly when such payments are made to entities outside the home country of the paying entity, for example in respect of royalties. As discussed at 3.1 above, the determination of whether such withholding taxes are in scope of Section 29 requires the entity to consider whether the taxes are based on a measure of taxable profits.

Illustration 3-2: Withholding taxes on royalty payments

Entity A is domiciled in Country X. Entity A develops and sells software licences to customers in the telecommunications industry. Entity A receives revenue in the form of royalties from licences. The royalties are determined as a fixed percentage of revenue. Entity A has a customer in Country Z from which it receives royalties. The royalties are paid by the customer net of withholding taxes determined as per regulations applicable in Country Z.

In Country Z, a tax is charged on entities that do not have a sufficient presence in Country Z to be required to register a business (branch) in Country Z and to be liable to pay local income tax.

Taxable profit for Entity A's income tax return in its home country (Country X) includes the gross amount of the royalty income (i.e., the amount invoiced by Entity A to the customer in Country Z). The withholding tax on royalties that is paid in Country Z is, however, deductible against income taxes payable in Country X.

How should Entity A account for the tax withheld by the customer in Country Z?

How we see it

In fact patterns similar to that above, the withholding tax is normally treated as a non-income tax outside the scope of Section 29 as the tax is based on the royalty amount invoiced to the customer rather than based on taxable profits. Consequently, the withholding tax is accounted for as an operating expense.

However, in limited circumstances there may be a combination of other factors that are sufficiently distinctive to result in a judgement that such a withholding tax is an income tax within the scope of Section 29, in a particular jurisdiction. Such factors may include, for example, the fact that Entity A receives a foreign tax credit for tax paid in Country Z that reduces its income tax liability in Country X and because the gross amount of royalty income is equal to the net profit earned by Entity A from this activity in Country Z.

Even if the withholding tax is determined not to be in scope of Section 29, it might give rise to timing differences in relation to Entity A's own tax return in its home jurisdiction, for example where the withholding tax incurred is not deductible until a later period. Such timing differences would be in scope of Section 29.

3.3 Investment tax credits

Investment tax credits are not defined in FRS 102, can take different forms and be subject to different terms. Sometimes a tax credit is given as a deductible expense in computing the entity's tax liability, and sometimes as a deduction from the tax liability, rather than as a deductible expense. In some cases, the value of the credit is chargeable to corporation tax and in others it is not. Entitlement to investment tax credits can be determined in a variety of ways. Some investment tax credits may relate to direct investment in property, plant and equipment. Other entities may receive investment tax credits relating to research and development or other specific activities. Some credits may be realisable only through a reduction in current or future corporation tax payable, while others may be settled directly in cash if the entity is loss-making or otherwise does not have sufficient corporation tax payable to offset the credit within a certain period. Access to the credit may be limited according to the total of all taxes paid including employment taxes (such as PAYE and NIC) and VAT, in addition to corporation tax. There may be other conditions associated with receiving the investment tax credit, for example with respect to the conduct and continuing activities of the entity, and the credit may become repayable if ongoing conditions are not met.

Section 24 *Government Grants* excludes from its scope government assistance that is either provided by way of a reduction in taxable income, or determined or limited according to an entity's income tax liability, citing investment tax credits as an example and then stating that taxes based on income are required to be accounted for under Section 29. [FRS 102.24.3]. This implies that those investment tax credits that are excluded from the scope of Section 24 must be accounted for as income tax. However, if government assistance is described as an investment tax credit, but it is neither determined or limited by the entity's income tax liability nor provided in the form of an income tax deduction, such assistance must be accounted for as a government grant under Section 24 (see Chapter 26 at 3.1.5).

This raises the question as to how an entity should assess whether a particular investment tax credit gives rise to assistance in the form of benefits that are available in determining taxable profit or loss, or are determined or limited on the basis of income tax liability and, therefore, whether Section 24 or Section 29 must be applied. [FRS 102.24.3].

How we see it

In our view, the determination of which section to apply to a particular investment tax credit (Section 29 or Section 24) is a matter of judgement and all facts and circumstances relating to the specific incentive need to be considered in assessing the substance of the arrangement.

The following factors will often be relevant, but this list of factors must not be considered exhaustive, and entities may identify other factors which they consider to be more important than those listed below.

Feature of credit	Indicator of Section 29 treatment (income tax)	Indicator of Section 24 treatment (grant)
Method of realisation	Only available as a reduction in income taxes payable (i.e., benefit is forfeited if there are insufficient income taxes payable). However, the longer the period allowed for carrying forward unused credits, the less relevant this indicator becomes.	Directly settled in cash where there are insufficient taxable profits to allow credit to be fully offset, or available for set off against payroll taxes, VAT or amounts owed to government other than income taxes payable.
Number of conditions not related to tax position (e.g. minimum employment, ongoing use of purchased assets)	None or few.	Many.
Restrictions as to nature of expenditure required to receive the grant	Broad criteria encompassing many different types of qualifying expenditure.	Highly specific.
Tax status of grant income	Not taxable.	Taxable.

Illustration 3-3 below describes accounting analysis of a scenario wherein eligible entities are entitled to a type of investment tax credit. The illustration below might be helpful in assessing other investment tax credit schemes governments may implement from time to time.

Illustration 3-3: Research and development expenditure credit (RDEC)

Eligible entities in certain jurisdictions might be entitled to an investment tax credit known as the RDEC (sometimes referred to colloquially as the 'above-the-line' tax credit). Features of the tax credit relevant to an accounting analysis might include the following:

- Entities are generally entitled to a gross credit of 10% of qualifying R&D expenditure (with some entities entitled to a higher rate).
- The gross credit is treated as taxable income.
- The available credit is first set against the entity's corporation tax liability for the current period.
- The amount of any remaining credit (net of corporation tax) is 'capped' by reference to employment expenditure (for example measured by reference to the entity's PAYE and NIC liabilities).
- Any remaining credit (net of corporation tax and the employment costs cap) can be carried back or carried forward to reduce the entity's corporation tax liability for certain earlier and later periods, or ceded by way of group relief.
- Any unrecovered excess can be offset against the entity's other outstanding tax liabilities (e.g. PAYE and NIC).

And

- Any amount not recovered in any of the ways listed above is recoverable in cash from the tax authority.

Should the RDEC credit be treated as a government grant or an element of income tax?

How we see it

In our view, analysis of these features by reference to the criteria set out above leads us to conclude that the RDEC credit is more appropriately regarded as a government grant. In particular, the benefits of the tax credit are capable of being realised in cash where there is insufficient corporation tax capacity; the tax credit relates to specific qualifying expenditure; and the grant income is determined on a pre-tax basis and is itself taxable.

Such an analysis requires a thorough understanding of the rules applying to the particular relief. Other seemingly similar reliefs must be treated as income taxes under Section 29 if, for example, the relief is not itself taxable; the relief could only be recovered by offset against other liabilities to corporation tax; or, where there is a cash payment alternative, the expected cash inflow approximates more closely to the value of the tax benefit rather than to the value of the expenditure incurred.

Where a tax credit is determined to be in the nature of an income tax, an entity will need to determine whether the related benefit is more appropriately accounted for as a discrete tax asset akin to a tax loss, or as a deduction in respect of a specific asset and therefore akin to accelerated capital allowances (see 6.3 below).

How we see it

In most cases, in our view, it will generally be more appropriate to treat a tax credit that is accounted for as income tax as a discrete tax asset akin to a tax loss. As a result, the recoverability of any amounts that are unused and available for carry forward to future years would be assessed in accordance with the criteria discussed at 6.2 below.

3.4 Interest and penalties

UK tax law (and that of other jurisdictions) provides for interest and/or penalties to be paid on late payments of tax. This raises the question of whether such penalties fall within the scope of Section 29. The answer can have consequences not only for the presentation of interest and penalties in the income statement; but also for the timing of recognition and on the measurement of amounts recognised. If such penalties and interest fall within the scope of Section 29, they are presented as part of tax expense and measured in accordance with the requirements of this section. Where uncertainty exists as to whether interest and penalties will be applied by the tax authorities, an entity must consider the effect of uncertain tax positions as discussed at 5.2 below. If interest and penalties do not fall within the scope of Section 29, they must be included in profit before tax, with recognition and measurement determined in accordance with other accounting requirements, most likely to be Section 21.

How we see it

In our view, in the absence of specific guidance in FRS 102 on recognition and measurement of interest and penalties on income tax, an entity may apply the hierarchy provided in Section 10 *Accounting Policies, Estimates and Errors* and accordingly, consider the guidance applied under IFRS.

In September 2017, the IFRS IC considered whether interest and penalties related to income taxes are in scope of IAS 12. The observations made by the IFRS IC in its discussion, that would be helpful to FRS 102 reporters, are described below:

- (a) The determination of whether Section 29 or Section 21 must be applied is not a simple accounting policy choice. Instead, the nature of the particular amount payable or receivable for interest and penalties, how it is calculated and whether this meets the definition of an income tax are relevant to making an appropriate judgement. If Section 29 is determined to apply, then the entity recognises and measures any current tax and deferred tax on that basis. If an entity does not apply Section 29 to interest and penalties, then it applies Section 21 to those amounts.
- (b) Paragraph 26 of Section 29 requires an entity to disclose the major components of tax expense (income) and paragraph 14 of Section 21 require a reconciliation of the carrying amount of a class of provisions at the beginning and end of the reporting period as well as various other pieces of information. Accordingly, regardless of whether an entity applies Section 29 or Section 21 when accounting for interest and penalties related to income taxes, the entity would disclose information about that interest and those penalties if it is material.

And

- (c) Paragraph 6 of Section 8 *Notes to the Financial Statements* requires disclosure of the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

How we see it

In our view, the judgement of whether Section 29 or Section 21 applies must be determined on a tax-by-tax basis. The observations made by the IFRS IC as described above, are clear that this is not an accounting policy choice whereby an entity has 'free rein' to choose the section that is applied. Instead, an entity would make a determination of the nature of the particular interest and penalties in question based on its understanding of the operation of the specific tax law and the way in which the charge or credit is calculated.

The following factors might also be relevant in determining whether an item is in scope of Section 29, although we believe that no particular order must be applied and that no single factor is conclusive:

- Whether there is a predominant local consensus in evidence or specific guidance issued locally by regulators as to the nature of interest and penalties applied to a specific tax in the relevant tax jurisdiction, leading to a predominant practice of accounting under FRS 102 for these as income tax or not. Where a treatment may not otherwise be clear, entities often refer to local practice in determining whether a tax is an income tax; whether legislation has been substantively enacted; and in the treatment of investment tax credits. Determining whether interest and penalties are part of income tax requires careful consideration of the local legislation and hence entities would usually defer to local consensus where it exists. Since the judgement depends on the circumstances of the tax laws in a particular country, it must be accepted that an international group could encounter different conclusions in relation to interest and penalties arising in different jurisdictions. In particular, we would normally not expect a conclusion based on local consensus to be reversed in a subsequent consolidation by an overseas parent.

- Whether the amounts are clearly identifiable as 'interest' or as 'penalty' making it more appropriate to not account for these as income tax. Does the tax legislation have specific rules and requirements that allow an entity to identify the amounts that are to be regarded as 'interest' and as 'penalties'? That is, if an entity pays a single lump sum to settle existing tax positions, it would only identify interest and penalty components to the extent that communications from the tax authorities and/or tax legislation allow the entity to identify such components. An entity would not bifurcate such a single payment to identify notional interest and penalty amounts as this would be too judgemental, but rather account for the whole as an income tax.
- The degree to which an entity believes it is certain that interest and penalties will be applied. A certain payment of interest for example may indicate it being a financing expense rather than an income tax. In some cases, an entity might decide to wait until a tax enquiry is concluded before settling an expected obligation. In others, the entity could be confident of recovering an overpayment of tax, with interest added to the expected refund. In these circumstances, it could be argued that interest and penalties result from an entity's conscious decision not to pay taxes due earlier or to secure the later receipt of interest. Hence, those interest and penalties might be regarded as not directly related to taxable income, but rather the result of the entity's financing decisions.
- Whether the amount is based on net taxable profit, indicating it is an income tax. As noted in 3.1 above, Section 29 only applies to income taxes, which are based on 'taxable profits'. However, in many jurisdictions income tax legislation contains elements that, when looked at in isolation, are not strictly based on a notion of taxable profits. Examples include tax exempt amounts, deductibility caps and super-deductions for certain eligible expenditure. As a practical matter it is normally not considered helpful or necessary to account for such elements as a separate unit of account, unless not doing so would significantly misrepresent the underlying substance of the arrangements.
- Whether the interest rate applied by the tax authorities reflects current market assessments of the time value of money, indicating it being a financing expense rather than income tax. If the applied rate clearly reflects the time value of money, it must be treated as interest. If the rate is largely punitive, the interest must be considered together with penalties. However, it would not be sensible to attempt to identify a notional time value component as this would be too judgemental.

Where the amounts involved are material, it will be appropriate for the entity to consider whether the judgements made and the amounts involved must be disclosed in accordance with the requirements of Section 8 (see Chapter 6 at section 7.3).

3.5 Effectively tax-free entities

Certain classes of entity (for example, in the UK, pension funds and certain partnerships) are exempt from income tax, and accordingly have no transactions within the scope of Section 29.

However, a more typical, and more complex, situation is that tax legislation has the effect that certain classes of entities, whilst not formally designated as 'tax-free' in law, are nevertheless exempt from tax provided that they meet certain conditions that, in practice, they are almost certain to meet. Examples in the UK are certain investment vehicles that pay no tax, provided that they distribute all, or a minimum percentage, of their earnings to investors.

Accounting for the tax affairs of such entities raises a number of challenges, as discussed further at 7.5 below.

3.6 Discontinued operations – interaction with Section 5

Section 5 *Statement of Comprehensive Income and Income Statement* requires the post-tax results of discontinued operations to be shown separately on the face of the statement of comprehensive income (and any separate income statement presenting the components of profit or loss). This is discussed further in Chapter 6.

The definitions of income tax, tax expense and taxable profit in Section 29 (see Appendix A) do not distinguish between the results of continuing and discontinued operations, or the tax on those results. Thus, Section 29 applies not only to the tax income or expense on continuing operations, but also to any tax income or expense relating to the results of discontinued operations.

3.7 International tax reform – Pillar Two model rules

The Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) addresses the tax challenges arising from the digitalisation of the global economy. To restore confidence in the international tax system and with the aim that profits are taxed where economic activities take place and value is created, the Inclusive Framework on BEPS proposes two “pillars”:

- Pillar One applies to multinational enterprises (MNEs) with global turnover above EUR20 billion and profitability (i.e., profit before tax/revenue) above 10%.
- Pillar Two applies to MNEs with consolidated revenue in excess of EUR750 million.

The Pillar Two Global anti-Base Erosion rules (GloBE Rules or Pillar Two model Rules) represent the first substantial overhaul of the international tax rules in almost a century. The GloBE Rules introduce four new taxing mechanisms under which MNEs would pay a minimum level of tax (Minimum Tax):

- The Subject to Tax Rule is a tax treaty-based rule that generally proposes a Minimum Tax on certain cross-border intercompany transactions that otherwise are not subject to a minimum level of tax.
- The Income Inclusion Rule (IIR).
- The Under Taxed Payments Rule (UTPR).
- The Qualified Domestic Minimum Top-up Tax (QDMT).

The new taxing mechanisms can impose a Minimum Tax on the income arising in each jurisdiction in which an MNE operates. The IIR, UTPR and QDMT do so by imposing a Top-up Tax in a jurisdiction whenever the effective tax rate (ETR), determined on a jurisdictional basis under the GloBE Rules, is below a 15% minimum rate (Minimum Rate). The GloBE Rules set out the mechanics for determining which entity (or entities) in an MNE Group (i.e., a group in which the ultimate parent entity has, directly or indirectly, at least one foreign subsidiary or a permanent establishment) would apply the IIR, the UTPR, and/or the QDMT, and the portion of Minimum Tax that is charged to each relevant entity. While the framework for the GloBE Rules is global, the GloBE Rules are being implemented through legislation enacted in jurisdictions that adopt the rules.

The GloBE Rules raise a number of accounting questions, in particular, whether the Minimum Tax is an income tax within the scope of Section 29 and, if so, when and how entities must account for the new tax.

The GloBE Rules are complex and contain complicated terminology that is not discussed in detail in this publication. The OECD has published GloBE model Rules, GloBE model Rules Commentary, and GloBE model Rules Examples, which can be found on their website.²³⁷ In addition, the OECD has published a summary, fact sheets, frequently asked questions, and press releases that provide additional information on the GloBE Rules. EY has published an executive summary and discussion of GloBE model Rules, Commentary and Examples, which provide helpful context and further explanation of the GloBE Rules.²³⁸ There remain numerous areas of uncertainty in the application of the GloBE Rules that require additional interpretive guidance.

3.7.1 The GloBE Rules

The OECD notes that “The GloBE Rules apply a system of Top-up Taxes - that is, an IIR and a UTPR - that brings the total amount of taxes paid on an MNE’s Excess Profit in a jurisdiction up to the Minimum Rate. This Top-up Tax does not operate as a typical direct tax on income of an Entity. Rather it applies to the Excess Profits calculated on a jurisdictional basis and only applies to the extent those profits are subject to tax in a given year below the Minimum Rate. Rather than a typical direct tax on income, the tax imposed under the GloBE Rules is closer in design to an international alternative minimum tax, that uses standardised base and tax calculation mechanics to identify pools of low-taxed income within an MNE Group and imposes a co-ordinated tax charge that brings the Group’s ETR on that income in each jurisdiction up to the Minimum Rate.”²³⁹

²³⁷ OECD website, www.oecd.org, (accessed on 30 September 2022).

²³⁸ [Tax Alert](#), *OECD releases Commentary and illustrative examples on Pillar Two Model Rules*, EY Global, 21 March 2022.

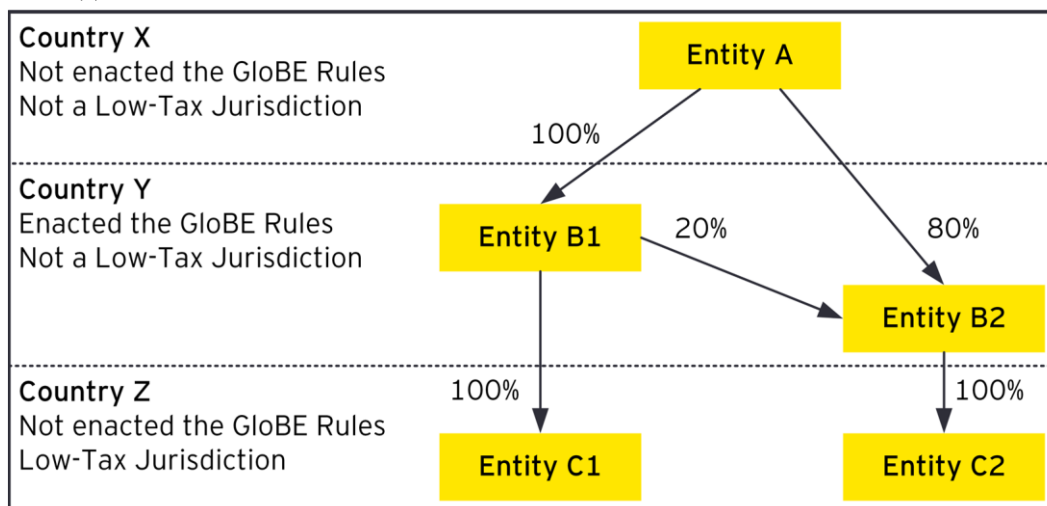
²³⁹ [OECD \(2022\)](#), *Tax Challenges Arising from the Digitalisation of the Economy - Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris, page 8.

3.7.1.A Applying five step process to the GloBE Rules

At the simplest level, the GloBE Rules impose a Top-up Tax that is calculated and applied at a jurisdictional level involving five steps: 1) identify MNE Groups in scope of the GloBE Rules; 2) determine GloBE income or loss for each constituent entity; 3) determine adjusted covered taxes; 4) compute GloBE ETR and Top-up Tax; and 5) determine the entities liable to pay taxes under the IIR, UTPR and/or QDMT. These elements are shown in Illustration 3-4 below.

Illustration 3-4: Application of GloBE Rules

The diagram below sets out the holding structure and location of the members of the ABC Group and illustrates the application of GloBE Rules.



Entities A, B1 and B2 have a GloBE ETR above the 15% Minimum Rate, but Entity C1 and Entity C2 are located in a low-tax jurisdiction with a GloBE ETR below 15%. Only Country Y has enacted an IIR.

Step 1: Identify MNE groups in scope of the GloBE Rules

Entity A, located in Country X, is the ultimate parent entity (UPE) of the consolidated group (ABC Group). ABC Group has determined it is an MNE Group in scope of the GloBE Rules. Accordingly, ABC Group has identified its constituent entities and their locations according to the diagram above. As Countries X and Z have not enacted GloBE Rules, any Top-up Taxes due by the entities located in those jurisdictions will be payable by entities in Country Y to the tax authority in Country Y (see Step 5).

Step 2: Determine GloBE income or loss for each constituent entity

ABC Group has determined GloBE income for each constituent entity in the MNE Group based on the group financial accounting net income of each constituent entity adjusted to the GloBE tax base. Only the results for C1 and C2 are given in this example, as they operate in a low-tax jurisdiction. Assume GloBE income is CU600 for C1 and CU1,800 for C2.

Step 3: Determine adjusted covered taxes

ABC Group has determined adjusted covered taxes for each constituent entity in the MNE Group based on group financial accounting tax expense/benefit adjusted to the GloBE covered taxes. Assume adjusted covered taxes are CU30 for Entity C1 and CU240 for Entity C2.

Step 4: Compute GloBE ETR and Top-up Tax

The GloBE ETR of the constituent entities located in Country Z is $(CU30 + CU240) \div (CU600 + CU1,800) = 11.25\%$ and thus, the Top-up Tax rate is 3.75% (i.e., minimum rate of 15% less GloBE ETR of 11.25%). The Excess Profit (amount of profit upon which the Top-up Tax is levied) is assumed to be equal to GloBE income, so the Top-up Tax is $(CU600 + CU1,800) \times 3.75\% = CU90$. The example assumes the Group does not have any substance-based income exclusion (i.e., exclusion of a fixed return for substantive activities within a jurisdiction from the application of the GloBE Rules).

Step 5: Determine the entities liable for payment of the Top-up Tax

In applying the IIR, a parent entity pays its allocable share of the Top-up Tax with respect to a low-taxed constituent entity. The IIR operates on a top-down approach, starting with the UPE. If the UPE is not located in a jurisdiction that has enacted an IIR, the highest parent entity in the ownership chain that is located in a jurisdiction that has enacted an IIR pays its allocable share of the Top-up Tax. (Note: an exception to the top-down approach applies in split-ownership situations).

In this example, only Country Y has enacted an IIR and thus, the intermediate parent Entities B1 and B2 are required to pay any Top-up Taxes. Entity B1 is liable for 100% of any Top-up Tax attributable to its wholly-owned subsidiary C1 and 20% of the Top-up Tax for C2, as a result of its 20% indirect shareholding interest in C2. Entity B2 is liable for 100% of any Top-up Tax attributable to its wholly-owned subsidiary C2.

As Entity B2 is liable for 100% of any Top-up Tax of C2, Entity B1's allocable share (i.e., 20%) of C2's Top-up Tax due to its indirect interest in C2 via B2 would result in double-taxation. To avoid double taxation, Entity B1 reduces its Top-up Tax attributable to its indirect ownership in C2 that is paid by B2.

In summary, Entity B1 pays Top-up Tax of CU22.5, calculated as follows: Entity C1: CU22.5 (i.e., $3.75\% \times \text{CU}600$), plus Entity C2: CU13.5 (20% of $3.75\% \times \text{CU}1,800$), less CU13.5 paid by Entity B2. Entity B2 pays Top-up Tax of CU67.5, calculated as follows: Entity C2: CU67.5 (i.e., $3.75\% \times \text{CU}1,800$).

This simple example demonstrates the application of only an IIR. In practice, if a UTPR and QDMT are enacted with an IIR, an MNE Group would first calculate the Top-up Tax under QDMT, then apply the IIR to capture residual Top-up Tax not included in the QDMT, and finally apply the UTPR to capture residual Top-up Tax not included in the IIR.

3.7.2 Multinational Top-up Tax – undertaxed profits rule

The UK government introduced the Multinational Top-up Tax and Domestic Top-up Tax in Finance (No.2) Act 2023²⁴⁰. These taxes are the UK's adoption of the GloBE rules. There are two elements to the legislation:

- The multinational top-up tax (MTUT)
- And

- The domestic top-up tax (DTT)

and both apply to large MNEs for accounting periods beginning on or after 31 December 2023.

This measure extends those taxes to give effect to the undertaxed profits rule (UTPR). The UTPR is effective for accounting periods beginning on or after 31 December 2024.

3.7.3 Accounting for Pillar Two income tax

Stakeholders had raised concerns regarding potential implications for income tax accounting resulting from the implementation of the Pillar Two model rules. To address those concerns, in July 2023, the FRC amended FRS 102 by issuing *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and FRS 101 Reduced Disclosure Framework International tax reform - Pillar Two model rules*. The amendments are based on similar amendments made to IAS 12 in *International Tax Reform–Pillar Two Model Rules (Amendments to IAS 12)*. [FRS 102.BC.B29.21]. The Amendments introduced:

- A mandatory temporary exception to the accounting for deferred taxes arising from the implementation of the Pillar Two model rules. See 3.7.3.A and 3.7.3.B below.
- Disclosure requirements for affected entities to help users of the financial statements better understand an entity's exposure to Pillar Two income taxes arising from that legislation. See 3.7.3.C and 3.7.3.D below.
- An exemption for qualifying entities from certain disclosures. See 3.7.3.F below

3.7.3.A Mandatory exception from recognition and measurement of deferred taxes

The amendments clarify that income taxes as defined in Section 29 include income taxes arising from tax law that implements the Pillar Two model Rules published by the OECD, including tax law that implements qualified domestic minimum top-up taxes described in those rules. Such tax legislation, and the income taxes arising from it, are referred to as 'Pillar Two legislation' and 'Pillar Two income taxes', respectively.

Section 29 now includes an exception from recognising and disclosing deferred tax assets and liabilities related to Pillar Two income taxes. [FRS 102.29.2B]. Further, Section 29 also includes an exception from taking into account the effects of Pillar Two legislation when measuring deferred tax assets and liabilities. [FRS 102.29.12A]. Accordingly, an entity is not permitted to remeasure deferred taxes, recognised under domestic tax regimes applying Section 29, to reflect Pillar Two income taxes it expects to pay because the exception applies to deferred tax assets and liabilities related to such income taxes.

²⁴⁰ [Multinational Top-up Tax – undertaxed profits rule - GOV.UK](#)

3.7.3.B Pillar Two taxes and the scope of Section 29

FRS 102 does not provide specific clarifications about when a Pillar Two top-up tax is considered to be an income tax in the scope of Section 29, nor to require entities to treat all top-up taxes as if they were income taxes. An entity is, therefore, required to apply judgement in determining which top-up taxes it considers to be income taxes in the entity's circumstances.

The scope of Section 29 is described in paragraph 29.2 and Appendix I defines income taxes. Considering the scope of Section 29 and definition of income taxes, Pillar Two top-up tax is considered as an income tax and, therefore, within the scope of Section 29 in the consolidated financial statements of the ultimate parent entity of a group subject to the Pillar Two model rules. However, this would not necessarily hold true in the financial statements of intermediate parents and subsidiaries of an MNE group that is subject to the Pillar Two model rules. For example, when those subsidiaries pay top-up taxes under the UTPR mechanism in respect of a fellow subsidiary's profits and the top-up tax allocation is not necessarily in direct proportion to the intermediate parent's ownership interest in its investees, the top up tax might not be in scope of Section 29.

How we see it

We believe that intermediate parents and subsidiaries of an MNE group need to apply judgement in determining whether in a particular situation a top-up tax meets the definition of an income tax in Section 29 and, where appropriate, disclose those judgements in accordance with Section 8.

If an entity concludes that Pillar Two taxes are outside the scope of Section 29, it needs to consider disclosing information, applying Section 8, that is helpful to other users of the financial statements in understanding how such Pillar Two taxes have been accounted for.

3.7.3.C Disclosure of the entity in scope of Pillar Two legislation

Where an entity is, or expects to be, within the scope of Pillar Two legislation, it shall disclose that fact. [FRS 102.29.28(a)].

3.7.3.D Disclosure of current tax

As discussed in 12.1 below, an entity is required to disclose separately major components of tax expense (income). Such components of tax expense (income) may include current tax expense (income) related to Pillar Two income taxes, as this helps users of financial statements understand the relative level of Pillar Two income taxes. [FRS 102.29.26(g)].

3.7.3.E Disclosure in periods after (substantive) enactment but before the legislation is effective

Although the requirements described in this section are not relevant to MNEs in the UK as the Pillar Two legislation is already effective, for MNEs in jurisdictions where the legislation is (substantively) enacted but not yet effective, FRS 102 requires disclosure of known or reasonably estimable information that helps users of financial statements understand the entity's exposure arising from Pillar Two income taxes. [FRS 102.29.28(b)]. To comply with these requirements, an entity is required to disclose qualitative and quantitative information about its exposure to Pillar Two income taxes at the end of the reporting period. [FRS 102.29.29]. For example, an entity could disclose the following information to meet these requirements:

- Qualitative information such as how an entity is affected by Pillar Two legislation and the main jurisdictions in which exposures to Pillar Two income taxes might exist.
- Quantitative information such as:
 - An indication of the proportion of an entity's profits that risks being subject to Pillar Two income taxes and the average effective tax rate applicable to those profits.
 - An indication of how the entity's overall effective tax rate would have changed if Pillar Two legislation had been effective.

The above information does not need to reflect all the specific requirements of the legislation and could be provided in the form of an indicative range. Further, to the extent information is not known or reasonably estimable, an entity is instead required to disclose a statement to that effect and information about its progress in assessing its exposure. [FRS 102.29.29].

3.7.3.F Exemptions for qualifying entities

As part of introducing disclosure requirements related to Pillar Two legislation, exemption from the requirements in paragraphs 29.28(b) and 29.29, as discussed above, was introduced for qualifying entities, provided that equivalent disclosures are included in the consolidated financial statements in which the entity is included. [FRS 102.1.12]. This approach was considered by the FRC to provide a proportionate solution to users' information needs because top-up taxes are determined on a group basis and therefore users of financial statements will be able to obtain useful information about exposure to paying top-up tax from the consolidated financial statements of the group in which the entity is included. [FRS 102.BC.B1.7].

4 Value Added Tax ('VAT') and other similar sales taxes

FRS 102 requires turnover shown in profit or loss to exclude VAT and other similar taxes on taxable outputs, and VAT imputed under the flat rate²⁴¹ VAT scheme. Similarly, recoverable VAT and other similar recoverable sales taxes must be excluded from expenses. Irrecoverable VAT that can be allocated to fixed assets and to other items disclosed separately in the financial statements must be included in the cost of those items where it is practical to do so, and the effect is material. [FRS 102.29.20].

²⁴¹ The flat rate scheme provides for a simplified calculation of VAT payable by entities with VAT taxable turnover below a certain threshold. Customers are still charged the applicable rate of VAT. Entities do not reclaim input VAT but instead account for output VAT using a fixed percentage according to category of business.

5 Current tax

Current tax is the amount of income taxes payable (refundable) in respect of the taxable profit (tax loss) for the current period or a past reporting period. *[FRS 102 Appendix I]*.

An entity recognises a current tax liability for tax payable on taxable profits for the current and past periods. If the amount already paid for the current and past periods exceeds the tax payable for those periods, the excess must be recognised as a current tax asset. *[FRS 102.29.3]*. An entity must recognise a current tax asset relating to a tax loss that can be carried back to recover tax paid in a previous period. *[FRS 102.29.4]*. Tax losses that can be carried forward to future periods are reflected in deferred tax.

Current tax must be measured at the amount expected to be paid to or recovered from the tax authorities by reference to tax rates and laws that have been enacted or substantively enacted by the reporting date (see 5.1 below). *[FRS 102.29.5]*.

Current tax assets or liabilities must not be discounted. *[FRS 102.29.17]*.

5.1 Enacted or substantively enacted tax legislation

Extract from Section 29

29.5 An entity shall measure a current tax liability (asset) at the amount of tax it expects to pay (recover) using the tax rates and laws that have been enacted or substantively enacted by the reporting date.

Section 29 requires current tax to be measured using tax rates or laws enacted 'or substantively enacted' at the end of the reporting period. *[FRS 102.29.5]*. Section 29 gives no guidance as to how this requirement is to be interpreted in different jurisdictions. In most jurisdictions, however, a consensus has emerged as to the meaning of 'substantive enactment' for that jurisdiction. Nevertheless, apparently similar legislative processes in different jurisdictions may give rise to different treatments under Section 29. For example, in most jurisdictions, tax legislation requires the formal approval of the head of state in order to become law. However, in some jurisdictions, the head of state has real executive power (and could potentially not approve the legislation), whereas in others the head of state has a more ceremonial role (and cannot practically fail to approve the legislation).

The general principle tends to be that in those jurisdictions where the head of state has executive power, legislation is not substantively enacted until approved by the head of state. Where, however, the head of state's powers are more ceremonial, substantive enactment is generally regarded as occurring at the stage of the legislative process where no further amendment is possible.

How we see it

Substantive enactment is a legal process rather than a concept for the purposes of applying the requirements in Section 29. As such the substantive enactment of new tax legislation is specific to a jurisdiction, its legislative processes and traditions. The assessment for a particular new tax must be consistent with the assessment applied to other taxes in that jurisdiction. Accordingly, the determination of the stage of the legislative process that constitutes substantive enactment would not vary because of the complexity of the tax legislation in question. Further, although it might appear that the legislative process in one jurisdiction is similar to that of another, it is possible that the conclusion as to the stage of the process that constitutes substantive enactment is different.

5.1.1 UK

In the UK, legislation is enacted when it receives Royal Assent. For the purposes of FRS 102, tax rates are regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so.

A UK tax rate is regarded as having been substantively enacted if it is included in either:

- A Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent.
- Or
- A resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968. Such a resolution is used to collect taxes at a new rate before that rate has been enacted.

FRS 102 notes that, in practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system. [FRS 102 Appendix I].

Section 29 refers to 'tax rates *and laws*' [emphasis added] that have been enacted or substantively enacted, [FRS 102.29.5], whereas the definition of 'substantively enacted' in the Glossary in Appendix I to FRS 102 refers only to 'tax rates'. In our view, there is no intentional distinction, and the guidance in the glossary must be applied equally to determining whether tax laws or tax rates have been substantively enacted.

5.1.2 Republic of Ireland

FRS 102 provides that a Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dáil. [FRS 102 Appendix I].

5.1.3 Changes to tax rates and laws enacted before the reporting date

Current tax must be measured at the amount expected to be paid to or recovered from the tax authorities by reference to tax rates and laws that have been enacted, or substantively enacted, by the reporting date. [FRS 102.29.5]. Accordingly, the effects of changes in tax rates and laws on current tax balances are required to be recognised in the period in which the legislation is substantively enacted.

Where the effect of changes in the applicable tax rates compared to the previous accounting period are material, an explanation of those effects is required to be provided in the notes to the financial statements (see 11.1 below). [FRS 102.29.27(d)].

5.1.4 Changes to tax rates and laws enacted after the reporting date

The requirement for substantive enactment by the end of the reporting period is clear. Section 32 *Events after the End of the Reporting Period* identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. [FRS 102.32.11(h)]. For example, an entity with a reporting period ending on 31 December issuing its financial statements on 20 April the following year would measure its current tax assets and liabilities by reference to tax rates and laws enacted or substantively enacted as at 31 December even if these had changed significantly before 20 April and even if those changes had retrospective effect. However, in these circumstances the entity would have to disclose the nature of those changes and provide an estimate of the financial effect of those changes if the impact is expected to be significant (see 12.3 below). [FRS 102.32.10].

5.2 Uncertain tax treatments

The terms 'uncertain tax treatment' or 'uncertain tax position' refer to an item, the tax treatment of which is either unclear or is a matter of unresolved dispute between the reporting entity and the relevant tax authority. Uncertain tax treatments generally occur where there is an uncertainty as to the meaning of the law, or to the applicability of the law to a particular transaction, or both. For example, the tax legislation may allow the deduction of research and development expenditure, but there may be disagreement as to whether a specific item of expenditure falls within the definition of eligible research and development costs in the legislation. In some cases, it may not be clear how tax law applies to a particular transaction, if at all. In other situations, a tax return might have been submitted to the tax authorities, who are yet to opine on the treatment of certain transactions, or may even have indicated that they disagree with the entity's interpretation of tax law.

Estimating the outcome of an uncertain tax treatment is often one of the most complex and subjective areas in accounting for tax. Historically, however, Section 29 did not specifically address the measurement of uncertain tax treatments, which are therefore implicitly subject to the general requirement of the standard to measure current tax and deferred tax at the amount expected to be paid or recovered, [FRS 102.29.5], (see 5.1 above).

As part of the Periodic Review 2024, amendments were made to FRS 102 to explain how to account for uncertain tax treatments. The requirements are based on those in IFRIC 23 *Uncertainty over Income Tax Treatments*. [FRS 102.BC.B29.22]. However, the amendments do not include any of IFRIC 23's application guidance. Applying the hierarchy allowed in paragraphs 10.4 to 10.6, the narrative below considers the guidance in IFRIC 23 to explain the application of certain aspects of the new requirements.

In order to support entities that could only apply the new requirements with the use of hindsight, the amendment allows an entity to apply the new requirements with the cumulative effect of doing so recognised at the beginning of the reporting period in which the amendments are first applied.

[FRS 102.BC.B29.22]

5.2.1 Requirements introduced in the periodic review

The amendments clarify how to apply the recognition and measurement requirements of Section 29 when there is uncertainty over income tax treatments. The new requirements are applied after determining the relevant taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates for the entity.

As described in paragraph 5 of IFRIC 23, the amendments are useful in addressing the following issues:

- a) Whether an entity must consider uncertain tax treatments separately.
- b) The assumptions an entity must make about the examination of tax treatments by taxation authorities.
- c) How an entity must determine taxable profit (tax loss), unused tax losses, unused tax credits and tax rates.
- d) How an entity must consider changes in facts and circumstances.

The newly introduced requirements would apply to interest and penalties where an entity concludes interest and penalties are in scope of Section 29. See 3.5 above for guidance on accounting for interest and penalties.

In determining 'uncertainty', the entity only needs to consider whether a particular tax treatment is probable, rather than highly likely or certain, to be accepted by the taxation authorities. As explained in 5.2.4 below, if the entity determines it is probable that a tax treatment will be accepted, then it must measure its income taxes on that basis. Only if the entity believes the likelihood of acceptance is not probable, would there be an uncertain tax treatment to be addressed by the new requirement reproduced above.

5.2.1.A Business combinations

Section 19 *Business Combinations and Goodwill* clarifies that an acquirer applies Section 29 to recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination. [FRS 102.19.15A]. However, Section 19 does not specifically address recognition and measurement of current tax assets and liabilities acquired in a business combination.

How we see it

Section 19 suggests that current tax assets and liabilities acquired in a business combination must be measured at fair value which differs from the subsequent measurement required by paragraph 29.17B.

Entities must consider whether to apply Section 19's fair value requirements to current tax assets and liabilities recognised in a business combination (which may result in possible Day 2 gains and losses when they are remeasured under Section 29) or the uncertain tax treatment requirements in Section 29.

We believe either approach is acceptable, provided that it is applied consistently (see also Chapter 22 at section 3.7.2.A).

5.2.2 Whether to consider uncertain tax treatments separately (unit of account)

Extract from Section 29

29.17A It may be unclear how tax law applies to a particular transaction or circumstance. An entity shall determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments based on which approach better predicts the resolution of the uncertainty.

A key input to any estimation process is to determine the unit of account. In practice this might be an entire tax computation, individual uncertain treatments, or a group of related uncertain treatments (e.g., all positions in a particular tax jurisdiction, or all positions of a similar nature or relating to the same interpretation of tax legislation).

The amendment requires that entities determine whether to consider tax uncertainties separately or grouped together on the basis of which approach provides a better prediction of the resolution of the uncertainty. [FRS 102.29.17A]. For example, if the entity prepares and supports tax treatments as a group or if the entity expects the taxation authority to assess items collectively during a tax examination, it would be appropriate to consider those uncertain tax treatments together. This implies that material tax uncertainties would be considered separately if there was no such inter-dependency as to the expected outcome.

5.2.3 Assumptions about the examination of tax treatments ('detection risk')

'Detection risk' is a term commonly used to refer to the likelihood that the taxation authority examines the amounts reported to it by the entity. The requirements clarify that in cases where the taxation authority has a right to examine amounts reported to it, the entity must assume that it will do so; and that when it performs those examinations, the taxation authority will have full knowledge of all related information. [FRS 102.29.17B]. This position is consistent with the requirement in paragraph 29.5 to measure the amount of a tax liability or asset based on the tax laws that have been enacted or substantively enacted at the reporting date. [FRS 102.29.5].

5.2.4 Determining the effect of an uncertain tax treatment or group of tax treatments

The amendments have established the following requirements regarding measurement of the effect of an uncertain tax treatments or group of tax treatments. [FRS 102.29.17B].

Extract from Section 29

- 29.17B An entity shall assume that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information when making those examinations. If an entity concludes:
- (a) it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.
 - (b) it is not probable that the taxation authority will accept an uncertain tax treatment, the entity shall reflect the effect of uncertainty in determining the related taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates by using either of the following methods, depending on which better predicts the resolution of the uncertainty:
 - (i) the most likely amount - the single most likely amount in a range of possible outcomes.
 - (ii) the expected value - the sum of the probability-weighted amounts in a range of possible outcomes.

How we see it

FRS 102 defines probable as 'more likely than not'. If the entity concludes that it is probable that the taxation authority will accept the tax treatment used or planned to be used in its tax filings, the entity determines its tax position on that basis. This is consistent with the requirement that current tax is measured at the amount expected to be paid or recovered from the taxation authorities, and that deferred tax is measured using the rates and tax laws expected to apply to the reversal of the timing difference. This means that all likelihoods beyond the probable threshold are treated in the same way. That is, any likelihood of acceptance by the taxation authority beyond 50% is treated in the same way as 100% likelihood of acceptance. Therefore, it is not necessary to distinguish between outcomes that are probable, highly likely or virtually certain.

If the entity concludes that acceptance of the uncertain tax treatment by the taxation authorities is not probable, it must apply one of the following two methods for reflecting the effect of uncertainty in its estimate of the amount it expects to pay or recover from the tax authorities: [FRS 102.29.17B].

- (a) The most likely amount - the single most likely amount in a range of possible outcomes.

Or

- (b) The expected value - the sum of the probability-weighted amounts in a range of possible outcomes.

The entity is required to use the method that it expects to better predict the resolution of the uncertainty. The most likely amount may be an appropriate method if the outcomes are binary (for example where an item might be deductible or disallowed for tax purposes) or are concentrated on one value (that is clearly more likely than the alternative outcomes). The expected value method may be more appropriate if possible outcomes are widely dispersed with low individual probabilities (where a number of individual but related uncertainties have been combined into a single unit of account).

Two illustrations that are based on the examples in IFRIC 23 are presented below. These examples portray hypothetical situations illustrating how an entity might apply some of the requirements in IFRIC 23 based on the limited facts presented as follows:

- When multiple tax treatments are considered together and when the expected value is used to reflect the effect of uncertainty (Illustration 5-1 below).
- When current and deferred tax is recognised and measured based on the most likely amount for a tax base that reflects the effect of uncertainty (Illustration 5-2 below).

In both of these examples, the entities have assumed that the taxation authority will examine the amounts reported to it and have full knowledge of all related information, as discussed in section 5.2.3 above.

Illustration 5-1: Multiple treatments, expected value method

Entity A's tax filing included a number of deductions related to transfer pricing. The taxation authority in its jurisdiction may challenge those tax treatments. Entity A notes that the taxation authority's decision on one transfer pricing matter would affect, or be affected by, the other transfer pricing matters. Entity A determines that the tax treatments must be considered together, because this better predicts the resolution of the uncertainty. At the end of the reporting period, Entity A concludes, on the basis of an evaluation of all available evidence, that it is not probable that the taxation authority will accept all of the tax treatments.

Entity A estimates the probabilities of what would be added to its taxable profits (in GBP), as follows:

	Estimated additional amount	Probability	Expected value
Outcome 1	-	5%	-
Outcome 2	200	5%	10
Outcome 3	400	20%	80
Outcome 4	600	20%	120
Outcome 5	800	30%	240
Outcome 6	1,000	20%	200
		100%	650

Outcome 5 is the most likely outcome, with a probability of 30%. However, entity A observes that the possible outcomes are neither binary nor concentrated in one value. Entity A therefore concludes that the expected value (£650) better predicts the resolution of the uncertainty. Accordingly, Entity A adds £650 to its estimate of the taxable profit, in addition to the amount reported in its tax filing.

Illustration 5-2: Treatment relates to deferred tax asset, most likely amount is applied

Entity B acquired a separately identifiable intangible asset for £100 that has an estimated useful life of 10 years and is, therefore, amortised over a period of 10 years in accordance with Section 18. Tax law specifies that the full amount of the intangible asset is deductible for tax purposes, but the timing of deductibility (i.e., period of amortisation under the tax law) is uncertain. Entity B has no similar intangible assets and it therefore decides that this tax treatment must be considered separately.

Entity B deducted £100 (the cost of the intangible asset) in calculating its taxable profit for Year 1 in its income tax filing. At the end of Year 1, Entity B concludes, on the basis of an evaluation of all available evidence (e.g., information about disputes for other entities' similar transactions), that it is not probable that this tax treatment will be accepted. Entity B estimates that the most likely deduction that the tax authority will accept for Year 1 is £25, and that the most likely amount better predicts the resolution of the tax uncertainty. Accordingly, at the end of Year 1, Entity B recognises and measures a deferred tax liability based on the cumulative amount of timing difference between the expense recognised in the profit or loss and the most likely amount of the tax deduction (i.e., the difference between £10 and £25).

Entity B also concludes that it must make similar judgements in estimating the most likely amount for its current tax for Year 1, because this uncertain tax treatment also affects the taxable profit. Entity B recognises and measures its current tax liability, based on the taxable profit that includes £75, in addition to the amount in its tax filing. (This is because Entity B deducted £100 from taxable income for Year 1, whereas the most likely amount is now estimated to be £25. Entity B concluded that it is not probable that the tax treatment used in its filing will be accepted.)

As emphasised in paragraph 12 of IFRIC 23, where the uncertain tax treatment affects both current tax and deferred tax, an entity is required to make estimates and judgements on a consistent basis.

5.2.5 Consideration of changes in facts and circumstances

Extract from Section 29

29.17C An entity shall reflect the effect of a change in relevant facts and circumstances, or of new information, on its judgements or estimates about uncertain tax treatments as a change in accounting estimate in accordance with paragraphs 10.14D to 10.18.

Facts and circumstances that an entity has considered in the measurement and recognition of uncertain tax treatments could change or new information might become available. In such a situation, the entity must reflect the effect of a change in relevant facts and circumstances, or of new information, on its judgements or estimates about uncertain tax treatments as a change in accounting estimate in accordance with paragraphs 10.14D to 10.18. [FRS 102.29.17C].

The Application Guidance in IFRIC 23 includes examples of changes that can result in the reassessment of judgements or estimates previously made by the entity:

- (a) The results of examinations or actions taken by a taxation authority. For example:
 - (i) Agreement or disagreement by the taxation authority with the tax treatment or a similar tax treatment used by the entity.
 - (ii) Information that the taxation authority has agreed or disagreed with a similar tax treatment used by another entity.
 - (iii) Information about the amount received or paid to settle a similar tax treatment.
- (b) Changes in rules established by the taxation authority.
- (c) The expiry of a taxation authority's right to examine or re-examine a tax treatment.

An uncertain tax treatment is resolved when the treatment is accepted or rejected by the taxation authorities. Such an acceptance or rejection of an uncertain tax treatment by the taxation authorities could be implicit or explicit. In practice, a taxation authority might accept a tax return without commenting explicitly on any particular treatment in it. Alternatively, it might raise some questions in an examination of a tax return. Unless such clearance is provided explicitly, it is not always clear if a taxation authority has accepted an uncertain tax treatment.

An entity may consider the following to determine whether a taxation authority has implicitly or explicitly accepted an uncertain tax treatment:

- The tax treatment is explicitly mentioned in a report issued by the taxation authorities following an examination.
- The treatment was specifically discussed with the taxation authorities (e.g., during an on-site examination) and the taxation authorities verbally agreed with the approach.

Or

- The treatment was specifically highlighted in the income tax filings, but not subsequently queried by the taxation authorities in their examination.

The Application Guidance in IFRIC 23 further clarifies that the absence of agreement or disagreement by a taxation authority with a tax treatment, in isolation, is unlikely to constitute a change in facts and circumstances or new information that affects the judgements and estimates required by IFRIC 23. [IFRIC 23.A3]. In such situations, an entity has to consider other available facts and circumstances before concluding that a reassessment of the judgements and estimates is required.

The amendments do not provide any specific guidance to deal with situations where facts and circumstances change or new information becomes available after the end of the reporting period.

How we see it

We believe where facts and circumstances change or new information becomes available after the end of the reporting period, the entity must apply the guidance in Section 32 to determine whether the change is an adjusting or non-adjusting event.

5.2.6 Disclosures relating to uncertain tax treatments

The amendments have not introduced additional disclosures relating to uncertain tax treatments. IFRIC 23 also did not propose any new disclosures. However, Application Guidance included in IFRIC 23 would be helpful to consider whether the following existing disclosure requirements are relevant in these circumstances:

- To disclose judgements made in the process of applying the entity's accounting policies in accordance with Section 8 *Notes to the Financial Statements* (see Chapter 6 at 7.3). [FRS 102.8.6]. Such judgements might include the decision to consider uncertain tax treatments separately or together (see 5.2.2 above); the determination as to whether acceptance by the taxation authorities is probable; or the decision to apply the 'most likely amount' or 'expected value' method to reflect uncertainty (see 5.2.5 above).
- To disclose information about the assumptions and estimates made in determining taxable profit or loss, unused tax losses, unused tax credits and tax rates in accordance with Section 8 regarding the sources of significant estimation uncertainty (see Chapter 6 at 7.4). [FRS 102.8.7].

As discussed in 5.2.4 above, if an entity determines that it is probable that a taxation authority will accept the tax treatment used or planned to be used in its tax filings, it determines its tax position on that basis. [FRS 102.29.17B].

As noted above, uncertain tax treatments generally relate to the estimate of the entity's liability for current tax. Any amount recognised for an uncertain current tax treatment must therefore normally be classified as current tax, and presented (or disclosed) accordingly (see Chapter 6 at 4).

However, there are circumstances where an uncertain tax treatment affects the timing difference and therefore relates to deferred tax, as shown in Illustration 5-2 in 5.2.4 above. For example, there might be doubt as to the amount of tax depreciation that can be deducted in respect of a particular asset, which in turn could lead to a permanent difference impacting recognition of deferred taxes.

5.2.7 Presentation of liabilities or assets for uncertain tax treatments

The Periodic Review 2024 did not introduce any requirements regarding the presentation of uncertain tax liabilities or assets in the statement of financial position and therefore an entity must follow the guidance set out at 10.1 below.

Where an entity selects an adapted format for the statement of financial position, it is clear it would present uncertain tax liabilities as current tax liabilities or deferred tax liabilities and uncertain tax assets as current tax assets or deferred tax assets as appropriate, rather than in a separate line item such as provisions.

[FRS 102.4.2A(o), FRS 102.4.2A(p)]. This is reinforced by observations made by the IFRS IC²⁴² when it discussed the presentation of uncertain tax liabilities when applying IAS 1 *Presentation of Financial Statements*, the requirements of which are substantially the same in this respect as those of FRS 102.

5.2.8 First time application

On initial application, entities can choose either to apply the requirements addressed in 5.2.1 to 5.2.7 above with full retrospective effect or by recognising their cumulative effect as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) and without restating comparative information. The full retrospective approach can only be applied if that is possible without the use of hindsight. [FRS 102.1.68].

5.3 'Prior year adjustments' of previously presented tax balances and expense (income)

The determination of the tax liability for all but the most straightforward entities is a complex process. It may be several years after the end of a reporting period before the tax liability for that period is finally agreed with the tax authorities and settled. Therefore, the tax liability initially recorded at the end of the reporting period to which it relates is no more than a best estimate at that time, which will typically require revision in subsequent periods until the liability is finally settled.

Tax practitioners often refer to such revisions as 'prior year adjustments' and regard them as part of the overall tax charge or credit for the current reporting period whatever their nature. However, for financial reporting purposes, the normal provisions of Section 10 (see Chapter 9) apply to tax balances and the related expense (income). Therefore, the nature of any revision to a previously stated tax balance must be considered to determine whether the revision represents:

- A correction of a material prior period error (in which case it must be accounted for retrospectively, with a restatement of comparative amounts and, where applicable, the opening balance of assets, liabilities and equity at the start of the earliest period presented). [FRS 102.10.21]

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Or

- A refinement in the current period of an estimate made in a previous period (in which case it must be accounted for in the current period). [FRS 102.10.17].

In some cases the distinction is clear. If, for example, the entity used an incorrect substantively enacted tax rate (see 5.1 above) to calculate the liability in a previous period, the correction of that rate would – subject to materiality – be a prior year adjustment. A more difficult area is the treatment of accounting changes to reflect the resolution of uncertain tax positions (see 5.2 above). These are in practice almost always treated as measurement adjustments in the current period. However, a view could be taken that the eventual denial, or acceptance, by the tax authorities of a position taken by the taxpayer indicates that one or other party (or both of them) were previously taking an erroneous view of the tax law. As with other aspects of accounting for uncertain tax positions, this is an area where considerable judgement may be required. Section 29 suggests that entities would reassess judgements and estimates in response to a change in facts and circumstances, and that the financial effect must be recognised as a change in estimate under Section 32, i.e., in the period of change (see section 5.2.5 above). [FRS 102.29.17C].

6 Deferred tax – Recognition

Deferred tax is defined as the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for future reporting periods as a result of past transactions or events. *[FRS 102 Appendix I]*.

Section 29 requires deferred tax to be recognised in respect of all timing differences at the reporting date (see 6.1 below), subject to further considerations relating to: *[FRS 102.29.6]*

- Unrelieved losses and other deferred tax assets (see 6.2 below).
- Tax allowances for the cost of a fixed asset when all the conditions for retaining the tax allowances have been met (see 6.3 below).

And

- Certain timing differences relating to the recognition in the financial statements of income and expenses from a subsidiary, associate, branch or an interest in a joint venture (see 6.4 below).

Deferred tax is not recognised in respect of permanent differences (see 6.5 below). *[FRS 102.29.10]*.

However, the general 'timing differences approach' of Section 29 does not apply when an entity recognises assets and liabilities in a business combination accounted for by applying the purchase method. In this situation, deferred tax is recognised in respect of the differences between the values recognised in the financial statements for the acquired assets (other than goodwill) and liabilities in the business combination accounted for by applying the purchase method and the respective amounts that can be deducted or otherwise assessed for tax purposes. *[FRS 102.29.11]*. Accounting for deferred tax in a business combination is discussed at 6.6 below.

6.1 Recognition of deferred tax on timing differences

Extract from Section 29

- 29.6 Deferred tax shall be recognised in respect of all **timing differences** at the reporting date, except as otherwise required by paragraphs 29.7 to 29.9 and 29.11A below. Timing differences are differences between taxable profits and **total comprehensive income** as stated in the **financial statements** that arise from the inclusion of **income** and **expenses** in tax assessments in periods different from those in which they are recognised in financial statements.

Timing differences are differences between taxable profits and total comprehensive income as stated in the financial statements that arise from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements. *[FRS 102.29.6]*. Timing differences are said to originate in the accounting period in which they first arise or increase and to reverse in subsequent periods when they decrease, eventually to zero.

6.1.1 Examples of timing differences

A deferred tax liability arises when:

- Expenditure is recognised for tax purposes before it is recognised in the financial statements.
- Or
- Income is recognised in the financial statements before it is recognised for tax purposes.

A deferred tax asset arises when:

- Expenditure is recognised for tax purposes after it is recognised in the financial statements.
- Or
- Income is recognised in the financial statements after it is recognised for tax purposes.

Examples of timing differences include:

- Tax deductions for the cost of property, plant and equipment are recorded before (deferred tax liability) or after (deferred tax asset) the related depreciation is charged to the income statement.
- Tax deductions are available in respect of provisions only when payments are made to settle the obligation. In this case, a deferred tax asset will arise when the entity recognises a provision for that obligation and the associated expense in the financial statements.

- Expenditure is capitalised in the financial statements, whereas tax deductions are obtained as the expenditure is incurred. Examples include capitalised borrowing costs and capitalised development costs. Another example arises when an entity accounts for tax-deductible loan issue costs (as a reduction in the recorded net proceeds as required by Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*), whereas tax relief is given when the issue costs are incurred. In these cases a deferred tax liability will be recognised, because the tax deduction is received before the related cost is depreciated or amortised through the income statement.
- Pensions liabilities are recognised in the financial statements but are allowed for tax purposes only when contributions are paid at a later date. This will give rise to a deferred tax asset when a pension liability is recorded and a deferred tax liability to the extent that a pension asset is recognised.
- Revaluations of property, plant and equipment give rise to a gain or loss recorded through other comprehensive income, but do not attract a tax charge until the asset is sold. In this example, a deferred tax liability would be recognised. A similar situation arises when an asset is sold and the related taxable gain is rolled over into the cost of a replacement asset.
- In consolidated financial statements, the elimination of intra-group profits in inventory will give rise to a timing difference (deferred tax asset) because tax is payable on the inter-company transfer before the sale of the related inventory (by the transferee subsidiary) is recognised in the consolidated income statement.
- Where a tax loss or tax credit is not relieved against past or current taxable profits but can be carried forward to reduce future taxable profits, a timing difference arises. Subject to the additional criteria set out at 6.2 below, this may give rise to a deferred tax asset being recognised.

And

- Where an entity holds an investment in a subsidiary, associate or joint venture and additional tax is payable when dividends are remitted to the investor, a timing difference will arise (deferred tax liability) to the extent that profits are recognised in the consolidated income statement before the related earnings are distributed by the investee. In certain circumstances the related timing difference is not required to be recognised, as explained at 6.4 below.

6.1.2 Deferred taxable gains

The UK (and some overseas) tax regime mitigates the tax impact of some asset disposals by allowing some or all of the tax liability on such transactions to be deferred, typically subject to conditions, such as a requirement to reinvest the proceeds from the sale of the asset disposed of in a similar 'replacement' asset. The postponement of tax payments achieved in this way may either be for a fixed period (often called holdover relief) or for an indefinite period until the new asset is disposed of without the sale proceeds being again reinvested in another replacement asset (often called rollover relief).

The ability to postpone tax payments in this way does not affect the recognition of deferred tax. The original disposal transaction gives rise to a timing difference on which deferred tax must be recognised.

6.2 Restrictions on the recognition of deferred tax assets

Embodied in the definition of an asset in FRS 102 is the expectation of an inflow of future economic benefits. [FRS 102 Appendix I]. A deferred tax asset can be recovered only out of future *taxable* profit. Evidence of future accounting profit is not necessarily evidence of future taxable profit (for example, if significant tax deductions or credits not reflected in the accounting profit are likely to be claimed by the entity in the relevant future periods).

Section 29 restricts the recognition of unrelieved tax losses and other deferred tax assets to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits. Section 29 observes that the very existence of unrelieved tax losses is strong evidence that there may not be other future taxable profits against which the losses will be relieved. [FRS 102.29.7].

How we see it

In our view, this does not represent a prohibition on their recognition in the absence of recognised deferred tax liabilities; just that more convincing evidence of the existence of profits is required.

6.2.1 Recovery against the reversal of recognised deferred tax liabilities

As stated above, recovery against the reversal of recognised deferred tax liabilities must be considered when recognising unrelieved tax losses and other deferred tax assets. Accordingly, before considering forecasts of future taxable profits, an entity must look to the deferred tax liabilities it has already recognised at the reporting date as a source of probable taxable profits that would allow any deferred tax assets to be utilised. IAS 12, on which this part of FRS 102 is based, explains it is 'probable' that there will be sufficient taxable profit if a deductible temporary difference can be offset against a taxable temporary difference relating to the same tax authority and the same taxable entity which will reverse in the same period as the asset, or in a period into which a loss arising from the asset may be carried back or forward. In such circumstances, a deferred tax asset is recognised. [IAS 12.28].

Any deferred tax liability used as the basis for recognising a deferred tax asset must represent a future tax liability against which the future tax deduction represented by the deferred tax asset can actually be offset. For example, in a tax jurisdiction where revenue and capital items are treated separately for tax purposes, a deferred tax asset representing a capital loss cannot be recognised by reference to a deferred tax liability relating to PP&E against which the capital loss could never be offset in a tax return. There is no need at this stage to estimate the future taxable profits of the entity. If there are sufficient deferred tax liabilities to justify the recognition of a deferred tax asset, then the asset is recognised.

Where there are insufficient deferred tax liabilities relating to the same tax authority to offset a deferred tax asset, the entity must then look to the availability of future taxable profits.

6.2.2 The availability of future taxable profits

Section 29 does not provide specific guidance regarding the availability of future taxable profits. However, IAS 12 provides certain clarifications as discussed below:

- Estimates of future taxable profits are only required to justify the recoverability of deferred tax assets in excess of the amounts already 'matched' against deferred tax liabilities recognised at the reporting date in the manner described in 6.2.1 above. [IAS 12.29].
 - A deferred tax asset must be recognised to the extent that it is probable that in future periods there will be sufficient taxable profits: [IAS 12.29]
 - Relating to the same tax authority and same taxable entity and arising in the same period as the reversal of the difference or in a period into which a loss arising from the deferred tax asset may be carried back or forward.
- Or
- Tax planning opportunities are available that will create taxable profit in appropriate periods.

How we see it

In our view, any deferred tax liability or future taxable profit used as the basis for recognising a deferred tax asset must also represent a future tax liability against which the future tax deduction can actually be realised. For example, where revenue and capital items are treated separately for tax purposes, a deferred tax asset representing a capital loss cannot be recognised by reference to an expected taxable profit from revenue items, against which the capital loss could never be offset in a tax return.

As discussed above, where a deferred tax asset is recognised on the basis of expected future taxable profits and those taxable profits arise from trading activities, the 'quality' of those profits must be considered. For example, it might be appropriate to give more weight to (say) revenues from existing orders and contracts than to those from merely anticipated future trading. Where an entity expects to recover from a recent loss-making position, greater scepticism as to the speed of a recovery in profits would also be appropriate. In the context of determining expected future taxable profits, neither Section 29 nor IAS 12 prescribe or suggest a forecast period.

How we see it

In our view, it will generally not be appropriate to restrict the assumed availability of future taxable profit to an arbitrary future timeframe (e.g., 3 years, 5 years etc.) unless such a restriction is imposed because losses expire under tax law. For example, it may well be the case that a deferred tax asset recoverable in twenty years from profits from a currently existing long-term supply contract with a creditworthy customer may be more robust than one recoverable in one year from expected future trading by a start-up company.

To the extent that it is not probable that taxable profit will be available against which the unused tax losses, unused tax credits or other timing differences can be utilised, a deferred tax asset is not recognised. [FRS 102.29.7]. In the UK, it is also relevant to consider that unused tax losses can normally be carried forward indefinitely.

6.2.2.A Tax planning opportunities

'Tax planning opportunities' are actions that the entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carryforward. Examples of ways taxable profit may be created or increased are:

- Electing to have interest income taxed on either a received or receivable basis.
- Deferring the claim for certain deductions from taxable profit.
- Selling, and perhaps leasing back, assets that have appreciated but for which the tax base has not been adjusted to reflect such appreciation.
- Selling an asset that generates non-taxable income (such as, in some jurisdictions, a government bond) in order to purchase another investment that generates taxable income.

How we see it

In our view, the requirement to have regard to future tax planning opportunities applies only to the measurement of deferred tax assets. Where an entity recognises a deferred tax asset on the basis that it will be recovered through profits generated as a result of a tax planning strategy, the entity must:

- Be able to demonstrate that the strategy is one that it will undertake, not merely one that it could theoretically undertake.
- Measure any deferred tax asset recognised on the basis of a tax planning strategy net of any cost of implementing that strategy (measured, where applicable, on an after-tax basis).

And

- Expect to be in a net taxable profit position at the relevant time. Where the entity is expected to remain tax loss-making (such that the strategy effectively will simply reduce future tax losses), we believe that the strategy does not generally form the basis for recognising a deferred tax asset, except to the extent that it will create net future taxable profits.

6.2.2.B Future changes to tax rates and laws are ignored

The assessment as to the probable existence of future taxable profits, including the availability of tax planning opportunities, is based on those tax rates and laws that have been enacted or substantively enacted by the reporting date. [FRS 102.29.12]. As noted at 5.1 above and at 7 below, the use of enacted rates is applied very strictly. In particular, no account must be taken of changes to tax rates and laws that are announced or enacted after the reporting date, even if they will create a new tax planning opportunity or result in a deductible timing difference ceasing to be recoverable. Section 32 identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. [FRS 102.32.11(h)]. Similarly, in assessing which tax planning opportunities 'are available', the entity can only consider its circumstances as they exist at the end of the reporting period, including the result of actions within the entity's control as at that date.

6.2.3 Reassessment of deferred tax assets

Section 29 does not provide any specific guidance on reassessment of deferred tax assets. However, IAS 12 provides the following guidance that might be helpful for an entity applying Section 29 in its assessment of whether to continue recognising deferred tax assets or recognise additional deferred tax assets that were previously unrecognised.

6.2.3.A Previously recognised assets

An entity must reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to enable the asset to be recovered. Any such reduction must be reversed if it subsequently becomes probable that sufficient taxable profit will be available. [IAS 12.56].

6.2.3.B Previously unrecognised assets

An entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that sufficient taxable profit will be available to enable the asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset to meet the recognition criteria. Special considerations apply when an entity re-appraises deferred tax assets of an acquired business at the date of the business combination or subsequently (see section 6.6.2 below). [IAS 12.37].

6.3 Capital allowances – when all conditions for their retention have been met

Section 29 requires deferred tax to be recognised on timing differences arising when the tax allowances for the cost of a fixed asset are accelerated (i.e., received before the depreciation of the asset is recognised in profit or loss) or decelerated (i.e., received after the depreciation of the asset is recognised in profit or loss). However, any recorded deferred tax must be reversed if and when all conditions for retaining the allowances have been met. [FRS 102.29.8].

A past example of a situation giving rise to such a reversal in the UK related to entities that had previously claimed industrial buildings allowances (IBAs) which ceased to be subject to clawback (or a balancing charge) if the asset had been held for 25 years. However, IBAs were phased out in the UK by 2012.

6.3.1 Treatment of assets brought into the UK tonnage tax regime

Companies subject to UK corporation tax, which operate qualifying vessels that are ‘strategically and commercially managed in the UK’, can take advantage of the tonnage tax regime. The tonnage tax regime differs from the main corporation tax system in a number of key respects, the most significant from an accounting point of view being that an entity in the tonnage tax regime is not assessed to tax on the basis of its reported profits from qualifying activities and does not receive capital allowances for the cost of its ships. Therefore, an entity’s operations within the tonnage tax regime are outside the scope of Section 29, because tonnage tax does not meet the definition of an income tax discussed at 3.1 above.

When an entity first enters the tonnage tax regime, not only does it cease to qualify for further capital allowances in relation to the vessels it held at the time of the change, but it is also exempt from any balancing charges on disposals of those vessels made while it is still in the tonnage tax regime. However, if the entity returns to the corporation tax system at a later date, there are rules which may cause this exposure to be reinstated. Membership of the tonnage tax regime is determined for a fixed period, albeit with a renewal option at the entity’s discretion; but HMRC also has the power in limited circumstances to withdraw an entity from the tonnage tax regime.

The question therefore arises as to whether an entity entering the tonnage tax regime should derecognise deferred tax balances related to its vessels on the basis that, ‘all conditions for retaining the tax allowances have been met’. [FRS 102.29.8].

How we see it

In our view it is appropriate for entities reporting under FRS 102 to continue the practice applied under previous UK GAAP and IFRS of derecognising the deferred tax balances related to assets brought into the tonnage tax regime unless there is evidence of a real possibility that the entity will become subject to the main corporation tax regime at a later date. Consideration must be given to the need to disclose (as a contingent liability) the financial consequences of a return to the main corporation tax system. An entity must not anticipate the effect of entering the tonnage tax regime before it is evident that the necessary clearances have been granted by the tax authorities.

6.4 Income or expenses from a subsidiary, associate, branch or joint venture

Entities are required to recognise deferred tax on timing differences that arise when income or expenses from a subsidiary, branch, associate or joint venture have been recognised in the financial statements and will be assessed to or allowed for tax in a future period, except where: [FRS 102.29.9]

- The reporting entity is able to control the reversal of the timing difference.
- And

- It is probable that the timing difference will not reverse in the foreseeable future.

Section 29 notes that such timing differences may arise where there are undistributed profits in a subsidiary, branch, associate or joint venture. [FRS 102.29.9]. For example, an entity may have recognised in its consolidated financial statements the profits of its subsidiaries or recognised in its consolidated income statement an amount in respect of its share of the earnings of its equity-accounted associates and joint ventures. In cases where the investee is required to deduct withholding tax on any distribution of those profits to its parent, there will be future tax consequences relating to those earnings that have been recognised in the entity's financial statements. Subject to the exception above, deferred tax must be recognised for such timing differences.

6.4.1 'Control' over reversal of timing differences

For this exception to apply, the investor must be able to control the reversal of the timing difference and not expect there to be a reversal in the foreseeable future. [FRS 102.29.9]. Section 29 does not discuss what is meant by 'control' in this context. However, IAS 12, in discussing the similar requirements, takes the following position:

- In respect of a subsidiary or a branch, the parent is able to control when and whether retained earnings are distributed. Therefore, no provision need be made for the tax consequences of distributing profits if the parent has determined that those profits will not be distributed in the foreseeable future. [IAS 12.40]
 - In the case of a joint venture, no amount is recorded for the tax consequences of distributing the share of profits recognised by the entity in its statement of comprehensive income to the extent that the joint venture agreement requires the consent of the entity before a dividend can be paid and the entity expects that it will not give such consent in the foreseeable future. [IAS 12.43]
- And
- In the case of an associate, however, the investor cannot usually control distribution policy. Therefore provision must be made for the tax consequences of the distribution of the share of profits recognised by the entity from its associate, except to the extent that there is a shareholders' agreement to the effect that those earnings will not be distributed in the foreseeable future. [IAS 12.42].

How we see it

In our view, an entity must consider the above criteria in determining whether it controls the reversal of such timing differences. Of course, if control is deemed to exist, but the entity expects its investee to make a distribution in the foreseeable future, any related tax consequences will have to be recognised at the reporting date.

6.5 Permanent differences

Extract from Section 29

29.10 Permanent differences arise because certain types of income and expenses are non-taxable or disallowable, or because certain tax charges or allowances are greater or smaller than the corresponding income or expense in the financial statements. Deferred tax shall not be recognised on permanent differences except for circumstances set out in paragraph 29.11.

Permanent differences are differences between an entity's taxable profits and its total comprehensive income as stated in the financial statements, other than timing differences. [FRS 102 Appendix I]. Permanent differences arise because certain types of income or expenses are non-taxable or disallowable, or because certain tax charges or allowances are greater than or smaller than the corresponding income or expense in the financial statements. [FRS 102.29.10]. These latter items are sometimes referred to as 'super-deductible' or 'partially-deductible' assets and liabilities. Examples of disallowable expenses might include certain penalties, fines and entertainment costs. Under Section 29, deferred tax is not recognised on permanent differences, except when an entity is accounting for assets and liabilities acquired in a business combination accounted for by applying the purchase method (see 6.6 below). [FRS 102.29.10].

A permanent difference might arise from the tax status of an asset (or liability) at the time of its initial recognition. For example, in the UK certain categories of building attract no tax deduction in respect of their use within the business, but are deductible only on a subsequent sale. Conversely, the tax deductions made available may exceed the actual expenditure incurred, such as in the case of certain companies engaged in North Sea exploration activities. A permanent difference might also arise when an asset is

transferred at book value from one member of a group to another, together with its tax history. In this case, the selling subsidiary derecognises the asset and any related deferred tax; but, in its own financial statements, the buying subsidiary recognises only the asset, despite the fact that the cost may be partially deductible for tax purposes.

In other cases, a permanent difference can be created as a result of changes in tax law subsequent to the original recognition of the asset, for example when the cost of an asset becomes deductible for tax purposes having previously been disallowed. Such changes can give rise to the recognition of deferred tax assets or liabilities under IFRS, but do not under Section 29, where the effect is recognised prospectively as timing differences arise.

In most cases, the application of this requirement for permanent differences is straightforward – either an item is deductible or assessable for tax, or it is not. However, certain items give rise to accounting income and expenditure of which some is assessable or deductible for tax, and some is not. Accounting for the deferred tax effects of such items can raise some issues of interpretation which particularly affect:

- Non-deductible assets subject to revaluation (see 6.5.1 below).
- And
- Partially deductible and super-deductible assets (see 6.5.2 below).

6.5.1 Non-deductible assets subject to revaluation

Where a non-deductible asset is acquired separately (i.e., not as part of a larger business combination), the difference between the original cost of the asset and the amount deductible for tax (i.e., zero) is a permanent difference on which no deferred tax is recognised. However, where a non-deductible asset is subsequently revalued, the revaluation would give rise to a timing difference as it results in the recognition of income which is expected to be taxed at a later date (either when the asset is used that generates taxable income or is sold resulting in taxable gain).

Further, as discussed at 7.4.2.B below, deferred tax related to a non-depreciable asset that is measured using the revaluation model in Section 17 *Property, Plant and Equipment* is measured using the tax rates and allowances that apply to the sale of the asset. [FRS 102.29.15].

The deferred tax impact where an asset is revalued is shown in Illustration 6-1 and Illustration 6-2 below.

Illustration 6-1: Revaluation of non-depreciable non-deductible asset

On 1 January 20X6 an entity paying tax on both revenue and capital profits at 20% acquires a non tax-deductible property for £2,000,000. Application of Section 17 results in no depreciation being charged on the property.

On 1 January 20X7 the entity revalues the property to £2,400,000. The revaluation of £400,000 is a timing difference giving rise to a deferred tax expense at 20% of £80,000. This tax expense would be recognised in other comprehensive income with the related revaluation gain (see 8 below).

Illustration 6-2: Revaluation of depreciable, non-deductible asset

On 1 January 20X6 an entity paying tax on revenue profits at 20% acquires a non-tax-deductible property for £2,000,000. The property is depreciated over 20 years at £100,000 per year to a residual value of zero. The entity's financial year ends on 31 December.

At 31 December 20X7, the carrying amount of the property is £1,800,000, and it is revalued upwards by £900,000 to its current market value of £2,700,000. As there is no change to the estimated residual value of zero, or to the expected life of the property, this will be depreciated over the next 18 years at £150,000 per year.

As stated above, subsequent revaluation of an asset gives rise to a timing difference. Accordingly, the revaluation in 20X7 gives rise to a timing difference of £900,000 resulting in a deferred tax charge of £180,000, at the tax rate of 20%, that is recognised in OCI (see 8 below) in the year ended 31 December 20X7. As the property is depreciated in future periods the £900,000 timing difference relating to the revaluation will reverse. However, £1,800,000 of the depreciation charged over a period of 18 years relates to the original cost which is not taxable.

How we see it

In our view, for the purposes of applying Section 29, £900,000 of depreciation charged in future periods must be considered as giving rise to a reversal of the timing difference created by the revaluation, and £1,800,000 must be considered as giving rise to a permanent difference.

For example, in 20X8, total depreciation is disaggregated as follows:

<i>Total depreciation</i>	<i>Permanent difference</i>	<i>Timing difference</i>
£	£	£
150,000	100,000	50,000

As the difference reverses in 20X8 the entity recognises deferred tax income of £10,000, representing the tax effect at 20% of the £50,000 depreciation relating to the revalued element of the property.

6.5.2 Partially deductible and super-deductible assets

The tax deductions for an asset are generally based on the cost of that asset to the legal entity that owns it. However, in some jurisdictions, certain categories of asset are deductible for tax but for an amount either less than the cost of the asset ('partially deductible') or more than the cost of the asset ('super-deductible'). In such cases the difference between the cost and the tax-deductible amount (whether lower or higher) is a permanent difference as defined in Section 29. Section 29 provides no specific guidance on the treatment of partially deductible and super-deductible assets. The issues raised by such assets are shown in Illustration 6-3 and Illustration 6-4 below.

Illustration 6-3: Partially deductible asset

An entity acquires an asset with a cost of £100,000, for which tax deductions of only £60,000 are available, in a transaction which is not a business combination. The asset is depreciated to a residual value of zero over 10 years, and qualifies for tax deductions of 20% per year over 5 years. In our view, in applying Section 29, the entity could analyse the annual depreciation of £10,000 per annum into a tax-deductible element of £6,000 and a non-deductible element of £4,000, reflecting the fact that only 60% of the cost of the asset is tax-deductible. Timing differences are then calculated by reference to the interaction of tax deductions claimed with the tax-deductible 'element' of the depreciation as set out below.

Year	Depreciation	40% non-deductible element	60% deductible element	Tax deductions	Cumulative timing difference
	a	b (40% of a)	c (60% of a)	d	c - d
1	10,000	4,000	6,000	12,000	6,000
2	10,000	4,000	6,000	12,000	12,000
3	10,000	4,000	6,000	12,000	18,000
4	10,000	4,000	6,000	12,000	24,000
5	10,000	4,000	6,000	12,000	30,000
6	10,000	4,000	6,000	-	24,000
7	10,000	4,000	6,000	-	18,000
8	10,000	4,000	6,000	-	12,000
9	10,000	4,000	6,000	-	6,000
10	10,000	4,000	6,000	-	-

If the entity pays tax at 30%, the amounts recorded for this transaction during year 1 (assuming that there are sufficient other taxable profits to absorb the tax loss created) would be as follows:

	£
Depreciation of asset	(10,000)
Current tax income ¹	3,600
Deferred tax charge ²	(1,800)
Net tax credit	1,800
Post tax depreciation	(8,200)

1 £100,000 [cost of asset] × 60% [deductible element] × 20% [tax depreciation rate] × 30% [tax rate]

2 £6,000 [timing difference] × 30% [tax rate] = £1,800 - brought forward deferred tax balance [nil] = £1,800

If this calculation is repeated for all 10 years, the following would be reported in the financial statements.

Year	Depreciation	Current tax credit	Deferred tax (charge)/credit	Total tax credit	Effective tax rate
	A	b	c	d (=b+c)	e (=d/a)
1	(10,000)	3,600	(1,800)	1,800	18%
2	(10,000)	3,600	(1,800)	1,800	18%
3	(10,000)	3,600	(1,800)	1,800	18%
4	(10,000)	3,600	(1,800)	1,800	18%
5	(10,000)	3,600	(1,800)	1,800	18%
6	(10,000)	-	1,800	1,800	18%
7	(10,000)	-	1,800	1,800	18%
8	(10,000)	-	1,800	1,800	18%
9	(10,000)	-	1,800	1,800	18%
10	(10,000)	-	1,800	1,800	18%

This methodology has the result that, throughout the life of the asset, a consistent tax credit is reported in each period. The effective tax rate in each period corresponds to the effective tax rate for the transaction as a whole - i.e. cost of £100,000 attracting total tax deductions of £18,000 (£60,000 at 30%), an overall rate of 18%.

How we see it

Whilst we believe that the approach shown above results in an appropriate effective tax rate in each period, it cannot be said to be required by Section 29 and other methodologies could well be appropriate, provided that they are applied consistently in similar circumstances.

Illustration 6-4: Super-deductible asset

The converse situation to that in Illustration 6-3 arises where tax authorities seek to encourage certain types of investment by giving tax allowances for an amount in excess of the expenditure actually incurred. Suppose that an entity invests £1 million in PP&E, for which tax deductions of £1.2 million are available, in a transaction which is not a business combination. The asset is depreciated to a residual value of zero over 10 years, and qualifies for five annual tax deductions of 20% of its deemed tax cost of £1,200,000.

The methodology we propose in Illustration 6-3 could be applied 'in reverse' - i.e., with the tax deductions, rather than the depreciation, of the asset being apportioned in the ratio 10:2 into a 'cost' element and a 'super deduction' element, and the timing difference calculated by reference to the 'cost' element as follows.

Year	Depreciation	Tax deduction	'Super deduction' element	Cost element	Cumulative timing difference
	a	b	c (=2/12 of b)	d (=10/12 of b)	a - d
1	100,000	240,000	40,000	200,000	100,000
2	100,000	240,000	40,000	200,000	200,000
3	100,000	240,000	40,000	200,000	300,000
4	100,000	240,000	40,000	200,000	400,000
5	100,000	240,000	40,000	200,000	500,000
6	100,000	-	-	-	400,000
7	100,000	-	-	-	300,000
8	100,000	-	-	-	200,000
9	100,000	-	-	-	100,000
10	100,000	-	-	-	-

If the entity pays tax at 30%, the amounts recorded for this transaction during year 1 (assuming that there are sufficient other taxable profits to absorb the tax loss created) would be as follows:

	£
Depreciation of asset	(100,000)
Current tax income ¹	72,000
Deferred tax charge ²	(30,000)
Net tax credit	42,000
Profit after tax	(58,000)

1 £1,200,000 [deemed tax cost of asset] × 20% [tax depreciation rate] × 30% [tax rate]

2 £100,000 [timing difference] × 30% [tax rate] = £30,000 - brought forward balance [nil] = £30,000.

If this calculation is repeated for all 10 years, the following would be reported in the financial statements.

Year	Depreciation	Current tax credit	Deferred tax (charge)/credit	Total tax credit	Effective tax rate
	a	b	c	d (=b+c)	e (=d/a)
1	(100,000)	72,000	(30,000)	42,000	42%
2	(100,000)	72,000	(30,000)	42,000	42%
3	(100,000)	72,000	(30,000)	42,000	42%
4	(100,000)	72,000	(30,000)	42,000	42%
5	(100,000)	72,000	(30,000)	42,000	42%
6	(100,000)	-	30,000	30,000	30%
7	(100,000)	-	30,000	30,000	30%
8	(100,000)	-	30,000	30,000	30%
9	(100,000)	-	30,000	30,000	30%
10	(100,000)	-	30,000	30,000	30%

This results in an effective 42% tax rate for this transaction being reported in years 1 to 5, and a rate of 30% in years 6 to 10, in contrast to the average effective rate of 36% for the transaction as a whole - i.e., cost of £1,000,000 attracting total tax deductions of £360,000 (£1,200,000 at 30%). This is because, in the case of a partially deductible asset as in Illustration 6-3 above, there is an accounting mechanism (i.e., depreciation) for allocating the non-deductible cost on a straight-line basis. However, in the present case of a super deductible asset there is no basis for spreading the £60,000 tax super-deductions, and these are therefore reflected as current tax income in the years in which they are claimed.

How we see it

Similar to Illustration 6-3 above, in our view, no single approach can be said to be required by FRS 102 and other methodologies could well be appropriate, provided that they are applied consistently in similar circumstances.

6.5.3 UK indexation allowance

UK tax legislation provides that when certain types of asset are disposed of the cost of the asset deducted in calculating any taxable gain on disposal may be increased by an 'indexation allowance' that is broadly intended to exclude from taxation any gains arising simply as a result of general price inflation.

On a strict interpretation of the definition of 'permanent difference', an indexation allowance is a permanent difference since it is effectively an item of expenditure that appears in taxable profit, but not in total comprehensive income.

How we see it

However, in our view - supported by long-standing practice under FRS 19 *Deferred tax* under which the same issue of interpretation would have arisen - it is more appropriate to deal with indexation allowance in the measurement of the related deferred tax liabilities (see 7.5 below).

6.6 Business combinations

Additional deferred tax arises on business combinations as a result of items such as:

- The application of Section 29 to the assets and liabilities of the acquired business in the consolidated financial statements, when it has not been applied in the separate financial statements of that business.
- Adjustments made to measure the assets and liabilities of the acquired business at fair value, with consequential changes in the temporary differences associated with those assets and liabilities.

Any deferred tax assets or liabilities on temporary differences that arise on a business combination affect the amount of goodwill or negative goodwill. [FRS 102.29.11].

6.6.1 Measurement and recognition of deferred tax in a business combination

Extract from Section 19

19.15A The acquirer shall recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in accordance with Section 29 Income Tax.

Section 19 generally requires the acquiree's identifiable assets and liabilities and a provision for certain contingent liabilities (those that satisfy the recognition criteria) to be measured at their fair values at the acquisition date (see Chapter 22). However, as an exception to this general principle, Section 19 requires an acquirer to recognise deferred tax asset and liability arising from the acquisition applying the principles in Section 29.

As discussed above, Section 29 follows a 'timing differences' approach that is different from the 'temporary differences approach' applied under IFRS. As an exception an entity is required to recognise deferred taxes on the differences between the values recognised for assets (other than goodwill) and liabilities acquired in a business combination accounted for applying the purchase method and the amounts at which those assets and liabilities will be assessed for tax (i.e., tax base of the asset or liability). [FRS 102.29.11].

This exception requires entities to account for deferred tax arising in a business combination accounted for applying the purchase method using the 'temporary differences' approach of IAS 12.

The accounting for deferred taxes arising from business combinations is largely consistent with the guidance in IAS 12 except for recognition of deferred taxes on goodwill. Whilst IAS 12 explicitly prohibits only the recognition of a deferred tax liability relating to the initial recognition of goodwill, [IAS 12.15(a)], Section 29 prohibits the recognition of both a deferred tax liability and a deferred tax asset on initial recognition of goodwill arising in a business combination. [FRS 102.29.11]. Accordingly, in the (albeit rare) situation where goodwill is tax deductible and the deductible amount exceeds the value recognised in the financial statements, no asset would be recognised under FRS 102 whereas a deductible temporary difference may qualify for recognition as a deferred tax asset under IAS 12. Deferred tax recognised in a business combination is reflected in the measurement of goodwill and not taken to total comprehensive income or equity. [FRS 102.29.11].

FRS 102 defines tax base as the amount that for an asset can be deducted for tax or for a liability will be assessed for tax. Accordingly, as explained in IAS 12, the tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. IAS 12 further explains that if those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. [IAS 12.7]. The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods. [IAS 12.8].

As noted above, deferred tax recognised in a business combination is reflected in the measurement of goodwill. This requirement may lead to the creation of goodwill which, on a literal reading of Section 27 *Impairment of Assets*, would be required to be immediately impaired, as shown by Illustration 6-5 below.

Illustration 6-5: Apparent 'day one' impairment arising from recognition of deferred tax in a business combination

Entity A, which is taxed at 20%, acquires Entity B for £100m in a transaction that is a business combination. The fair values of the identifiable net assets of Entity B, and the amounts deductible for those net assets for tax purposes are as follows:

	Fair value £m	Tax deduction £m
Brand name	60	-
Other net assets	20	15
This will give rise to the following consolidation journal:		
	£m	£m
Goodwill (balance)	33	
Brand name	60	
Other net assets	20	
Deferred tax ¹		13
Cost of investment		100

1 20% of (£[60m + 20m] - £15m)

The fair value of the consolidated assets of the subsidiary (excluding deferred tax) and goodwill as presented in the financial statements is now £113m, but the cost of the subsidiary is only £100m. Clearly £13m of the goodwill arises solely from the recognition of deferred tax. However, Section 27, paragraph 18(b), explicitly requires tax to be excluded from the estimate of future cash flows used to calculate any impairment. This raises the question of whether there should not be an immediate impairment write-down of the assets to £100m. In our view, this cannot have been the intention of Section 27, as discussed in Chapter 29 at 4.8.3.

6.6.2 Determining the manner of recovery of assets and settlement of liabilities

In determining the tax base of an asset or a liability arising from a business combination, Section 29 requires an entity to consider the manner in which the entity expects to recover the relevant asset or settle the liability at the end of the reporting period. [FRS 102.29.11A].

The acquirer's assessment of the manner of recovery for the purposes of Section 29 may well differ from that of the acquired entity. For example, the acquired entity might have intended to recover an asset through use, whereas the acquirer intends to sell it.

How we see it

In our view, the requirement in Section 19 to recognise and measure deferred tax arising in a business combination in accordance with Section 29 has the effect that the expectations of the acquirer are used to determine the tax base of an item and the measurement of any deferred tax associated with the item.

See 7.4 below for further discussion regarding expected manner of recovery that will apply to the recognition of deferred taxes on assets and liabilities arising from business combinations.

6.6.2.A Changes in tax base consequent to the business combination

In some jurisdictions, a business combination may provide the opportunity to revise the tax base of an asset to an amount equal to the fair value assigned to it in accounting for the business combination. Most significantly, this may include the ability to create a tax base for an intangible asset or goodwill which may have had no tax base at all for the acquiree.

In some cases, the increase (as it generally is) in tax base may be more or less automatic. In others, the taxpayer may be required to make a formal claim or election for the increase to the tax authority. Sometimes further restructuring may be required - for example, it may be necessary for the business of the acquired entity to be transferred to another entity in the acquirer's group in the same tax jurisdiction.

An increase in a tax base that requires action by the relevant entity after the acquisition (such as making a claim or election or undertaking a restructuring) occurs after the business combination. However, some hold the view that the ability to increase a tax base following a business combination is a benefit that is taken into account by an informed buyer in negotiating the purchase price. Accordingly, it is argued, the increase is most appropriately reflected by adjusting the tax base of assets acquired as at the date of the business combination as if the increase had occurred at that date. This reduces any deferred tax liability and, therefore, reduces any goodwill (or increases any negative goodwill).

Those who support this view note that, if the increase in tax base is accounted for only when it legally occurs in the post-combination period, the net effect is to increase goodwill and reduce post-combination tax expense when in reality the entity may have done little more than fill in a form. It might also be difficult to sustain the higher carrying amount of goodwill arising from this treatment.

How we see it

We believe that it is generally appropriate to anticipate an increase to a tax base that legally occurs following a business combination in accounting for the business combination where the increase:

- Is automatic or requires only a notification to the tax authority.
 - Requires an application to the tax authority that is not normally refused for transactions of a comparable nature.
- Or
- Is contingent on some post-acquisition restructuring, where this can be done without substantial difficulty.

Conversely, we believe that it would not generally be appropriate to account for an increase in a tax base until it occurs where the increase:

- Relies on 'bespoke' tax planning that may be challenged by the tax authority.
 - Requires an application to the tax authority that in practice is frequently and successfully challenged for transactions of a comparable nature.
- Or
- Is contingent on some post-acquisition restructuring, where this will involve a substantial process, such as obtaining approval from regulators, unions, pension fund trustees etc.

6.6.3 Deferred tax assets arising on a business combination

Deferred tax assets that were previously not recognised by the acquirer or the acquiree, might arise in a business combination as discussed below.

6.6.3.A Assets of the acquirer

Section 29 does not provide specific guidance regarding the recognition of previously unrecognised deferred tax asset of the acquirer as a result of the business combination. However, IAS 12 provides further guidance that would be helpful when applying the requirements in Section 29.

Extract from IAS 12

- 67 As a result of a business combination, the probability of realising a pre-acquisition deferred tax asset of the acquirer could change. An acquirer may consider it probable that it will recover its own deferred tax asset that was not recognised before the business combination. For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree. Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. In such cases, the acquirer recognises a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination.

Therefore, when the acquiring entity is able to recognise a previously unrecognised tax asset of its own (e.g., unused tax losses), the recognition of the asset is accounted for as income in the period of the business combination, and not as part of the accounting for the business combination. Accordingly, the acquirer does not take it into account in measuring the goodwill or bargain purchase gain it recognises in the business combination. [IAS 12.67].

As noted in section 6.6.2.B below, an acquirer does not recognise the effect (positive or negative) relating to a target entity being acquired until the period in which the business combination is accounted for.

6.6.3.B Assets of the acquiree

It may be the case that deferred tax assets of an acquired entity do not meet the recognition criteria of Section 29 from the perspective of the acquired entity, but do meet the criteria from the perspective of the acquirer. Similar to above, Section 29 does not provide specific guidance regarding recognition of deferred tax assets that is previously not recognised by the acquiree. However, IAS 12 provides further guidance that would be helpful.

In such cases, the general principles of IAS 12 require the acquirer's perspective to be applied as at the date of the business combination. Accordingly, a deferred tax asset would be recognised, with a corresponding reduction in goodwill. [IAS 12.66].

The potential benefit of the acquiree's income tax loss carryforwards or other deferred tax assets may not satisfy the criteria for separate recognition when a business combination is initially accounted for but may be realised subsequently. Any changes in recognised deferred tax assets of an acquired entity are accounted for as follows:

- Acquired deferred tax benefits recognised within the measurement period (see Chapter 22 at 2.6) that result from new information about facts and circumstances that existed at the acquisition date are applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits are recognised in profit or loss.
- All other acquired deferred tax benefits realised are recognised in profit or loss (or outside profit or loss if IAS 12 so requires - see 8 below). [IAS 12.68].

6.6.4 Deferred tax liabilities of acquired entity

Neither Section 29 (nor IAS 12) provide specific guidance regarding the recognition of a deferred tax liability of an acquired entity after the date of the original combination. The recognition of such liabilities must therefore be accounted for in accordance with the general principles in Section 29 (i.e., in the period in which the liability arises), unless either:

- The recognition of the liability occurs within the provisional measurement period for the business combination and reflects new information about facts and circumstances that existed at the acquisition date, in which case the acquisition date value of the liability is retrospectively adjusted - see Chapter 22 at 2.6
- Or
- The failure to recognise the liability at the time of the combination was an error, in which case the provisions of Section 10 must be applied - see Chapter 9 at 3.6.

6.6.5 Acquisition of subsidiary not accounted for as a business combination

Occasionally, an entity may acquire a subsidiary which is accounted for as the acquisition of an asset rather than as a business combination. This will most often be the case where the subsidiary concerned is a 'single asset entity' holding a single item of property, plant and equipment which is not considered to comprise a business as defined in FRS 102 (see Chapter 22). Where an asset is acquired in such circumstances, the normal provisions of Section 29 apply. Accordingly, any difference between the cost of the asset and the amount (if any) that will be deductible for tax in respect of that asset is a permanent difference, and deferred tax must not be recognised.

6.6.6 Group reconstructions for which the merger accounting method is used

Section 19 requires all business combinations to be accounted for using the purchase method, except for group reconstructions and certain public benefit entity combinations that are a merger. [FRS 102.19.6].

These are accounted for using the merger accounting method under which the carrying values of the assets and liabilities of the parties to the combination are not required to be adjusted to fair value, although appropriate adjustments are required to be made to achieve uniformity of accounting policies in the combining entities. [FRS 102.19.29].

How we see it

In our view, this approach applies equally to any deferred tax assets and liabilities of the parties to the combination, such that carrying values would not be adjusted in a transaction accounted for using the merger accounting method other than any consequential adjustments as are necessary to align accounting policies of the combining entities.

6.7 'Tax-transparent' ('flow-through') entities

Certain entities are not taxed in their own right. Instead, the income of such entities is taxed in the hands of their owners as if it were income of the owners. An example might be a partnership which does not itself pay tax, but whose partners each pay tax on their share of the partnership's profits. Such entities are sometimes referred to as 'tax-transparent' or 'flow-through' entities. Generally, a tax transparent entity does not recognise tax paid by its owners in its financial statements.

The tax status of such an entity is of no particular relevance to the accounting treatment, in the investor's financial statements, of the current tax on the income of the entity. An investor in such an entity will determine whether the entity is a subsidiary, associate, joint arrangement, branch or a financial asset investment and account for it accordingly. The investor then accounts for its own current tax payable as it arises under the relevant tax legislation.

7 Deferred tax – Measurement

7.1 Legislation at the end of the reporting period

Extract from Section 29

29.12 An entity shall measure a deferred tax liability (asset) using the tax rates and laws that have been enacted or substantively enacted by the reporting date that are expected to apply to the reversal of the timing difference.

Like current tax, deferred tax must be measured by reference to the tax rates and laws that have been enacted or substantively enacted by the reporting date. *[FRS 102.29.12]*. 'Enacted or substantively enacted' for the purposes of deferred tax has the same meaning as for the purposes of calculating current tax, as discussed at 5.1 above. Similar to current tax deferred tax must not be discounted. *[FRS 102.29.17]*.

In measuring deferred tax assets and deferred tax liabilities, an entity is required to apply those enacted rates that are expected to apply to the reversal of the timing difference. *[FRS 102.29.12]*. As noted at 5.1 and 6.2.2.B above, the use of enacted rates is quite clear in the literature. In particular, no account must be taken of changes to tax rates and laws that are announced or enacted after the reporting date, even if they will be applied retrospectively or result in a deductible temporary difference ceasing to be recoverable. Section 32 identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. *[FRS 102.32.11(h)]*.

When different tax rates apply to different levels of taxable profit, deferred tax assets and liabilities are measured using the average enacted or substantively enacted rates that are expected to apply to the taxable profit (tax loss) of the periods in which the entity expects the deferred tax asset to be realised or the deferred tax liability to be settled. *[FRS 102.29.13]*.

7.1.1 Changes to tax rates and laws enacted before the reporting date

Deferred tax must be measured by reference to the tax rates and laws, as enacted or substantively enacted by the end of the reporting period. *[FRS 102.29.12]*. This requirement for substantive enactment is clear. Changes that have not been enacted by the end of the reporting period are ignored, but changes that are enacted before the reporting date must be applied, even in circumstances when legislation is substantively enacted shortly before the end of an annual or interim reporting period.

In cases where the effective date of any enacted changes is after the end of the reporting period, deferred tax must still be calculated by applying the new rates and laws to the timing differences that are expected to reverse in those later periods. *[FRS 102.29.12]*. When the effective date of any rate changes is not the first day of the entity's annual reporting period, deferred tax would be calculated by applying a blended rate to the taxable profits for each year.

Disclosures related to such changes in tax rates and laws required by Section 29 are discussed in 11.2 below.

7.1.2 Changes to tax rates and laws enacted after the reporting date

Section 32 identifies the enactment or announcement of a change in tax rates and laws after the end of the reporting period as an example of a non-adjusting event. *[FRS 102.32.11(h)]*. For example, an entity with a reporting period ending on 31 December issuing its financial statements on 20 April the following year would measure its deferred tax assets and liabilities by reference to tax rates and laws enacted or substantively enacted as at 31 December even if these had changed significantly before 20 April and even if those changes have retrospective effect. However, in these circumstances the entity would have to disclose the nature of those changes and provide an estimate of the financial effect of those changes if the impact is expected to be significant (see 11.2 below). *[FRS 102.32.10]*.

7.2 Revalued non-depreciable assets and investment property measured at fair value

Section 29 specifies the manner of recovery that must be applied by entities in two situations as follows:

- Deferred tax relating to a non-depreciable asset that is measured using the revaluation model in Section 17 must be measured using the tax rates and allowances that apply to the sale of the asset. [FRS 102.29.15].
And
- Deferred tax relating to investment property that is measured at fair value in accordance with Section 16 *Investment Property* must be measured using the tax rates and allowances that apply to the sale of the asset, except for investment property that has a limited useful life and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time. [FRS 102.29.16].

These provisions of Section 29 are derived from IAS 12, where they appear as an exception to a more general principle that measurement of deferred tax must have regard to the manner in which an entity expects to recover the asset, or settle the liability, to which the deferred tax relates. [IAS 12.51, IAS 12.51B, IAS 12.51C]. There is no such equivalent general principle expressed in Section 29, although it could be implied from the requirement that deferred tax is measured using the tax rates 'that are expected to apply to the reversal of the timing difference'. [FRS 102.29.12]. In measuring deferred tax arising on a business combination accounted for by applying the purchase method, an entity must consider the manner in which it expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities (see 6.6.1 above). [FRS 102.29.11A].

How we see it

Whilst this requirement applies only to the measurement of deferred tax arising on a business combination accounted for by applying the purchase method, in our view, its underlying principle must be applied more generally.

The concept of the 'manner of recovery' is discussed in more detail at 7.4 below.

7.3 'Prior year adjustments' of previously presented tax balances and expense (income)

The requirement to revise estimates of amounts recognised as deferred tax assets and liabilities at successive reporting dates is an inevitable consequence of the Standard and, in that respect, the normal requirements of Section 10 apply (see Chapter 9). As discussed in the context of current tax at 5.3 above, the nature of any revision to a previously stated deferred tax balance must be considered to determine whether the revision represents:

- A correction of a material prior period error (in which case it must be accounted for retrospectively, with a restatement of comparative amounts and, where applicable, the opening balance of assets, liabilities and equity at the start of the earliest period presented). [FRS 102.10.21].
Or
- A refinement in the current period of an estimate made in a previous period (in which case it must be accounted for in the current period). [FRS 102.10.17].

7.4 Expected manner of recovery of assets or settlement of liabilities

As noted at 7.2 above, Section 29 requires that in measuring deferred tax arising on a business combination accounted for by applying the purchase method, an entity must consider the manner in which it expects to recover or settle the carrying amount of its assets and liabilities. [FRS 102.29.11A].

How we see it

In our view the principle described above must be applied in measuring all deferred tax, in order to meet the requirement of Section 29 to measure deferred tax using the tax rates and laws that are 'expected' to apply to the reversal of the timing difference.

If a different rate or law would apply to the reversal of the difference depending on the manner of reversal (e.g., depreciation or sale), the expected manner of reversal is an essential input to the assessment of the expected applicable tax rate or law.

7.4.1 Tax planning strategies to reduce liabilities are not anticipated

As discussed at 6.2.2.A above, it may be appropriate for an entity to have regard to tax planning strategies in determining whether a deferred tax asset is recognised. Some believe that this must be extended and have argued that, where an entity has the ability and intention to undertake transactions in the future that will lead to its being taxed at a lower rate, it may take this into account in measuring deferred tax liabilities relating to timing differences that exist at the reporting date and will reverse in future periods when the lower rate is expected to apply.

How we see it

In our view, while tax planning opportunities may be relevant in assessing whether a deferred tax asset must be *recognised*, entities are not permitted to take into account future tax planning opportunities in relation to the measurement of deferred tax liabilities as at the reporting date, nor are entities allowed to anticipate future tax deductions that are expected to become available. Such opportunities do not impact on the *measurement* of deferred tax until the entity has undertaken them, or is at least irrevocably committed to doing so.

7.4.2 Assets and liabilities with more than one manner of recovery (settlement) ('dual-based' assets)

In the UK, and some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:

- The tax rate applicable when the entity recovers (settles) the carrying amount of the asset (or liability).
And
- The amount at which the asset or liability is recognised for tax purposes.

For example, in the UK, many types of building are not eligible for capital allowances while they are in use, but are deductible on sale for an amount equal to cost plus indexation allowance. Assets which are treated differently for tax purposes depending on whether their value is recovered through use or sale are commonly referred to as 'dual-based' assets.

In practice, however, many such assets are not realised wholly through use or wholly through sale, but are routinely acquired, used for part of their life and then sold before the end of that life. This is particularly the case with long-lived assets such as property. We set out below the approach which we believe must be adopted in assessing the manner of recovery of:

- Depreciable PP&E and intangible assets (see 7.3.2.A below).
- Non-depreciable PP&E and investment properties (see 7.3.2.B below).
And
- Other assets and liabilities (see 7.4.2.C below).

7.4.2.A Depreciable PP&E and intangible assets

Depreciable PP&E and investment properties that are rented to another group entity when the reporting entity chooses to use the cost model are accounted for in accordance with Section 17. Intangible assets are accounted for in accordance with Section 18 *Intangible Assets other than Goodwill*. Sections 17 and 18, which are discussed in detail in Chapters 20 and 21, require the carrying amount of a depreciable asset to be separated into a 'residual value' and a 'depreciable amount'.

'Residual value' is defined as:

"... the estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and condition expected at the end of its useful life"

and 'depreciable amount' as:

"... the cost of an asset, or other amount substituted for cost ... , less its residual value".

[FRS 102 Appendix I].

It is inherent in the definitions of 'residual value' and 'depreciable amount' that, in determining residual value, an entity is effectively asserting that it expects to recover the depreciable amount of an asset through use and its residual value through sale. If the entity does not expect to sell an asset, but to use and scrap it, then the residual value (i.e., the amount that would be obtained from sale) must be nil.

How we see it

Accordingly, we believe that, in determining the expected manner of recovery of an asset for the purposes of Section 29, an entity must assume that, in the case of an asset accounted for under Section 17 or Section 18, it will recover the residual value of the asset through sale and the depreciable amount through use.

Such an analysis is also consistent with the requirement of Section 10 to account for similar transactions consistently (see Chapter 9). This suggests that consistent assumptions must be used in determining both the residual value of an asset for the purposes of Section 17 or Section 18 and the expected manner of its recovery for the purposes of Section 29.

The effect of this treatment, in the context of a business combination, is as follows.

Illustration 7-1: Dual-based asset

As part of a business combination an entity purchases an opencast mine to which there is assigned a fair value of £10 million. The tax system of the jurisdiction where the mine is located provides that, if the site is sold (with or without the minerals *in situ*), £9 million will be allowed as a deduction in calculating the taxable profit on sale. The profit on sale of the land is taxed as a capital item. If the mine is exploited through excavation and sale of the minerals, no tax deduction is available.

The entity intends to fully exploit the mine and then to sell the site for retail development. Given the costs that any developer will need to incur in preparing the excavated site for development, the ultimate sales proceeds are expected to be £2 million. Thus, for the purposes of Section 17, the quarry is treated as having a depreciable amount of £8 million and a residual value of £2 million.

On the analysis above, there is a deferred tax liability arising from the temporary difference of £8 million associated with the depreciable amount of the asset (i.e. difference between the carrying amount of £8 million less tax base in use of nil), and a deferred tax asset arising from the temporary difference of £7 million associated with the residual value (i.e. difference between the carrying amount of £2 million less tax base on disposal of £9 million).

The entity will therefore provide for a deferred tax liability on the temporary difference of £8 million. The extent to which a deferred tax asset is recognised in respect of the temporary difference as described above will depend on whether it is probable that taxable profits will be available against which that deferred tax asset can be utilised (see 6.2 above). In some tax regimes, capital profits and losses are treated separately from revenue profits and losses to a greater or lesser degree, so that it may be difficult to recognise such an asset due to a lack of suitable taxable profits.

Historically, under IAS 12, there were alternative interpretations adopted in practice in substantially similar fact patterns that had resulted in diversity as a result. Some might have persuaded themselves that there is single net deferred tax liability based on the net book-tax difference of £1 million. However, in response to a request for guidance on a similar matter, the IFRS IC issued an agenda decision in April 2020 that would also be helpful to entities applying Section 29 since the underlying deferred tax treatment in the context of business combinations is aligned with IAS 12 (see 6.6 above). The agenda decision, described below²⁴³, supports the above analysis.

243 [IFRIC Update](#), April 2020, available on the IFRS Foundation's website.

Frequently asked questions

Question 7-1: How do you determine the tax base of an asset under IAS 12, when for tax purposes no deductions are available through use; but its cost is fully deductible when sold?

The IFRS IC was asked to consider an example in which an entity acquires an intangible asset with a finite useful life (a licence) as part of a business combination. The entity intends to recover the carrying amount of the licence through use, and the expected residual value of the licence at expiry is nil. Under the applicable tax law, two tax regimes are prescribed: an income tax regime and a capital gains tax regime. Any tax arising under each regime is not permitted to be offset in determining taxable profit. Tax paid under both regimes meets the definition of income taxes in IAS 12. Recovering the licence's carrying amount has both of the following tax consequences:

- Under the income tax regime - the entity pays income tax on the economic benefits it receives from recovering the licence's carrying amount through use, but receives no tax deductions in respect of amortisation of the licence (taxable economic benefits from use).
- Under the capital gains tax regime - the entity receives a tax deduction when the licence expires that is equal to its initial carrying value (capital gain deduction). The capital gain deduction cannot be used to offset the taxable economic benefits from use in determining taxable profits.

In reaching its conclusion, the IFRS IC cited the fundamental principle on which IAS 12 is based, that "an entity shall, with certain limited exceptions, recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences".

[IAS 12.10]. The IFRS IC determined that the entity must separately identify the temporary differences in a manner that reflects the distinct tax consequences under the two tax regimes of recovering the asset's carrying amount, by comparing:

- (a) The portion of the asset's carrying amount that will be recovered under one tax regime
To
- (b) The tax deductions the entity will receive under that same tax regime (which are reflected in the asset's tax base)

In the fact pattern described in the request, the IFRS IC concluded that the entity identifies both:

- (a) A taxable temporary difference under the income tax regime, reflecting the fact that it will receive no tax deductions as it recovers the asset through use
And
- (b) A deductible temporary difference under the capital gains tax regime, representing the deduction received upon expiry of the licence

The entity must then apply the requirements in IAS 12 considering the applicable tax law in recognising and measuring deferred tax for the identified temporary differences.

On this basis, the IFRS IC concluded that the principles and requirements in IAS 12 provide an adequate basis for an entity to recognise and measure deferred tax in the fact pattern described in the request and consequently decided not to add the matter to its standard-setting agenda.²⁴⁴

7.4.2.B Non-depreciable PP&E and investment properties at fair value

As noted at 7.2 above, Section 29 requires that where a non-depreciable asset, such as land, is accounted for using the revaluation model, any deferred tax on the revaluation must be calculated by reference to the tax consequences that would arise on sale of the asset. [FRS 102.29.15]. Section 29 also requires any deferred tax asset or liability associated with an investment property that is measured at fair value in accordance with Section 16 to be measured by reference to the tax consequences that would arise on sale of the asset, except when the investment property has a limited useful life and the entity's business model is to consume substantially all the economic benefits embodied in the investment property over time, in which case the deferred tax is measured using tax rates and allowances that apply when the carrying amount of the property is recovered through use. [FRS 102.29.16].

²⁴⁴ [IFRIC Update](#), April 2020, available on the IFRS Foundation's website.

7.4.2.C Other assets and liabilities

In a number of areas of accounting FRS 102 effectively requires a transaction to be accounted for in accordance with an assumption as to the ultimate settlement of that transaction that may not reflect the entity's expectation of the actual outcome.

For example, if the entity enters into a share-based payment transaction with an employee that gives the employee the right to require settlement in either shares or cash, Section 26 *Share-based Payment* requires the transaction to be accounted for on the assumption that it will be settled in cash, however unlikely this may be. Section 28 *Employee Benefits* may assert that an entity has a surplus on a defined benefit pension scheme on an accounting basis, when in reality it has a deficit on a funding basis. Similarly, if an entity issues a convertible bond that can also be settled in cash at the holder's option, Section 11 requires the bond to be accounted for on the assumption that it will be repaid, however probable it is that the holders will actually elect for conversion. It may well be that such transactions have different tax consequences depending on the expected manner of settlement, as illustrated in Illustration 7-2 below.

Illustration 7-2: Convertible bond deductible if settled

An entity, with functional currency of GBP, issues a convertible bond for £1 million. After three years, the holders can elect to receive £1.2 million or 100,000 shares of the entity. If the bond were settled in cash, the entity would receive a tax deduction for the £200,000 difference between its original issue proceeds and the amount payable on redemption. If the bond is converted, no tax deduction is available.

Under Section 11, the premium on redemption of the bond would be accreted as interest over the three-year issue period. Since tax relief on the interest is not given until the bond is settled, a deductible timing difference of £200,000 arises over the issue period. It is assumed that the deferred tax asset relating to this difference would meet the recognition criteria in Section 29 (see 6.2 above).

For various reasons, it is extremely unlikely that the bond will be redeemed in cash.

Illustration 7-2 raises the issue of whether any deferred tax asset must be recognised in respect of the £200,000 temporary difference.

One view would be that deferred tax must be recognised and measured based on management's actual expectation of the manner of recovery of the asset (or settlement of the liability) to which the deferred tax relates, even where this differs from the expectation inherent in the accounting treatment. The contrary view would be that deferred tax must be recognised and measured based on the expectation inherent in the accounting treatment of the manner of recovery of the asset (or settlement of the liability) to which the deferred tax relates, even where this differs from management's actual expectation.

How we see it

In our view, the treatment must be based on management's actual expectation. We see a difference between the analysis here and that relating to depreciable PP&E and intangible assets discussed at 7.4.2.A above. In the case of depreciable PP&E and intangibles, Sections 17 and 18 effectively require management to assess whether such assets will be realised through use or sale, and it therefore seems reasonable to use that same assessment for the purpose of measuring deferred tax under Section 29. In the case of the items discussed above, however, FRS 102 may require management to make assumptions that are directly contrary to its expectations, which therefore need not be used for the purposes of Section 29. Therefore, while the entity accretes interest on the bond, it assumes that no tax deduction will be available, because it is unlikely that the liability will be settled in cash.

7.4.3 Timing differences relating to subsidiaries, branches, associates and joint ventures

Such differences, and the special recognition criteria applied to them in Section 29, are discussed in more detail at 6.4 above.

Where deferred tax is recognised on such a timing difference, the question arises as to how it must be measured. Broadly speaking, investors can realise an investment in one of two ways – either indirectly (by remittance of retained earnings or capital) or directly (through sale of the investment). In many jurisdictions, the two means of realisation have very different tax consequences.

How we see it

In our view, the entity must apply the general principle (discussed above) that, where there is more than one method of recovering an investment, the entity must measure any associated deferred tax asset or liability by reference to the expected manner of recovery of the investment. In other words, to the extent that the investment is expected to be realised through sale, the deferred tax is measured according to the tax rules applicable on sale, but to the extent that the temporary difference is expected to be realised through a distribution of earnings or capital, the deferred tax is measured according to the tax rules applicable on distribution.

Where the expected manner of recovery is through distribution, there may be tax consequences for more than one entity in the group. For example, the paying company may be required to deduct a withholding tax on the dividend paid and the receiving company may suffer income tax on the dividend received. In such cases, provision must be made for the cumulative effect of all tax consequences. A withholding tax on an intragroup dividend is not accounted for in the consolidated financial statements as a withholding tax (i.e. within equity), but as a tax expense in profit or loss, since the group is not making a distribution but transferring assets from a group entity to a parent of that entity.

7.4.4 Change in expected manner of recovery of an asset or settlement of a liability

A change in the expected manner of recovery of an asset or settlement of a liability must be dealt with as an item of deferred tax income or expense for the period in which the change of expectation occurs, and recognised in profit or loss or in other comprehensive income or movements in equity for that period as appropriate (see 8 below).

This may have the effect, in certain situations, that some tax consequences of a disposal transaction are recognised before the transaction itself. For example, an entity might own an item of PP&E which has previously been held for use but which the entity now expects to sell.

How we see it

In our view, any deferred tax relating to that item of PP&E must be measured on a 'sale' rather than a 'use' basis from the point when the entity's expected manner of recovery changes, even though the disposal itself, and any related current tax, will not be accounted for until the disposal occurs.

7.5 UK indexation allowance

A UK company, in computing the taxable gain on the sale of an asset, may be allowed to increase the cost of the asset by an indexation allowance, depending on when it was acquired. The broad intention of this is to exclude purely inflationary gains from taxation. As noted at 6.5.3 above, on a strict interpretation of the definition of 'permanent difference', an indexation allowance is a permanent difference since it is effectively an item of expenditure that appears in taxable profit, but not in total comprehensive income.

How we see it

In our view, supported by long-standing practice under FRS 19 (under which the same issue of interpretation would have arisen), it is more appropriate to take account of the indexation allowance in measuring any deferred tax that would be expected to arise on the sale of an asset.

Furthermore, deferred tax at the reporting date must be computed based on the indexation that would be available if disposal were to occur at the balance sheet date. Possible increases in the allowance due to future inflation must not be assumed.

Under the UK tax regulations, the benefit of an indexation allowance can be taken only to the extent that it reduces a tax liability. It cannot be used to create or increase a tax loss. Therefore, a deferred tax asset must not be recognised in respect of an asset whose indexed cost for tax purposes is greater than its carrying amount.

7.6 Effectively tax-free entities

In the UK, and elsewhere, certain types of entity, typically investment vehicles, are exempt from corporate income tax provided that they fulfil certain criteria, which generally include a requirement to distribute all, or a minimum percentage, of their annual income as a dividend to investors. Examples in the UK include investment trusts and real estate investment trusts 'REITs'. This raises the question of how such entities must measure income taxes.

One view would be that such an entity has a liability to tax at the normal rate until the dividend for a year becomes a liability. The liability for a dividend for an accounting period typically arises after the end of that period. Under this analysis, therefore, such an entity would be required, at each period end, to record a liability for current tax at the standard corporate rate. That liability would be released in full when the dividend is recognised as a liability in the following period. This would mean that, on an ongoing basis, the income statement would show a current tax charge or credit comprising:

- A charge for a full liability for the current period.
- And
- A credit for the reversal of the corresponding liability for the prior period.

In addition, deferred tax would be recognised at the standard tax rate on all timing differences.

A second view would be that the provisions of Section 29 regarding different tax rates for distributed and undistributed tax rates are intended to apply where the only significant factor determining the differential tax rate is the retention or distribution of profit.

How we see it

On this view, the analysis would be that such an entity can choose to operate within one of two tax regimes (a 'full tax' regime or a 'no tax' regime), rather than that it operates in a single tax regime with a dual tax rate depending on whether profits are retained or distributed.

By contrast, the tax status of an investment fund typically depends on many more factors than whether profits are distributed, such as restrictions on its activities, the nature of its investments and other regulatory or listing requirements.

7.6.1 Subsidiaries of charitable entities

Arrangements whereby tax legislation grants an entity tax-exempt status must be distinguished from those situations where legislation provides allowances and reliefs that allow an entity to effectively extinguish its liability to corporation tax. For example, many charitable entities, including registered providers of social housing and higher education institutions, carry out trading activities through a non-charitable subsidiary. Profits from the subsidiary might be distributed to the parent charity in a tax-efficient manner as a donation which is eligible for corporation tax relief under the gift aid rules, provided it is made during the relevant reporting period or during the following nine months. [FRS 102.BC.B29.11]. Such entities that gift-aid 100% of their taxable profits within the required period can therefore achieve an effective tax rate of zero.

However, these are not tax-exempt entities and must therefore account for income taxes, and deferred tax, under Section 29, for the following reasons:

- Unlike the entities described at 7.6 above, there are no conditions as to the establishment and conduct of these trading subsidiaries over and above the simple requirement to make a gift-aid payment equal to the otherwise determined taxable profit.
- Such gift-aid payments have been determined in law to be distributions of profits, and therefore subject to the same restrictions that apply to the declaration and payment of dividends. An entity would be unable to distribute an amount equal to its taxable profits in any period (as determined under enacted tax laws) if the value of its distributable profits (as determined under accounting standards and the Companies Act) is lower.

For example, a subsidiary that has recognised a significant level of provisions would have to deduct those amounts from its measure of distributable profits, whilst for tax purposes such costs might not be deductible. Any shortfall between the gift-aid payment that it can legally make to its parent and the measure of its taxable profits would result in a corporation tax liability. That is, the subsidiary would have taxable profits and need to recognise a tax expense.

As it performed its triennial review of FRS 102, the FRC was made aware of significant differences in accounting treatment arising in practice in relation to the accounting for payments made, or expected to be made, by a subsidiary to its charitable parent that will qualify for gift aid (expected gift aid payments).

[FRS 102.BC.B29.10].

The general rule in Section 29 requires an entity to measure current and deferred taxes at the tax rate applicable to undistributed profits until it recognises a liability to pay a dividend (see 9.1.1 below). When the entity recognises a liability to pay a dividend, it recognises the resulting current or deferred tax liability (asset), and the related tax expense (income). [FRS 102.29.14]. However, FRS 102 contains an exception to this requirement when:

- (a) An entity is wholly-owned by one of more charitable entities.
- (b) It is probable that a gift aid payment will be made to a member of the same charitable group, or a charitable venturer, within nine months of the reporting date.

And

- (c) That payment will qualify to be set against profits for tax purposes.

If all of these conditions are satisfied, the income tax effects of that gift-aid payment are measured consistently with the tax treatment planned to be used in the entity's income tax filings. Consequently, a deferred tax liability is not recognised in relation to such a gift aid payment. [FRS 102.29.14A]. The footnote to paragraph 14A clarifies that in this context, 'charitable' refers to an entity that has been recognised by HMRC as being eligible for certain tax reliefs because of its charitable purposes.

8 Share-based payment transactions

The accounting treatment of share-based payment transactions, some knowledge of which is required to understand the discussion below, is dealt with in Chapter 28.

In the UK, and many other jurisdictions, an entity receives a tax deduction in respect of remuneration paid in shares, share options or other equity instruments of the entity. The amount of any tax deduction may differ from the related remuneration expense, and may arise in a later accounting period. For example, in the UK, an entity recognises an expense for employee services in accordance with Section 26 (based on the fair value of the award at the date of grant), but does not receive a tax deduction until the award is exercised (in the case of options) or vests (in the case of free shares). The tax deduction is for the fair value of the award at the date of vesting or exercise (as the case may be), which will be equal to the intrinsic value at that date.

Under Section 29, any tax deduction received in excess of the amount recognised as an expense under Section 26 gives rise to a permanent difference which is recognised as current tax when it is received. However, recognition of the Section 26 expense in advance of the tax deduction being received to the extent of that expense gives rise to timing differences, on which a deferred tax asset must be recognised (subject to the general restrictions discussed at 6.2 above).

Section 29 does not prescribe how these timing differences must be calculated. As the tax relief will ultimately be given for the intrinsic value of the award, this forms a reasonable basis for computing the timing difference, which has generally been followed in practice under UK GAAP. However, practice varies as to whether the timing difference is computed as:

- The lower of (a) the total expected tax deduction based on the intrinsic value at the reporting date and (b) the cumulative share-based payment expense (Approach 1).
- Or
- The lower of (a) the cumulative share-based payment expense and (b) the total expected tax deduction based on the intrinsic value at the reporting date, multiplied by the expired portion of the vesting period at that date (Approach 2).

Where the intrinsic value of the award is equal to, or more than, the grant date fair value used in applying Section 26, the two approaches have the same effect. However, where the intrinsic value falls below the grant date fair value, the two approaches give rise to a different result, as shown in Illustration 8-1 below.

Illustration 7-3: Timing differences on share-based payment transactions

On 1 January 20X5, an entity with a reporting date of 31 December makes an award of free shares to an employee with a grant date fair value of £300,000. The vesting period is three years. In applying Section 26, it is assumed throughout the vesting period that the award will vest in full. The award actually vests, and is fully deducted for tax in the year of vesting at its intrinsic value on vesting date.

The expense recognised under Section 26 would therefore be as follows:

Year ending	Expense for period	Cumulative expense
	£	£
31 December 20X5	100,000	100,000
31 December 20X6	100,000	200,000
31 December 20X7	100,000	300,000

The intrinsic value of the award at each reporting date is as follows:

	£
31 December 20X5	270,000
31 December 20X6	290,400
31 December 20X7	320,000

Under Approach 1 above, the timing difference would be calculated as the lower of (a) the total intrinsic value at the reporting date and (b) the cumulative share-based payment expense.

Year ending	Total intrinsic value	Cumulative expense	Timing difference
	<i>a</i>	<i>b</i>	<i>Lower of a and b</i>
	£	£	£
31 December 20X5	270,000	100,000	100,000
31 December 20X6	290,400	200,000	200,000
31 December 20X7	320,000	300,000	N/A ¹

1 The award vests at this point so that any tax relief is recognised as current tax.

Under Approach 2 above, the timing difference would be calculated as the lower of (a) the cumulative share-based payment expense and (b) the total intrinsic value, multiplied by the expired portion of the vesting period at that date.

Year ending	Total intrinsic value	Pro-rated intrinsic value	Cumulative expense	
	<i>a</i>	<i>b</i>	<i>c</i>	<i>Lower of b and c</i>
	£	£	£	£
31 December 20X5	270,000	90,000	100,000	90,000
31 December 20X6	290,400	193,600	200,000	193,600
31 December 20X7	320,000	320,000	300,000	N/A ¹

1 The award vests at this point so that any tax relief is recognised as current tax.

How we see it

In our view, either approach is acceptable provided that it is applied consistently.

8.1 Allocation of tax deduction between profit or loss and equity

As discussed above, under Section 29, any tax deduction received in excess of the amount recognised as an expense under Section 26 gives rise to a permanent difference therefore, deferred tax is not recognised. However, current tax on the excess deduction is recognised when the deduction is received. Section 29 does not provide specific guidance regarding where current tax related to the excess deduction must be recognised besides requiring an entity to present tax expense and income in the same component of total comprehensive income or equity as the transaction or other event that resulted in the tax expense or income. Consequently, an entity might regard the tax as relating to the share-based payment expense and recognise such current tax in profit or loss.

IAS 12, however, specifically clarifies that where the amount of any tax deduction exceeds the amount of the related cumulative remuneration expense, the tax associated with the excess must be recognised directly in equity. IAS 12 explains that the excess tax deduction 'indicates that the tax deduction relates not only to remuneration expense but also to an equity item.' [IAS 12.68C]. Accordingly, an entity applying FRS 102 could consider the following two approaches to recognise current tax related to the excess deduction as described below:

- All taxes on share-based payments transactions including tax related to excess deductions is recognised in profit or loss.
- Or
- All taxes on share-based payment transaction are recognised in the profit or loss with the exception of tax related to excess deductions that is recognised in the statement of changes in equity.

How we see it

In our view, either approach is acceptable provided that it is applied consistently.

9 Allocation of tax charge or credit

Section 29 requires an entity to present changes in current tax and deferred tax as tax income or tax expense, except for those changes that arise on the initial recognition of a business combination accounted for by applying the purchase method, which is taken into account in the determination of goodwill or negative goodwill (see 6.6 above). [FRS 102.29.21].

Section 29 also requires an entity to present tax expense (or tax income) in the same component of comprehensive income (i.e. continuing or discontinued operations, and in profit or loss or in other comprehensive income) or equity as the transaction or other event that resulted in the tax expense (or tax income). [FRS 102.29.22]. This would be the case even in instances where the transaction or other event that results in a tax impact occurred in a different period in the past.

The approach described above is consistent with IAS 12. This requirement to have regard to the previous history of a transaction in accounting for its tax effects is commonly referred to as 'backward tracing'. However, an entity must present the tax income or tax expense effects of distributions to owners in profit or loss. [FRS 102.29.22A].

Except as stated above in relation to distributions to owners, Section 29 does not consider profit or loss as a default statement to recognise tax impact. Section 29 does not explicitly require tax that is not directly related to a particular component of total comprehensive income or equity to be recognised in profit or loss.

9.1 Dividends and transaction costs of equity instruments

9.1.1 Dividend subject to differential tax rate

In some jurisdictions, the rate at which tax is paid depends on whether profits are distributed or retained. In other jurisdictions, distribution may lead to an additional liability to tax, or a refund of tax already paid. Section 29 requires current and deferred taxes to be measured using the rate applicable to undistributed profits until a liability to pay a dividend is recognised, at which point the tax consequences of that dividend must also be recognised. [FRS 102.29.14]. This is discussed further at 8 above.

Where taxes are remeasured on recognition of a liability to pay a dividend, the difference must normally be recognised in profit or loss rather than directly in equity, even though the dividend itself is recognised directly in equity under FRS 102. Section 29 implicitly takes the view that any additional (or lower) tax liability relates to the original profit now being distributed rather than to the distribution itself. Where, however, the dividend is paid out of profit arising from a transaction that was originally recognised in other comprehensive income or equity, the adjustment to the tax liability must also be recognised in other comprehensive income or equity.

9.1.2 Dividends subject to withholding tax

When an entity pays dividends to its shareholders, it may be required to pay a portion of the dividends to taxation authorities on behalf of shareholders. Where dividends are paid by the reporting entity subject to withholding tax, such withholding tax must be included as part of the dividend deducted from equity. Other taxes, such as attributable tax credits, must be excluded from the amount recorded as a dividend.

[FRS 102.29.18].

Incoming dividends and similar income receivable are recognised at an amount that includes any withholding tax but excludes other taxes, such as attributable tax credits. Any withholding tax suffered is shown as part of the tax charge. [FRS 102.29.19].

9.1.2.A Distinction between a withholding tax and a differential rate for distributed profits

The provisions of Section 29, described above, may prove somewhat problematic in practice. There may be little economic difference, from the paying entity's perspective, between a requirement to pay a 5% 'withholding tax' on all dividends and a requirement to pay an additional 5% 'income tax' on distributed profit. Yet, the accounting treatment varies significantly depending on the analysis. If the tax is considered a withholding tax, it is treated as a deduction from equity in all circumstances. If, however, it is considered as an additional income tax, it will generally be treated as a charge to profit or loss (see 9.1.1 above).

9.1.2.B Intragroup dividend subject to withholding tax

Where irrecoverable withholding tax is suffered on intragroup dividends, the withholding tax does not relate to an item recognised in equity in the consolidated financial statements (since the intragroup dividend to which it relates has been eliminated in those financial statements). The tax must therefore be accounted for in profit or loss for the period.

9.2 Gain/loss in profit or loss and loss/gain outside profit or loss offset for tax purposes

It often happens that a gain or loss accounted for in profit or loss can be offset for tax purposes against a gain or loss accounted for in other comprehensive income (or an increase or decrease in equity). This raises the question of how the tax effects of such transactions must be accounted for, as shown in Illustration 9-1 below.

Illustration 9-1: Loss in other comprehensive income and gain in profit or loss offset for tax purposes

During the year ended 31 December 20X5, an entity that pays tax at 20% makes a taxable profit of £50,000 comprising:

- £80,000 trading profit less finance costs accounted for in profit or loss.
- And
- £30,000 foreign exchange losses accounted for in other comprehensive income ('OCI').

Should the total tax liability of £10,000 (20% of £50,000) be presented as either:

(a) A charge of £10,000 in profit or loss.

Or

(b) A charge of £16,000 (20% of £80,000) in profit or loss and a credit of £6,000 (20% of £30,000) in other comprehensive income?

How we see it

In our view, (b) is the appropriate treatment, since the amount accounted for in other comprehensive income represents the difference between the tax that would have been paid absent the exchange loss accounted for in other comprehensive income and the amount actually payable. This indicates that this is the amount of tax that, in the words of paragraph 22 of Section 29, 'resulted' from items that are recognised in other comprehensive income.

Similar issues may arise where a transaction accounted for outside profit or loss generates a suitable taxable profit that allows recognition of a previously unrecognised tax asset relating to a transaction previously accounted for in profit or loss, as shown in Illustration 9-2 below.

Illustration 9-2: Recognition of deferred tax asset in profit or loss on the basis of tax liability accounted for outside profit or loss

An entity that pays tax at 20% has brought forward unrecognised deferred tax assets (with an indefinite life) totalling £1 million, relating to trading losses accounted for in profit or loss in prior periods. On 1 January 20X5 it invests £100,000 in government bonds, which it holds until they are redeemed for the same amount on maturity on 31 December 20X8. For tax purposes, any taxable income arising from revaluation of the bonds can be offset against the brought forward tax losses.

Where an entity elects to account for the bonds as available-for-sale applying the requirements in IAS 39 it carries the bonds at fair value (see Chapter 13). Over the period to maturity the fair value of the bonds at the end of each reporting period (31 December) is as follows:

	£
20X5	110,000
20X6	115,000
20X7	120,000
20X8	100,000

Movements in value would be accounted for in other comprehensive income ('OCI'). Taken in isolation, the valuation gains in 20X5 to 20X7 would give rise to current tax liabilities (at 20%) of £2,000 (20X5), £1,000 (20X6) and £1,000 (20X7). However, these liabilities can be offset against the losses brought forward. This raises the question as to whether there should be either:

- (a) No tax charge or credit in either profit or loss or other comprehensive income in any of the periods affected.
- Or
- (b) In each period, a current tax charge in other comprehensive income (in respect of the taxable income arising from valuation gains on the bonds) and current tax income in profit or loss (representing the recognition of the previously unrecognised deferred tax asset).

How we see it

In our view, the treatment in (b) must be followed. Although the previously unrecognised deferred tax asset can only be recovered as the result of the recognition of a current tax liability arising from a transaction accounted for in other comprehensive income, the previously unrecognised asset relates to a trading loss previously recorded in profit or loss. Accordingly, the current tax credit arising from the recognition of the asset is properly accounted for in profit or loss.

9.3 Discontinued operations

As noted above, Section 29 requires tax income and tax expense to be allocated between continuing and discontinued operations. Some of the practical issues raised by this requirement are shown in illustrations 9-3 to 9-5 below.

Illustration 9-3: Profit in continuing operations and loss in discontinued operations offset for tax purposes

Entity A, which pays tax at 25%, has identified an operation as discontinued for the purposes of Section 5. During the period the discontinued operation incurred a loss of £2 million and the continuing operations made a profit of £10 million. The net £8 million profit is fully taxable in the period, and there is no deferred tax income or expense. In our view, the tax expense must be allocated as follows:

	£m	£m
Dr. Current tax expense (continuing operations) ¹	2.5	
Cr. Current tax income (discontinued operation) ²		0.5
Cr. Current tax liability ³		2.0

- 1 Continuing operations profit £10m @ 25% = £2.5m
- 2 Discontinued operations loss £2m @ 25% = £0.5m.
- 3 Net taxable profit £8m @ 25% = £2.0m

The tax allocated to the discontinued operation represents the difference between the tax that would have been paid absent the loss accounted for in discontinued operations and the amount actually payable.

Illustration 9-4: Taxable profit on disposal of discontinued operation reduced by previously unrecognised tax losses

Entity B disposes of a discontinued operation during the current accounting period. The disposal gives rise to a charge to tax of £4 million. However, this is reduced to zero by offset against brought forward tax losses, which relate to the continuing operations of the entity, and for which no deferred tax asset has previously been recognised.

In our view, even though there is no overall tax expense, this must be reflected for financial reporting purposes as follows:

	£m	£m
Dr. Current tax expense (discontinued operation)	4.0	
Cr. Current tax income (continuing operations)		4.0

This allocation reflects that fact that, although the transaction that allows recognition of the brought forward tax losses is accounted for as a discontinued operation, the losses themselves arose from continuing operations. This is essentially the same analysis as is used in Illustration 9-2 above (where a current tax liability recognised in other comprehensive income gives rise to an equal deferred tax asset recognised in profit or loss).

Illustration 9-5: Taxable profit on disposal of discontinued operation reduced by previously recognised tax losses

Entity B disposes of a discontinued operation during the current accounting period. The disposal gives rise to a charge to tax of £4 million. However, this is reduced to zero by offset against brought forward tax losses, which relate to the entity's continuing operations, and for which a deferred tax asset has previously been recognised.

In our view, even though there is no overall tax expense, this must be reflected for financial reporting purposes as follows:

	£m	£m
Dr. Current tax expense (discontinued operation)	4.0	
Dr. Deferred tax expense (continuing operations)	4.0	
Cr. Current tax income (continuing operations)		4.0
Cr. Deferred tax asset (statement of financial position)		4.0

This allocation reflects that fact that, although the transaction that allows recognition of the brought forward tax losses is accounted for as a discontinued operation, the losses themselves arose from continuing operations. This is essentially the same analysis as is used in Illustration 9-3 above.

9.4 Defined benefit pension plans

Section 28 requires an entity, in accounting for a defined benefit post-employment benefit plan, to recognise actuarial gains and losses relating to the plan in full in other comprehensive income ('OCI'). At the same time, a calculated current (and, where applicable, past) service cost and finance income and expense relating to the plan assets and liabilities are recognised in profit or loss – see Chapter 30.

In the UK, and many other jurisdictions, tax deductions for post-employment benefits are given on the basis of cash contributions paid to the plan fund (or benefits paid when a plan is unfunded).

This significant difference between the way in which defined benefit plans are treated for tax and financial reporting purposes can make the allocation of tax deductions for them between profit or loss and OCI somewhat arbitrary, as shown in Illustration 9-6 below.

Illustration 9-6: Tax deductions for defined benefit pension plans

At 1 January 20X5 an entity that pays tax at 20% has a fully-funded defined benefit pension scheme. During the year ended 31 December 20X5 it records a total cost of £1 million, of which £800,000 is allocated to profit or loss and £200,000 to other comprehensive income ('OCI'). In January 20X6 it makes a funding payment of £400,000, a tax deduction for which is received through the current tax charge for the year ended 31 December 20X5.

Assuming that the entity is able to recognise a deferred tax asset for the entire £1 million charged in 20X5, it will record the following entry for income taxes in 20X5.

	£	£
Dr. Deferred tax asset [£1,000,000 @ 20%]	200,000	
Cr. Deferred tax income (profit or loss) [£800,000 @ 20%]		160,000
Cr. Deferred tax income (OCI) [£200,000 @ 20%]		40,000

When the funding payment is made in January 20X6, the accounting deficit on the fund is reduced by £400,000. This gives rise to a current tax deduction of £80,000 (£400,000 @ 20%), in relation to the contribution paid to the pension scheme, and a deferred tax expense of £80,000 in respect of the reversal of the temporary difference arising as some of the deferred tax asset as at 31 December 20X5 is released. The difficulty is how to allocate this movement in the deferred tax asset between profit or loss and OCI, as it is ultimately a matter of arbitrary allocation as to whether the funding payment is regarded as making good (for example):

- £400,000 of the £800,000 deficit previously accounted for in profit or loss.
- The whole of the £200,000 of the deficit previously accounted for in OCI and £200,000 of the £800,000 deficit previously accounted for in profit or loss.

Or

- A pro-rata share of those parts of the total deficit accounted for in profit or loss and OCI.

In the example above, the split is of relatively minor significance, since the entity was able to recognise 100% of the potential deferred tax asset associated with the pension liability. This means that, as the scheme is funded, there will be an equal and opposite amount of current tax income and deferred tax expense. The only real issue is therefore one of presentation, namely whether the gross items comprising this net nil charge are disclosed within the tax charge in profit or loss or in OCI.

In other cases, however, there might be an amount of net tax income or expense that needs to be allocated. Suppose that, as above, the entity recorded a pension cost of £1 million in 20X5 but determined that the related deferred tax asset did not meet the criteria for recognition under Section 29. In 20X6, the entity determines that an asset of £50,000 can be recognised in view of the funding payments and taxable profits anticipated in 20X6 and later years. This results in a total tax credit of £130,000 (£80,000 current tax, £50,000 deferred tax) in 20X6, raising the question of whether it must be allocated to profit or loss, to OCI, or allocated on a pro-rata basis. This question might also arise if, as the result of newly enacted tax rates, the existing deferred tax balance were required to be remeasured.

How we see it

In our view, any reasonable method of allocation may be used, provided that it is applied on a consistent basis.

One approach might be to compare the funding payments made to the scheme in the previous few years with the charges made to profit or loss under Section 28 in those periods. If, for example, it is found that the payments were equal to or greater than the charges to profit or loss, it might reasonably be concluded that the funding payments have 'covered' the charge recognised in profit or loss, so that any surplus or deficit on the statement of financial position is broadly represented by items that have been accounted for in OCI.

However, a surplus may also arise from funding the scheme to an amount greater than the liability recognised under Section 28 (for example under a minimum funding requirement imposed by local legislation or agreed with the pension fund trustees). In this case, the asset does not result from previously recognised income but from a reduction in another asset (i.e. cash). The entity must assess the expected manner of recovery of any asset implied by the accounting treatment of the surplus - i.e. whether it has been recognised on the basis that it will be 'consumed' (resulting in an accounting expense) or refunded to the entity in due course.

Where it is concluded that the asset will be 'consumed' (resulting in accounting expense), the entity will need to determine whether such an expense is likely to be recognised in profit or loss or in OCI in a future period.

9.5 Change in tax status of entity or shareholders

Sometimes there is a change in an entity's tax assets and liabilities as a result of a change in the tax status of the entity itself or that of its shareholders, for example an entity becoming a REIT. Section 29 does not address how the impact of such change in tax status must be reflected. However, SIC 25 specifies that the effect of such a change must be recognised in profit or loss for the period except to the extent that it involves a remeasurement of tax originally accounted for in other comprehensive income or in equity, in which case the change must also be dealt with in, respectively, other comprehensive income or equity.

[SIC-25.4].

10 Offset of taxable profits and losses within groups

10.1 Transfer of tax losses within groups

In the UK, it is possible for one member of a group to transfer tax losses to one or more other members of the group in order to reduce their tax liabilities. In some groups a company whose tax liability is reduced by such an arrangement may be required, as a matter of group policy, to make a payment to the member of the group that transfers losses to it. In other groups no such charge is made.

The transfer of any tax losses in this way raises the question of the appropriate accounting treatment in the separate financial statements of the group entities involved. In particular, should the company receiving the tax losses simply reflect a reduction in their tax expense/increase in tax income equal to the amount mitigated as a result of the transfer or should the benefit be reflected as a capital contribution (when the losses are transferred by a parent or fellow subsidiary) or as other income akin to a dividend (when transferred by a subsidiary)?

How we see it

Section 29 is silent on this issue and, in our view, no single approach can be said to either be prohibited or required. However, there is a long-standing practice by many companies in the UK for the company receiving such tax losses to present the benefit as a reduction in their tax expense/increase in tax income, rather than as a capital contribution or other income akin to a dividend.

In the context of payments made by subsidiaries of charitable entities in the UK under the gift aid regime, specific requirements are discussed at 7.6.1 above.

10.2 Payments for intragroup transfer of tax losses

Where one member of a group transfers tax losses to another member of the group, the entity whose tax liability is reduced may be required, as matter of group policy, to pay an amount of compensation to the member of the group that transferred to it the losses. Such payments are referred to in the discussion below as 'group relief payments'.

Group relief payments are generally made in an amount equal to the tax saved by the paying company. In some cases, however, payment may be made in an amount equal to the nominal amount of the tax loss, which will be greater than the amount of tax saved. This raises the question of how such payments must be accounted for.

The first issue is whether such payments should be recognised wholly or partly:

- In total comprehensive income.
And/or
- As a distribution (e.g. in the case of a payment from a subsidiary to a parent) or a capital contribution (e.g., in the case of a payment from a parent to a subsidiary).

The second issue is, to the extent that the payments are accounted for in total comprehensive income, whether, and/or the extent to which, they must be classified as:

- Income tax, allocated between profit or loss, other comprehensive income or equity (see 9 above). The argument for this treatment is that the payments made or received are amounts that would otherwise be paid to or received from (or offset against an amount paid to) a tax authority.
Or
- Operating income or expense in profit or loss (for example on the grounds that, as a matter of fact, the payments are not made to or received from any tax authority).

How we see it

Section 29 is silent on this issue and, in our view, no single approach can be said to either be prohibited or required. However, there is a long-standing practice by many companies in the UK that to the extent such payments do not exceed the amount of tax that would otherwise have been paid by the paying company they are treated as if they were income taxes. Where a group relief payment is made in excess of this amount, we consider that it is more appropriate to account for the excess not as an income tax but as either:

- A distribution or capital contribution (as applicable).
- Or
- Operating income or expense (as applicable).

The chosen treatment must be applied consistently.

The Guidance on Realised and Distributable Profits under the Companies Act 2006 (TECH 02.17BL) indicates the acquisition or surrender of tax losses (group relief) for a non-arms-length sum (such as paying a parent or fellow subsidiary more than the tax relief that will be obtained) may, as a matter of law, involve a distribution. Therefore, companies must be cautious when making such transfers, especially those with a deficit of distributable profits.

11 Presentation

In addition to meeting any requirements specified in FRS 102 discussed below, entities preparing statutory accounts must also comply with relevant legislation in the UK or Ireland, as appropriate.

For entities incorporated in the UK, these regulations are principally The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (Regulations). The Regulations establish prescribed formats for the statutory accounts and include the option to apply 'adapted formats' which are similar but not identical to formats included in IAS 1 *Presentation of Financial Statements*.

Companies subject to the small companies regime are entitled to apply The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (Small Companies Regulations). Micro-entities are entitled to apply The Small Companies (Micro Entities' Accounts) Regulations 2013 (Micro-entity Regulations).

The requirements under the UK Companies Act for statutory accounts and reports are discussed in Chapter 6 at 3. The presentation requirements for financial statements prepared under FRS 102 are explained in Chapter 6, with the application of 'adapted formats' discussed in Chapter 6 at 4.1.

11.1 Statement of financial position

Section 29 requires deferred tax liabilities to be included within provisions for liabilities and deferred tax assets to be included within debtors when an entity applies statutory formats to present its statement of financial position. [FRS 102.29.23]. Where an entity applies the adapted formats permitted under the UK Companies Act (see Chapter 6 at 4.1), deferred tax assets and liabilities must be shown as separate line items on the face of the statement of financial position, but classified as non-current. [FRS 102.4.2A(p)].

When the statutory formats are applied, deferred tax assets are included within current assets, even if due after more than one year. However, where the amount of debtors due after more than one year is so material in the context of net current assets that in the absence of disclosure of the debtors due after more than one year on the face of the statement of financial position readers may misinterpret the financial statements, FRS 102 requires the amount to be disclosed on the face of the statement of financial position, but still within current assets. [FRS 102.4.4A].

As noted in Chapter 6 at 4.1.12, certain of the statutory disclosures in the Regulations may cause particular complexity when deferred tax is included as a line item within provisions. In particular, UK companies preparing Companies Act accounts must state the provision for deferred tax separately from any other tax provisions and reconcile movements in deferred tax (as it is a line item under provisions). [1 Sch 59-60].

How we see it

In our view, the reconciliation of movements in deferred tax is also required where 'adapted formats' (as well as statutory formats) are used, even though deferred tax is not shown as a provision in the balance sheet.

Section 29 does not explicitly require separate disclosure of the current tax creditor on the face of the statement of financial position and, as discussed in Chapter 6 at 4.3.8.G, note (9) to the balance sheet statutory formats in Schedule 1 to the Regulations would require current tax to be disclosed within the line item for 'Other creditors, including taxation and social security'. However, where an entity applies the 'adapted formats' permitted under the UK Companies Act, current tax assets and current tax liabilities must be shown as separate line items on the face of the statement of financial position, and classified appropriately as current and/or non-current. [FRS 102.4.2A(o)].

11.1.1 Offset

11.1.1.A Current tax

Current tax assets and liabilities must be offset if, and only if, the entity:

- Has a legally enforceable right to set off the amounts.
- And
- Intends either to settle them net or simultaneously. [FRS 102.29.24].

11.1.1.B Deferred tax

Deferred tax assets and liabilities must be offset if, and only if:

- The entity has a legally enforceable right to set off current tax assets and liabilities.
And
- The deferred tax assets and liabilities concerned relate to income taxes raised by the same taxation authority on either:
 - The same taxable entity.
Or
 - Different taxable entities which intend to settle their current tax assets and liabilities either on a net basis or simultaneously, in each future period in which significant amounts of deferred tax are expected to be settled or recovered. [FRS 102.29.24A].

The offset criteria for deferred tax are less clear than those for current tax. The position is broadly that, where in a particular jurisdiction current tax assets and liabilities relating to future periods will be offset, deferred tax assets and liabilities relating to that jurisdiction and those periods must be offset (even if the deferred tax balances actually recognised in the statement of financial position would not satisfy the criteria for the offset of current tax).

IAS 12 (from which these requirements are derived) suggests that this slightly more pragmatic approach was adopted in order to avoid the detailed scheduling of the reversal of temporary differences that would be necessary to apply the same criteria as for current tax. However, IAS 12 notes that, in rare circumstances, an entity may have a legally enforceable right of set-off, and an intention to settle net, for some periods but not for others. In such circumstances, detailed scheduling may be required to determine the extent of permitted offset.

11.1.1.C Offset of current and deferred tax

Section 29 contains no provisions allowing or requiring the offset of current tax and deferred tax. Accordingly, in our view, given the general restrictions on offset in Section 2 *Concepts and Pervasive Principles* (see Chapter 4) current and deferred tax may not be offset against each other and must always be presented gross.

11.2 Statement of comprehensive income

As discussed at 9 above, except for tax relating to distributions to owners that are accounted in profit or loss, Section 29 requires an entity to present tax expense (or tax income) in the same component of comprehensive income (i.e., continuing or discontinued operations, and in profit or loss or in other comprehensive income) or equity as the transaction or other event that resulted in the tax expense (or tax income). [FRS 102.29.22].

An entity must also disclose on the face of the income statement (or statement of comprehensive income if presented) an amount comprising the total of the post-tax profit or loss of discontinued operations and the post-tax gain or loss attributable to the impairment or on the disposal of the assets or disposal group(s) constituting discontinued operations. [FRS 102.5.7E].

The results of equity-accounted entities must be presented on a post-tax basis. [FRS 102.14.8].

11.3 Statement of cash flows

Cash flows arising from taxes on income are separately disclosed and classified as cash flows from operating activities, unless they can be specifically identified with financing and investing activities. Where tax cash flows are allocated over more than one class of activity, the total amount of taxes paid must be disclosed. [FRS 102.7.17].

12 Disclosure

Section 29 requires an entity to disclose information that enables users of its financial statements to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events. [FRS 102.29.25]. Disclosure requirements are summarised below.

12.1 Components of tax expense

The major components of tax expense (or income) must be disclosed separately. These may include: [FRS 102.29.26]

- (a) Current tax expense (or income)
- (b) Any adjustments recognised in the period for current tax of prior periods
- (c) The amount of deferred tax expense (or income) relating to the origination and reversal of timing differences
- (d) The amount of deferred tax expense (or income) relating to changes in tax rates or the imposition of new taxes
- (e) Adjustments to deferred tax expense (or income) arising from a change in the tax status of the entity or its shareholders
- (f) The amount of tax expense (or income) relating to changes in accounting policies and errors (see Chapter 9 at 3.6)

And

- (g) Current tax expense (income) relating to Pillar Two income tax

12.2 International tax reform-Pillar Two model rules

See 3.7.3.C and 3.7.3.D above for the disclosure requirements related to Pillar Two Income Taxes.

12.3 Other disclosures required by FRS 102

The following must also be disclosed separately: [FRS 102.29.27]

- (a) The aggregate current and deferred tax relating to items that are recognised as items of other comprehensive income or equity.
- (b) A reconciliation between the tax expense (income) included in profit or loss and the profit or loss on ordinary activities multiplied by the applicable tax rate.
- (c) The amount of the net reversal of deferred tax assets and deferred tax liabilities expected to occur during the year beginning after the reporting period together with a brief explanation for the expected reversal.
- (d) An explanation of changes in the applicable tax rate(s) compared with the previous reporting period.
- (e) The amount of deferred tax liabilities and deferred tax assets at the end of the reporting period for each type of timing difference.
- (f) The amount of unused tax losses and tax credits and the expiry date, if any, of timing differences, unused tax losses and unused tax credits.

And

- (h) Where different tax rates apply to retained and distributed profits (see 8 above), an explanation of the nature of the potential income tax consequences that would result from the payment of dividends to shareholders.

The requirement at (c) above is noteworthy in that it is not required by IAS 12. The disclosure must be given on a net basis, which takes account of both the reversal of existing timing differences and the origination of new ones. [FRS 102.BC.B29.9J]. For example, for timing differences related to property, plant and equipment, an entity needs to compare next year's depreciation charge and next year's tax writing down allowances to see if it reverses or increases the timing difference.

The Basis for Conclusions notes that the net basis provides information that is relevant to the entity's future cash flows, and hence is more relevant than disclosure on a gross basis. The Basis for Conclusions also noted that the additional benefit of disclosure on a net basis outweighed the cost to preparers of forecasting future new timing differences. [FRS 102.BC.B29.9]. Given that, unlike the requirement at (e) above, the disclosure does not ask for an analysis for each type of timing difference, it would appear that the disclosure of a single net figure would be sufficient.

In addition, Section 32 requires entities to provide information about the nature of any changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities. [FRS 102.32.11(h)]. An estimate of the financial effect of these changes must also be disclosed, or a statement given that such an estimate cannot be made. [FRS 102.32.10]. The requirements of Section 32 are discussed in Chapter 34.

13 Summary of GAAP differences

The differences between FRS 102 and IFRS are set out below.

FRS 102		IFRS
Deferred tax on unremitted earnings of subsidiaries etc.	Recognise in relation to timing differences only, and subject to a control test.	Control test.
Deferred tax on accelerated capital allowances where conditions for retaining allowances are met.	Derecognise.	Continue to recognise.
Deferred tax relating to effect of changes in tax base (e.g., grant of North Sea Field Allowance).	Not recognised (only changes measurement of previously recognised deferred tax).	Recognised.
Deferred tax on excess tax relief on share-based payments.	Permanent difference, no deferred tax.	Recognise deferred tax in equity.
Discounting of current tax receivable or payable.	Prohibited	Neither prohibited nor required. Entities must consider discounting current tax balances if the amounts involved are material.
Balance sheet classification of current tax assets and liabilities.	Not specified in Section 29. Statutory formats require current tax to be included within 'Other creditors, including taxation and social security'. When an entity applies the 'adapted formats', current tax assets and liabilities are disclosed as separate line items on the face of the balance sheet, classified as current or non-current as appropriate.	Disclosed as separate line items on face of balance sheet, classified as current or non-current as appropriate.
Balance sheet classification of deferred tax assets and liabilities.	When 'statutory formats' are applied, deferred tax assets are shown in the balance sheet as a current asset. Deferred tax liabilities are disclosed within provisions for liabilities. When an entity applies the 'adapted formats', deferred tax assets and liabilities are disclosed as separate line items on the face of the balance sheet, as non-current assets (liabilities) when an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet.	Disclosed as separate line items on face of balance sheet. When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet, it does not classify deferred tax assets (liabilities) as current assets (liabilities)
Disclose split of current tax charge between domestic and foreign tax.	Not specified in Section 29, however, this additional information is required by 1 Sch 67 of the Regulations.	Not explicitly required.

FRS 102		IFRS
Disclose effect of double tax relief.	Not specified in Section 29, however, this additional information is required by 1 Sch 67 of the Regulations.	Not explicitly required.
Disclose nature of evidence to support recognition of deferred tax assets.	Not explicitly required.	Required.
Disclose expected net reversal of timing differences in the following reporting period.	Required.	Not required.
Pillar Two income tax	Section 29 includes an exemption for qualifying entities from certain disclosures that are primarily relevant to the consolidated financial statements of a group, provided that equivalent disclosures are included in the consolidated financial statements in which the qualifying entity is included.	No such exemptions in IAS 12.

Appendix A – Terms used in Section 29

Extract from FRS 102

Appendix I Glossary

actuarial gains and losses	Changes in the present value of the defined benefit obligation resulting from: (a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and (b) the effects of changes in actuarial assumptions.
business combination	The bringing together of separate entities or businesses into one reporting entity.
contingent liability	A contingent liability is either: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.
current tax	The amount of income tax payable (refundable) in respect of the taxable profit (tax loss) for the current period or past reporting periods.
deferred tax	Income tax payable (recoverable) in respect of the taxable profit (tax loss) for future reporting periods as a result of past transactions or events.
deferred tax assets	Income tax recoverable in future reporting periods in respect of: (a) future tax consequences of transactions and events recognised in the financial statements of the current and previous periods; (b) the carry forward of unused tax losses; and (c) the carry forward of unused tax credits.
deferred tax liabilities	Income tax payable in future reporting periods in respect of future tax consequences of transactions and events recognised in the financial statements of the current and previous periods.
income tax	All domestic and foreign taxes that are based on taxable profits. Income tax also includes taxes, such as withholding taxes, that are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.
permanent differences	Differences between an entity's taxable profits and its total comprehensive income as stated in the financial statements, other than timing differences.
pillar Two income tax	Income tax arising from Pillar Two legislation.
pillar Two legislation	Tax law that implements the Pillar Two model rules published by the Organisation for Economic Co-operation and Development (OECD), including tax law that implements qualified domestic minimum top-up taxes described in those rules.
probable	More likely than not.

substantively enacted	Tax rates shall be regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so. A UK tax rate shall be regarded as having been substantively enacted if it is included in either: (a) a Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent; or (b) a resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968. (Such a resolution could be used to collect taxes at a new rate before that rate has been enacted. In practice, corporation tax rates are now set a year ahead to avoid having to invoke the Provisional Collection of Taxes Act for the quarterly payment system). A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dáil.
tax base	The amount that for an asset can be deducted for tax or for a liability will be assessed for tax.
tax expense	The aggregate amount included in total comprehensive income or equity for the reporting period in respect of current tax and deferred tax.
taxable profit (tax loss)	The profit (loss) for a reporting period upon which income taxes are payable or recoverable, determined in accordance with the rules established by the taxation authorities. Taxable profit equals taxable income less amounts deductible from taxable income.
timing differences	Differences between taxable profits and total comprehensive income as stated in the financial statements that arise from the inclusion of income and expenses in tax assessments in periods different from those in which they are recognised in financial statements.
uncertain tax treatment	A tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. For example, a tax treatment that relies on an interpretation of the law that is not in accordance with the way in which the taxation authority is known to interpret the law.

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Chapter 32 Foreign currency translation

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Overview

This chapter discusses the requirements of Section 30 *Foreign Currency Translation* in respect of foreign currency transactions and foreign operations into the financial statements of an entity and how to translate financial statements into a presentation currency.

Section 30 of FRS 102 is similar to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, with the differences discussed below. Other differences, not discussed, mainly relate to issues addressed by IAS 21 that are not discussed in FRS 102.

What you need to know

- Each entity - whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) - must determine its functional currency. The functional currency is the currency of the primary economic environment in which it operates.
- Where an entity enters into a transaction denominated in a currency other than its functional currency, it translates the related foreign currency items into its functional currency and reports the effects of the translation in accordance with the requirements of Section 30, with exchange differences reported in profit or loss.
- An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it is required to translate its results and financial position into the presentation currency. The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with the provisions of Section 30, with exchange differences reported in other comprehensive income.
- Exchange differences recognised in other comprehensive income are not reclassified to profit or loss on disposal of the foreign operation.
- Section 30 requires management to use its judgement to determine the entity's functional currency such that it most faithfully represents the economic effects of the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once it has been determined, it may only be changed if there is a change to those underlying transactions, events and conditions. A change in functional currency is accounted for prospectively from the date of the change.
- Changing presentation currency is not addressed in Section 30, but is, in our view, similar to a change in accounting policy. Therefore, when an entity chooses to change its presentation currency, we consider it appropriate to follow the approach in Section 10 *Accounting policies, Estimates and Errors* which requires retrospective application except to the extent it is impracticable. Comparatives must be restated and presented in the new presentation currency. This is discussed further at 3.9 below.

1 Introduction

An entity can conduct foreign activities in two ways. It may enter directly into transactions which are denominated in foreign currencies, the results of which need to be translated into the currency in which the company measures its results and financial position. Alternatively, it may conduct foreign operations through a foreign entity, such as a subsidiary, associate, joint venture or branch which keeps its accounting records in terms of its own currency. In this case it will need to translate the financial statements of the foreign entity for the purposes of inclusion in the consolidated financial statements.

2 Comparison between Section 30 and IFRS

2.1 Reclassification of foreign exchange differences on disposal of a foreign operation

Under IAS 21 all exchange differences arising on translation of a foreign operation that have been accumulated in equity are reclassified to profit and loss on disposal of the net investment. [IAS 21.48]. Section 30 of FRS 102 prohibits such reclassifications on disposal. [FRS 102.9.18A, FRS 102.30.13].

2.2 Unrealised exchange gains on intercompany balances

Unrealised exchange gains on intercompany balances that are part of the net investment in a foreign operation are recognised in other comprehensive income in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation. Under IAS 21, all such exchange gains are recognised in profit or loss. [FRS 102.30.13, IAS 21.32]. The treatment in FRS 102 results from the general restriction in the Companies Act 2006 (CA 2006) from recognising unrealised profits in the profit and loss account (see 4 and 5 below).

3 Requirements of Section 30 for foreign currency translation

3.1 Scope

Section 30 applies to foreign currency transactions, foreign operations and the translation of financial statements into a presentation currency. [FRS 102.30.1].

Section 30 does not apply to hedge accounting of foreign currency items. This is dealt with in Section 12 *Other Financial Instruments Issues* (see Chapter 14). [FRS 102.30.1A].

3.2 Summary of the approach required by Section 30

In preparing financial statements, the following approach is required to be followed:

- Each entity - whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch) - determines its functional currency. [FRS 102.30.2]. This is discussed at 3.3 below.
In the case of group financial statements, there is not a 'group' functional currency; each entity included within the group financial statements, be it the parent, a subsidiary, associate, joint venture or branch, has its own functional currency.
- Where an entity enters into a transaction denominated in a currency other than its functional currency, it translates the related foreign currency items into its functional currency and reports the effects of the translation in accordance with the requirements of Section 30 discussed at 3.4 below.
- The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with the provisions of Section 30 discussed at 3.6 below.

Many reporting entities comprise a number of individual entities (e.g., a group is made up of a parent and one or more subsidiaries). Entities may also have investments in associates or joint ventures or have branches (see 3.3.2 below). It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements (if this presentation currency is different from the individual entity's functional currency). [FRS 102.30.17].

3.3 Determination of an entity's functional currency

Functional currency is defined as the currency of "the primary economic environment in which the entity operates". [FRS 102.30.2].

Section 30 sets out a number of factors or indicators that an entity needs to consider in determining its functional currency. When the factors or indicators are mixed and the functional currency is not obvious, management must use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. We believe that as part of this approach, management must give priority to the most important indicators before considering the other indicators, which are designed to provide additional supporting evidence to determine an entity's functional currency.

The primary factors that FRS 102 requires an entity to consider in determining its functional currency are as follows:

Extract from Section 30

- 30.3** The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. Therefore, the following are the most important factors an entity considers in determining its functional currency:
- (a) The currency:
 - (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and
 - (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services; and
 - (b) The currency that mainly influences labour, material and other costs of providing goods or services. (this will often be the currency in which such costs are denominated and settled). [FRS 102.30.3].

Where the functional currency of the entity is not obvious from the above, the following factors may also provide evidence of an entity's functional currency: [FRS 102.30.4]

(a) The currency in which funds from financing activities (issuing debt and equity instruments) are generated.

And

(b) The currency in which receipts from operating activities are usually retained.

An operation that carries on business as if it were an extension of the parent's operations, will have the same functional currency as the parent. In this context, the term parent is drawn broadly and is the entity that has the foreign operation as its subsidiary, branch, associate or joint venture. Therefore, the following additional factors are also considered in determining the functional currency of a foreign operation, particularly whether its functional currency is the same as that of the reporting entity: [FRS 102.30.5]

(a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it. An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings, all substantially in its local currency.

(b) Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

(c) Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

(d) Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

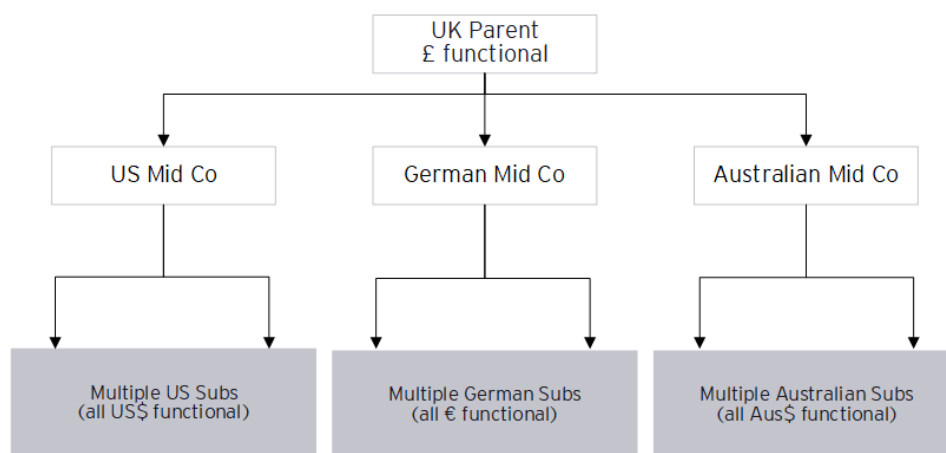
Since an entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it, once it is determined, Section 30 requires that the functional currency is not changed unless there is a change in those underlying transactions, events and conditions. [FRS 102.30.15]. The implication of this is that management of an entity cannot decree what the functional currency is - it is a matter of fact, albeit subjectively determined fact based on management's judgement of all the circumstances.

3.3.1 Intermediate holding companies or finance subsidiaries

For many entities the determination of functional currency will be relatively straightforward. However, for some entities, particularly entities within a group, this may not be the case. One particular difficulty is the determination of the functional currency of an intermediate holding company or finance subsidiary within an international group.

Illustration 3-1: Functional currency of intermediate holding companies or finance subsidiaries

An international group is headquartered in the UK. The UK parent entity has a functional currency of pound sterling, which is also the group's presentation currency. The group has three international sub-operations, structured as follows:



What is the functional currency of the three Mid Cos?

There are a variety of factors to be considered for intermediate holding companies or finance subsidiaries when deciding on the appropriate functional currency. Therefore, there will not be a single analysis applicable to all such entities.

FRS 102 defines a 'foreign operation' as "an entity that is a subsidiary...the activities of which are based or conducted in a country or currency other than those of the reporting entity" (see 3.3 above). This definition suggests that a foreign operation must have its own 'activities'.

Paragraph 2 of Section 30 states that the functional currency is "the currency of the primary economic environment in which the entity operates". However, this is determined by reference to the currency that mainly influences sales prices and the operation's costs (see 3.3 above) and is therefore not directly relevant to intermediate holding companies or finance subsidiaries. Paragraphs 4 and 5 of Section 30 set out several factors to consider in determining the functional currency of a foreign operation. The theme running through these factors is the extent to which the activities and cash flows of the foreign operation are independent of those of the reporting entity.

How we see it

In the case of an intermediate holding company or finance subsidiary, the acid-test question to consider is whether it is an extension of the parent and performing the functions of the parent - i.e., whether its role is simply to hold the investment in, or provide finance to, the foreign operation on behalf of the parent company or whether its functions are essentially an extension of a local operation (e.g., performing selling, payroll or similar activities for that operation) or indeed it is undertaking activities on its own account.

This means that subsidiaries that do nothing but hold investments or borrow money on behalf of the parent will normally have the functional currency of the parent. The borrowings of such companies are frequently guaranteed by the parent, which is itself likely to be a relevant factor. In other words, on whose credit is the lender relying? If the lender is looking to the ultimate parent, then the functional currency is likely to be that of the ultimate parent. However, if the lender is looking to the sub-group, then the functional currency of the companies in the sub-group will be relevant.

How we see it

Accordingly, any analysis that such a company has a functional currency other than that of the parent will require careful consideration of the features of the entity which give rise to that conclusion. Complex situations are likely to require the application of careful management judgement.

As for other entities within a group, the circumstances of each entity are reviewed against the indicators and factors set out in Section 30. This requires management to use its judgement in determining the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions applicable to that entity.

3.3.2 Branches and divisions

Section 30 uses the term 'branch' to describe an operation within a legal entity that may have a different functional currency from the entity itself. However, it contains no definition of that term, nor any further guidance on what arrangements are regarded as a branch. Many countries' governments have established legal and regulatory regimes that apply when a foreign entity establishes a place of business (often called a branch) in that country.

How we see it

Where an entity has operations that are subject to such a regime, it will normally be appropriate to regard them as a branch and evaluate whether those operations have their own functional currency. In this context, the indicators in paragraph 30.5 used to assess whether an entity has a functional currency that is different from its parent (see 3.3 above) will be particularly relevant.

An entity may also have an operation, e.g., a division, that operates in a different currency environment to the rest of the entity but which is not subject to an overseas branch regime.

How we see it

If that operation represents a sufficiently autonomous business unit it may be appropriate to view it as a branch and evaluate whether it has a functional currency that is different to the rest of the legal entity. However, in our experience, this situation will not be a common occurrence.

3.4 Reporting foreign currency transactions in the functional currency of an entity

Where an entity enters into a transaction denominated in a currency other than its functional currency then it will have to translate those foreign currency items into its functional currency and report the effects of such translation. The general requirements of Section 30 are discussed at 3.4.1 to 3.4.13 below.

3.4.1 Initial recognition

Extract from Section 30

- 30.6** A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity:
- (a) buys or sells goods or services whose price is denominated in a foreign currency;
 - (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
 - (c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency. [FRS 102.30.6].
- 30.7** An entity shall record a foreign currency transaction, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. [FRS 102.30.7].

The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with FRS 102. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate. [FRS 102.30.8].

3.4.2 Identifying the date of transaction

The date of a transaction is the date on which it first qualifies for recognition in accordance with FRS 102. Although this sounds relatively straightforward, the following Illustration shows the difficulty that can sometimes arise in determining the transaction date:

Illustration 3-2: Establishing the transaction date (1)

A UK entity buys an item of inventory from a Canadian supplier. The dates relating to the transaction, and the relevant exchange rates, are as follows:

Date	Event	£1=C\$
14 April 20X6	Goods are ordered	1.50
5 May 20X6	Goods are shipped from Canada and invoice dated that day	1.53
7 May 20X6	Invoice is received	1.51
10 May 20X6	Goods are received	1.54
14 May 20X6	Invoice is recorded	1.56
7 June 20X6	Invoice is paid	1.60

Section 13 *Inventories* does not make any reference to the date of initial recognition of inventory and Section 11 *Basic Financial Instruments* deals with the initial recognition of financial liabilities only in general terms. Generally, an entity does not recognise a liability at the time of the commitment but delays recognition until the ordered goods have been shipped or delivered, i.e., the date that the risks and rewards of ownership have passed. Accordingly, it is unlikely that the date the goods are ordered is required to be used as the date of the transaction.

If the goods are shipped free on board (f.o.b.) then as the risks and rewards of ownership pass on shipment (5 May) then this date must be used.

If, however, the goods are not shipped f.o.b. then the risks and rewards of ownership will often pass on delivery (10 May) and therefore the date the goods are received will be treated as the date of the transaction. In practice, the transaction date will depend on the precise terms of the agreement (which are often based on standardised agreements such as the Incoterms rules).

The dates on which the invoice is received and is recorded are irrelevant to when the risks and rewards of ownership pass and therefore is not, in principle, considered to be the date of the transaction. In practice, it may be acceptable that as a matter of administrative convenience that the exchange rate at the date the invoice is recorded is used, particularly if there is no undue delay in processing the invoice. If this is done, then care must be taken to ensure that the exchange rate used is not significantly different from that ruling on the 'true' date of the transaction.

It is clear from Section 30 that the date the invoice is paid is not the date of the transaction because if it were then no exchange differences would arise on unsettled transactions.

Illustration 3-2 above highlights that the date that a transaction is recorded in an entity's books and records is not necessarily the same as the date at which it qualifies for recognition under FRS 102.

One of the difficulties in identifying the date of transaction is the fact that Section 13 contains little guidance on determining when purchased inventory is recognised as an asset. Others such as Section 23 *Revenue from Contracts with Customers* contains more detailed guidance in this respect. As such, determining the date of transaction may require the application of judgement and the date that a transaction is recorded in an entity's books and records will not necessarily be the same as the date at which it qualifies for recognition under FRS 102.

Other situations where this is likely to arise is where an entity is recording a transaction that relates to a period, rather than one being recognised at a single point in time, as illustrated below:

Illustration 3-3: Establishing the transaction date (2)

On 30 September 20X6 Company A, whose functional currency is the pound sterling, acquires a US dollar bond for US\$8,000. The bond carries fixed interest of 5% per annum paid quarterly, i.e., US\$100 per quarter. The exchange rate on acquisition is US\$1 to £1.50.

On 31 December 20X6, the US dollar has appreciated, and the exchange rate is US\$1 to £2.00. Interest received on the bond on 31 December 20X6 is US\$100 (= £200).

Although the interest might be recorded only on 31 December 20X6, the rate on that date is not the spot rate ruling at the date of the transaction. Since the interest has accrued over the 3 month period, it is translated at the spot rates applicable to the accrual of interest during the 3 month period. Accordingly, a weighted average rate for the period is used. Assuming that the appropriate average rate is US\$1 to £1.75 the interest income is £175 (= US\$100 × 1.75).

Accordingly, there is also an exchange gain on the interest receivable of £25 (= US\$100 × [2.00 - 1.75]) to be reflected in profit or loss. The journal entry for recording the receipt of the interest on 31 December 20X6 is therefore as follows:

	£	£
Dr. Cash	200	
Cr. Interest income (profit or loss)		175
Cr. Exchange gain (profit or loss)		25

3.4.3 Using average rates

Rather than using the actual rate ruling at the date of the transaction "an average rate for a week or month may be used for all foreign currency transactions occurring during that period", if the exchange rate does not fluctuate significantly (see 3.4.1 above). [FRS 102.30.8]. For entities which engage in many foreign currency transactions it will be more convenient for them to use an average rate rather than using the exact rate for each transaction. If an average rate is to be used, what guidance can be given in choosing and using such a rate?

(a) Length of period

As an average rate is only used as an approximation of actual rates then care has to be taken that significant fluctuations in the day-to-day exchange rates do not arise in the period selected. For this reason, the period chosen is not to be too long.

How we see it

We believe that it would be inappropriate to use a period of more than one month and where there is volatility of exchange rates it will be better to set rates more frequently, say on a weekly basis, especially where the value of transactions is significant.

(b) Estimate of average rate relevant to date of transaction

The estimation of the appropriate average rate will depend on whether the rate is to be applied to transactions which have already occurred or to transactions which will occur after setting the rate. Obviously, if the transactions have already occurred then the average rate used relates to the period during which those transactions occurred, e.g., purchase transactions for the previous week are translated using the average rate for that week, not an average rate for the week the invoices are being recorded. If the rate is being set for the following period, the rate selected is a reasonable estimate of the expected exchange rate during that period. This could be done by using the closing rate at the end of the previous period or by using the actual average rate for the previous period.

How we see it

We would suggest that the former be used. Whatever means is used to estimate the average rate, the actual rates during the period need to be monitored and if there is a significant move in the exchange rate away from the average rate then the rate being applied is revised.

(c) Application of average rate to type of item

How we see it

We believe that average rates are to be used only as a matter of convenience where there are a large number of transactions.

Even where an average rate is used, we recommend that the actual rate is used for large one-off transactions such as the purchase of a fixed asset or an overseas investment or taking out a foreign loan. Where the number of foreign currency transactions is small it will probably not be worthwhile setting and monitoring average rates and therefore actual rates are to be used.

3.4.4 Calculation of an average rate

When translating the results of an entity whose functional currency is not that of a hyperinflationary economy, for practical reasons, the reporting entity may use a rate that approximates the actual exchange rate, e.g., an average rate for the period, to translate income and expense items. [FRS 102.30.8].

The standard does not give any guidance on the factors that are to be taken into account in determining what may be an appropriate average rate for the period - it merely says that "if exchange rates fluctuate significantly, the use of the average rate for the period is inappropriate". [FRS 102.30.8]. What methods are, therefore, available to entities to use in calculating an appropriate average rate? Possible methods include:

- (a) Mid-year rate
- (b) Average of opening and closing rates
- (c) Average of month end/quarter end rates
- (d) Average of monthly average rates
- (e) Monthly/quarterly results at month end/quarter end rates
- (f) Monthly/quarterly results at monthly/quarterly averages

Illustration 3-4: Calculation of average rate

A UK entity has a foreign subsidiary and is preparing its consolidated financial statements for the year ended 30 April 20X6. It intends to use an average rate for translating the results of the subsidiary. The relevant exchange rates for £1=FC are as follows:

Month	Month end	Average for month	Average for quarter	Average for year
April 20X5	1.67			
May 20X5	1.63	1.67		
June 20X5	1.67	1.64		
July 20X5	1.64	1.65	1.65	
August 20X5	1.67	1.64		
September 20X5	1.70	1.63		
October 20X5	1.67	1.68	1.65	
November 20X5	1.65	1.70		
December 20X5	1.66	1.66		
January 20X6	1.64	1.67	1.68	
February 20X6	1.60	1.65		
March 20X6	1.61	1.63		
April 20X6	1.61	1.62	1.63	1.65

Average of month end rates - 1.65
 Average of quarter end rates - 1.64

The results of the subsidiary for each of the 12 months to 30 April 20X6 and the translation thereof under each of the above methods (using monthly figures where appropriate) are shown below:

Method (a)	FC31,050 @ 1.67 = €18,593
Method (b)	FC31,050 @ 1.64 = €18,933
Method (c) - monthly	FC31,050 @ 1.65 = €18,818
Method (c) - quarterly	FC31,050 @ 1.64 = €18,933
Method (d)	FC31,050 @ 1.65 = €18,818

		(e)	(e)	(f)	(f)
		quarterly	monthly	quarterly	monthly
Month	FC	£	£	£	£
May 20X5	1,000		613		599
June 20X5	1,100		659		671
July 20X5	1,200	2,012	732	2,000	727
August 20X5	1,300		778		793
September 20X5	1,300		765		798
October 20X5	1,350	2,365	808	2,394	804
November 20X5	1,400		848		824
December 20X5	1,400		843		843
January 20X6	2,000	2,927	1,220	2,857	1,198
February 20X6	5,000		3,125		3,030
March 20X6	10,000		6,211		6,135
April 20X6	4,000	11,801	2,484	11,656	2,469
Total	31,050	19,105	19,086	18,907	18,891

It can be seen that by far the simplest methods to use are the methods (a) to (d).

How we see it

In our view methods (a) and (b) are not normally used as it is unlikely in times of volatile exchange rates that they will give appropriate weighting to the exchange rates which have been in existence throughout the period in question. They are only likely to give an acceptable answer if the exchange rate has been static or steadily increasing or decreasing throughout the period.

Method (c) based on quarter end rates has similar drawbacks and therefore is not normally used.

Method (c) based on month end rates and method (d) are better than the previous methods as they do take into account more exchange rates which have applied throughout the year, with method (d) being more precise, as this will have taken account of daily exchange rates. Method (d) will normally give reasonable and acceptable results when there are no seasonal variations in items of income and expenditure.

Average monthly rates for most major currencies are likely to be given in publications issued by the government, banks and other sources and therefore it is unnecessary for entities to calculate their own. The work involved in calculating an average for the year, therefore, is not very onerous.

Where there are seasonal variations in items of income and expenditure, using a single average rate for the entire reporting period is unlikely to result in a reasonable approximation of applying actual rates. In these situations, appropriate exchange rates are applied to the appropriate items. This can be done by using either of methods (e) or (f) preferably using figures and rates for each month. Where such a method is being used care is to be taken to ensure that the periodic accounts are accurate and that cut-off procedures have been adequate, otherwise significant items may be translated at the wrong average rate.

Where there are significant one-off items of income and expenses then it is likely that actual rates at the date of the transaction will need to be used to translate such items.

3.4.5 Dual rates or suspension of rates

One practical difficulty in translating foreign currency amounts is where there is more than one exchange rate for that particular currency depending on the nature of the transaction. In some cases, the difference between the exchange rates can be small and therefore it probably does not matter which rate is actually used. However, in other situations the difference can be quite significant. So, what rate is used?

There is no specific guidance on this matter in FRS 102. So, in accordance with the hierarchy set out in Section 10 an entity could look to the requirements in IFRS for guidance. IAS 21 states that “when several exchange rates are available, the rate used is that at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date”. [IAS 21.26]. Companies would therefore normally look at the nature of the transaction and apply the appropriate exchange rate.

Another practical difficulty which could arise is where, for some reason, exchangeability between two currencies is temporarily lacking at the transaction date or subsequently at the end of the reporting period. Again FRS 102 provides no specific guidance although IAS 21 requires that the rate to be used is “the first subsequent rate at which exchanges could be made”. [IAS 21.26].

In certain circumstances it might not be possible to determine an exchange rate for a particular currency pair directly. For example, geopolitical developments may have stopped substantially all exchanges of Currency A and Currency B. However, in such circumstances it will normally be possible to derive an exchange rate indirectly. For example, if those geopolitical developments had not significantly affected exchanges of Currency A for Currency C nor exchanges of Currency B for Currency C, one could derive an exchange rate for Currency A and Currency B from the Currency A/Currency C exchange rate and the Currency B/Currency C rate. When using such a method, the result will be more reliable if the intermediate currency (Currency C in this case) is one that is stronger and/or more actively exchanged.

In August 2023, the IASB published amendments to IAS 21 which provide additional guidance for scenarios where there is a lack of exchangeability. Refer to the EY publication, International GAAP®.

3.4.6 Reporting at the ends of the subsequent reporting periods

Extract from Section 30

- 30.9** At the end of each reporting period, an entity shall:
- (a) translate foreign currency monetary items using the closing rate;
 - (b) translate non-monetary items that are measured in terms of historical cost in a foreign currency using the exchange rate at the date of the transaction; and
 - (c) translate non-monetary items that are measured at fair value in a foreign currency using the exchange rates at the date when the fair value was determined. [FRS 102.30.9].

The treatment of exchange differences arising from this is set out at 3.4.7 and 3.4.8 below for monetary and non-monetary items respectively.

3.4.7 Treatment of exchange differences - monetary items

The general rule in Section 30 is that exchange differences on the settlement or retranslation of monetary items is recognised in profit or loss in the period in which they arise. [FRS 102.30.10].

Where additional guidance is required in applying paragraph 30.10 of the standard, an entity could look to the requirements within IFRS under for further guidance. IAS 21 requires that when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each period up to the date of settlement is determined by the change in exchange rates during each period. [IAS 21.29].

These requirements can be shown in the following illustrations:

Illustration 3-5: Reporting an unsettled foreign currency transaction in the functional currency

A UK entity purchases plant and equipment on credit from a Canadian supplier for C\$328,000 in January 20X6 when the exchange rate is £1=C\$1.64. The entity records the asset at a cost of £200,000. At the UK entity's year end at 31 March 20X6 the account has not yet been settled. The closing rate is £1=C\$1.61. The amount payable would be retranslated at £203,727 in the balance sheet and an exchange loss of £3,727 would be reported as part of the profit or loss for the period. The cost of the asset would remain as £200,000.

Illustration 3-6: Reporting a settled foreign currency transaction in the functional currency

A UK entity sells goods to a German entity for €87,000 on 28 February 20X6 when the exchange rate is £1=€1.45. It receives payment on 31 March 20X6 when the exchange rate is £1=€1.50. On 28 February the UK entity will record a sale and corresponding receivable of £60,000. When payment is received on 31 March the actual amount received is only £58,000. The loss on exchange of £2,000 would be reported as part of the profit or loss for the period.

There are situations where the general rule above will not be applied. The first exception relates to exchange differences arising on a monetary item that, in substance, forms part of an entity's net investment in a foreign operation (see 3.6.4 below). In this situation the exchange differences are recognised in other comprehensive income and accumulated in equity. However, in general, this treatment applies only in the financial statements that include the foreign operation and the reporting entity (e.g., consolidated financial statements when the foreign operation is a subsidiary). It does not normally apply to the reporting entity's separate financial statements or the financial statements of the foreign operation. This is discussed further at 3.6.6 below.

The next exception relates to hedge accounting for foreign currency items, to which Section 12 applies. The application of hedge accounting requires an entity to account for some exchange differences differently from the treatment required by Section 30. For example, Section 12 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are recognised initially in other comprehensive income to the extent the hedge is effective. Hedge accounting is discussed in more detail in Chapter 14.

Another situation where exchange differences on monetary items are not recognised in profit or loss in the period they arise would be where an entity capitalises borrowing costs under Section 25 *Borrowing Costs* since that section of FRS 102 requires exchange differences arising from foreign currency borrowings to be capitalised to the extent that they are regarded as an adjustment to interest costs (see Chapter 27 at 3.5.4). [FRS 102.25.1].

3.4.8 Treatment of exchange differences - non-monetary items

When non-monetary items are measured at fair value in a foreign currency, they are translated using the exchange rate as at the date when the fair value was determined. [FRS 102.30.9(c)]. Therefore, any re-measurement gain or loss will include an element relating to the change in exchange rates. In this situation, the exchange differences are recognised as part of the gain or loss arising on the fair value re-measurement.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss is also recognised in other comprehensive income. [FRS 102.30.11]. For example, Section 17 *Property, Plant and Equipment* requires some gains and losses arising on a revaluation of property, plant and equipment to be recognised in other comprehensive income (see Chapter 20 at 3.7). When such an asset is measured in a foreign currency, the revalued amount is translated using the rate at the date the value is determined, resulting in an exchange difference that is also recognised in other comprehensive income.

Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, e.g., financial instruments that are measured at fair value through profit or loss in accordance with Section 12 (see Chapter 13 at 6.4) or an investment property accounted for using the fair value model (see Chapter 19 at 3.3.1, any exchange component of that gain or loss is recognised in profit or loss. [FRS 102.30.11].

The carrying amount of some items is determined by comparing two or more amounts. For example, Section 13 *Inventories* requires the carrying amount of inventories to be determined as the lower of cost and estimated selling price less costs to complete and sell. Similarly, in accordance with Section 27 *Impairment of Assets* the carrying amount of an asset for which there is an indication of impairment is the lower of its carrying amount before considering possible impairment losses and its recoverable amount. When such an asset is non-monetary and is measured in a foreign currency, the carrying amount is determined by comparing:

- The cost or carrying amount, as appropriate, translated at the exchange rate at the date when that amount was determined (i.e., the rate at the date of the acquisition for an item measured in terms of historical cost).
- And
- The estimated selling price less costs to complete or recoverable amount, as appropriate, translated at the exchange rate at the date when that value was determined (e.g., the closing rate at the end of the reporting period).

The effect of this comparison may be that an impairment loss is recognised in the functional currency but would not be recognised in the foreign currency, or *vice versa*.

3.4.9 Determining whether an item is monetary or non-monetary

Section 30 generally requires that monetary items denominated in foreign currencies be retranslated using closing rates at the end of the reporting period and non-monetary items must not be retranslated (see 3.4.7 and 3.4.8 above). Monetary items are defined as “units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency”. [FRS 102 Appendix I]. Section 30 does not elaborate further on this, however IAS 21 states that ‘the essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency’. Some examples given by IAS 21 (and which would also apply under FRS 102) are pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; and cash dividends that are recognised as a liability. More obvious examples are cash and bank balances; trade receivables and payables; and loan receivables and payables.

Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples are amounts prepaid for goods and services (e.g., prepaid rent); goodwill; intangible assets; inventories; property, plant and equipment; and provisions that are to be settled by the delivery of a non-monetary asset. Investments in equity instruments are generally non-monetary items. However, there are several situations where the distinction may not be altogether clear.

3.4.10 Deposits or progress payments

Entities may be required to pay deposits or progress payments when acquiring certain assets, such as property, plant and equipment or inventories, from foreign suppliers. The question then arises as to whether such payments must be retranslated as monetary items or non-monetary items.

FRS 102 does not provide any guidance on this area therefore following the GAAP hierarchy in Section 10 users may turn to IFRS in developing an accounting policy. IFRIC 22 *Foreign Currency Transactions and Advance Consideration* contains guidance on determining the date of the transaction for deposits or progress payments where these deposits or progress payments are recognised as non-monetary items.

IFRIC 22 applies to foreign currency transactions where an entity recognises a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration before the entity recognises the related asset, expense, or income. It requires that the exchange rate to use on initial recognition of the related asset, expense, or income is the exchange rate on the date of the transaction, which is the date on which the entity initially recognises the non-monetary asset or non-monetary liability arising from the advance consideration.

Illustration 3-7: Deposits or progress payments

A UK entity contracts to purchase an item of plant and machinery for €10,000 on the following terms:

Payable on signing contract (1 August 20X6)	10%
Payable on delivery (19 December 20X6)	40%
Payable on installation (7 January 20X6)	50%

At 31 December 20X6 the entity has paid the first two amounts on the due dates when the respective exchange rates were £1=€1.25 and £1=€1.20. The closing rate at the end of its reporting period, 31 December 20X6, is £1=€1.15.

	€	(i) £	(ii) £
First payment	1,000	800	870
Second payment	4,000	3,333	3,478
		<u>4,133</u>	<u>4,348</u>

- If the payments made are regarded as prepayments or as progress payments, then the amounts must be treated as non-monetary items and included in the balance sheet at £4,133.
- If the payments made are regarded as deposits, and are refundable, then the amounts could possibly be treated as monetary items and included in the balance sheet at £4,348 and an exchange gain of £215 recognised in profit or loss. A variant of this would be to treat only the first payment as a deposit until the second payment is made, since once delivery is made it is less likely that the asset will be returned and a refund sought from the supplier.

How we see it

In practice, it will often be necessary to consider the terms of the contract to ascertain the nature of the payments made to determine the appropriate accounting treatment and this may require the application of judgement. An entity could look to the additional guidance set out in IFRIC 22 when determining the appropriate accounting treatment.

3.4.11 Investments in preference shares

Entities may invest in preference shares of other entities. Whether such shares are monetary items or not will depend on the rights attaching to the shares. As discussed at 3.4.8 above, investments in equity instruments are generally considered to be non-monetary items. Thus, if the terms of the preference shares are such that they are classified by the issuer as equity, rather than as a financial liability, then they are non-monetary items. However, if the terms of the preference shares are such that they are classified by the issuer as a financial liability (e.g., a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date), then it would appear that they must be treated as monetary items.

3.4.12 Assets and liabilities arising from insurance contracts

FRS 103 *Insurance Contracts* states that for the purposes of applying the requirements of Section 30 an entity must treat all assets and liabilities arising from an insurance contract as monetary items. [FRS 103.2.26]. This means that items such as deferred acquisition costs and unearned premiums that arose in a foreign currency will be retranslated into the entity's functional currency at the closing exchange rate at each reporting date even though they have characteristics that are more akin to a non-monetary item.

3.4.13 Post-employment benefit plans - foreign currency assets

For most entities, benefits payable under a defined benefit post-employment plan will be payable in the functional currency of the entity. However, such a plan may have monetary assets that are denominated in a foreign currency and/or non-monetary assets, the fair value of which are determined in a foreign currency.

Consider, for example, a UK company with the pound sterling as its functional currency which has a funded pension scheme in which benefit payments are based on the employees' sterling denominated salaries and are paid in sterling. The majority of plan assets comprise a mix of sterling denominated bonds, UK equities and UK properties. However, those assets also include a number of US dollar denominated bonds and equities issued by US companies that are listed on a US stock exchange. Section 28 *Employee Benefits* requires all plan assets to be measured at their fair value at the end of the reporting period, but how does the entity deal with any exchange differences or changes in fair value attributable to changes in exchange rates arising on the US assets?

The standard defines monetary items as "units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency". [FRS 102 Appendix I]. Pension assets fall within this definition. Further, the accounting for defined benefit schemes under Section 28 requires an entity to reflect net interest on the net defined benefit asset or liability in profit or loss, and any difference between this amount and the actual return on plan assets in other comprehensive income (see Chapter 30 at sections 3.5.10.B). [FRS 102.28.25A].

How we see it

It would consequently seem appropriate to view the net pension asset or liability as a single unit of account measured in the functional currency (in this case sterling). Therefore, the gains and losses on all the assets denominated in a non-functional currency (in this case the US plan assets) which are attributable to changes in foreign exchange rates, would be dealt with as remeasurements in accordance with Section 30 and recognised in other comprehensive income.

3.5 Change in functional currency

Section 30 requires management to use its judgement to determine the entity's functional currency such that it most faithfully represents the economic effects of the underlying transactions, events and conditions that are relevant to the entity (see 3.3 above). Accordingly, once the functional currency is determined, it may be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. [FRS 102.30.15].

Extract from Section 30

30.14 When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change. [FRS 102.30.14].

In other words, an entity translates all items into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. [FRS 102.30.16].

Illustration 3-8: Change in functional currency

The management of Entity A has considered the functional currency of the entity to be the Sterling. However, as a result of change in circumstances affecting the operations of the entity, management determines that on 1 January 20X6 the functional currency of the entity is now the US dollar. The exchange rate at that date is £1=US\$1.20. The balance sheet of Entity A at 1 January 20X6 in its old functional currency is as follows:

	£
Property, plant and equipment	200,000
Current assets	
Inventories	10,000
Receivables	20,000
Cash	5,000
	35,000
Current liabilities	
Payables	15,000
Taxation	3,000
	18,000
Net current assets	17,000
	217,000
Long-term loans	120,000
	97,000

Included within the balance sheet at 1 January 20X6 are the following items:

- Inventories with a cost of £6,000. These were purchased for US\$6,000 and have been translated at the rate ruling at the date of purchase of £1=US\$1.00.
- Payables of £5,000 representing the US\$6,000 due in respect of the above inventories, translated at the rate ruling at 1 January 20X6.

Entity A applies the translational procedures applicable to its new functional currency prospectively from the date of change. Accordingly, all items in its balance sheet at 1 January 20X6 are translated at the rate of £1=US\$1.20 giving rise to the following amounts:

	\$
Property, plant and equipment	240,000
Current assets	
Inventories	12,000
Receivables	24,000
Cash	6,000
	<u>42,000</u>
Current liabilities	
Payables	18,000
Taxation	3,600
	<u>21,600</u>
Net current assets	<u>20,400</u>
Property, plant and equipment plus net current assets	260,400
	<u>144,000</u>
Long-term loans	<u>116,400</u>

The inventories purchased in US dollars are included at \$7,200, being £6,000 translated at £1=US\$1.20. This is despite the fact that Entity A knows that the original cost was \$6,000.

As far as the payables in respect of the inventories are concerned, these are included at \$6,000, being £5,000 translated at £1=US\$1.20. This represents the original amount payable in US dollars.

Often an entity's circumstances change gradually over time, and it may not be possible to determine a precise date on which the functional currency changes. In these circumstances an entity will need to apply judgement to determine an appropriate date from which to apply the change, which might coincide with the beginning or end of an interim or annual accounting period.

Where an entity's functional currency changes, its management will often choose to align the entity's presentation currency with the new functional currency. The approach to be adopted when changing presentation currency is covered in 3.9 below.

3.6 Use of a presentation currency other than the functional currency

An entity may, subject to the requirements of relevant laws and regulations, present its financial statements in any currency (or currencies) (see 3.3 above).

Extract from Section 30

30.17 An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, the entity shall translate its items of income and expense and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the items of income and expense and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented. [FRS 102.30.17].

There is no concept of a 'group' functional currency. Each entity within the group has its own functional currency, and the results and financial position of each entity must be translated into the presentation currency that is used for the consolidated financial statements.

The requirements of Section 30 in respect of this translation process are discussed below. The procedures to be adopted apply not only to the inclusion of foreign subsidiaries in consolidated financial statements but also to the incorporation of the results of associates and joint ventures. They also apply when the results of a foreign branch are to be incorporated into the financial statements of an individual entity and to a stand-alone entity presenting financial statements in a currency other than its functional currency.

In addition to these procedures, Section 30 has additional provisions that apply when the results and financial position of a foreign operation are translated into a presentation currency so that the foreign operation can be included in the financial statements of the reporting entity by consolidation or the equity method. These additional provisions are covered at 3.6.3 to 3.6.12 below.

3.6.1 Translation to the presentation currency

The method of translation depends on whether the entity's functional currency is that of a hyperinflationary economy or not, and if it is, whether it is being translated into a presentation currency which is that of a hyperinflationary economy or not. Guidance identifying hyperinflationary economies is provided in Section 31 *Hyperinflation* (see Chapter 33 at 3.1). This chapter covers only the requirements for translating an operation into a presentation currency of a non-hyperinflationary economy. For information on translation to the presentation currency which is that of a hyperinflationary economy see Chapter 33.

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency using the following procedures: [FRS 102.30.18]

- (a) Assets and liabilities for each balance sheet presented (i.e., including comparatives) are translated at the closing rate at the date of each respective balance sheet.

And

- (b) Income and expenses for each statement of comprehensive income (i.e., including comparatives) are translated at exchange rates at the dates of the transactions.

And

- (c) All resulting exchange differences are recognised in other comprehensive income.

For practical reasons, the reporting entity may use a rate that approximates the actual exchange rate, e.g., an average rate for the period, to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate. [FRS 102.30.19].

The exchange differences referred to in item (c) above result from: [FRS 102.30.20]

- (a) Translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate.

And

- (b) Translating the opening net assets at a closing rate that differs from the previous closing rate.

The use of an exchange rate which approximates the actual exchange rate, is not completely accurate because, if the entity has had any transactions with equity holders that have resulted in a change in the net assets during the period, there are likely to be further exchange differences that need to be recognised to the extent that the closing rate differs from the rate used to translate the transaction. For example, this would be the case if a parent had subscribed for further equity shares in a subsidiary.

How we see it

In our view, the guidance noted above does not apply to the translation of an entity's results into a presentation currency; instead, the date of transaction for this purpose is the date on which income or expense is recorded in profit or loss or other comprehensive income of the foreign operation.

A foreign operation may have reclassification adjustments to profit or loss of gains or losses previously recognised in other comprehensive income, for example as a result of the application of cash flow hedge accounting. However, FRS 102 does not explicitly address how these adjustments are translated into the presentation currency. The most commonly applied approach is to regard them as income or expenses of the foreign operation to be translated at the exchange rate at the date of reclassification in accordance with paragraph 18 of Section 30. For cash flow hedges, this better reflects the hedge accounting reported in the foreign operation's own financial statements. Nevertheless, some would argue that reclassification adjustments do not represent income or expenses. Consequently, paragraph 18 of Section 30 would not apply, and the reclassification is translated using the historical exchange rates at the dates the original gains or losses arose.

How we see it

In our view, each of the approaches described above represents an acceptable accounting policy choice.

The application of these procedures is shown in the following Illustration.

Illustration 3-9: Translation of a non-hyperinflationary functional currency to a non-hyperinflationary presentation currency

A UK entity owns 100% of the share capital of a foreign entity which was set up a number of years ago when the exchange rate was £1=FC2. It is consolidating the financial statements of the subsidiary in its consolidated financial statements for the year ended 31 December 20X6. The exchange rate at the year-end is £1=FC4 (20X5: £1=FC3). For the purposes of illustration, it is assumed that exchange rates have not fluctuated significantly and the appropriate weighted average rate for the year was £1=FC3.5, and that the currency of the foreign entity is not that of a hyperinflationary economy. The income statement of the subsidiary for that year and its balance sheet at the beginning and end of the year in its functional currency and translated into £ are as follows:

Income statement

	FC	£
Sales	35,000	10,000
Cost of sales	(33,190)	(9,483)
Depreciation	(500)	(143)
Interest	(350)	(100)
Profit before taxation	960	274
Taxation	(460)	(131)
Profit after taxation	500	143

Balance sheets	20X5	20X6	20X5	20X6
	FC	FC	£	£
Property, plant and equipment	6,000	5,500	2,000	1,375
Current assets				
Inventories	2,700	3,000	900	750
Receivables	4,800	4,000	1,600	1,000
Cash	200	600	67	150
	7,700	7,600	2,567	1,900
Current liabilities				
Payables	4,530	3,840	1,510	960
Taxation	870	460	290	115
	5,400	4,300	1,800	1,075
Net current assets	2,300	3,300	767	825
	8,300	8,800	2,767	2,200
Long-term loans	3,600	3,600	1,200	900
	4,700	5,200	1,567	1,300
Share capital	1,000	1,000	500	500
Retained profits*	3,700	4,200	1,500	1,643
Exchange reserve*			(433)	(843)
	4,700	5,200	1,567	1,300

* The opening balances for 20X5 in £ have been assumed and represent cumulative amounts since the foreign entity was set up.

The movement of £(410) in the exchange reserve included as a separate component of equity is made up as follows:

- The exchange loss of £392 on the opening net investment in the subsidiary, calculated as follows:

Opening net assets at opening rate	FC4,700 at FC3 =	£1,567
Opening net assets at closing rate	FC4,700 at FC4 =	£1,175
Exchange loss on net assets		£392

- The exchange loss of £18, being the difference between the income account translated at an average rate, i.e., £143, and at the closing rate, i.e., £125.

When the exchange differences relate to a foreign operation that is consolidated but not wholly-owned, accumulated exchange differences arising from translation and attributable to non-controlling interests are allocated to, and recognised as part of, non-controlling interests in the consolidated balance sheet.

[FRS 102.30.20].

3.6.2 Functional currency is that of a hyperinflationary economy

A UK based group preparing consolidated financial statements under FRS 102 might have a subsidiary that operates in, and has a functional currency of, a country subject to hyperinflation. In this case, FRS 102 requires the subsidiary's results and financial position to be adjusted using the procedures specified in Section 31 (see Chapter 33) before translating them into a different presentation currency as follows: All amounts (i.e., assets, liabilities, equity items, income and expenses, including comparatives) are translated at the closing rate at the date of the most recent statement of financial position. However, when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts must be those that were presented as current year amounts in the relevant prior period financial statements.

[FRS 102.30.21].

3.6.3 Exchange differences on intragroup balances

The incorporation of the results and financial position of a foreign operation with those of the reporting entity follows normal consolidation procedures, such as the elimination of intragroup balances and intragroup transactions of a subsidiary. [FRS 102.30.22]. On this basis, there is a tendency sometimes to assume that exchange differences on intragroup balances will not affect the reported profit or loss for the group in the consolidated financial statements. However, an intragroup monetary asset (or liability), whether short-term or long-term, cannot be eliminated against the corresponding intragroup liability (or asset) without the entity with the currency exposure recognising an exchange difference on the intragroup balance.

This exchange difference will be reflected in that entity's profit or loss for the period (see 3.4.7 above) and, except as indicated at 3.6.4 below, Section 30 requires this exchange difference to continue to be included in profit or loss in the consolidated financial statements. This is because the monetary item represents a commitment to convert one currency into another and exposes the reporting entity to a gain or loss through currency fluctuations. [FRS 102.30.22].

3.6.4 Monetary items included as part of the net investment in a foreign operation - general

As an exception to the general rule at 3.6.3 above, where an exchange difference arises on an intragroup balance that, in substance, forms part of an entity's net investment in a foreign operation, the exchange difference is not recognised in profit or loss in the consolidated financial statements but is recognised in other comprehensive income and accumulated in a separate component of equity. [FRS 102.30.13].

The 'net investment in a foreign operation' is defined as being "the amount of the reporting entity's interest in the net assets of that operation". [FRS 102 Appendix I]. This will include a monetary item that is receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future (often referred to as a 'permanent as equity' loan) because it is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables. [FRS 102.30.12].

How we see it

In our view, trade receivables and payables can be included as part of the net investment in the foreign operation, but only if cash settlement is not made or planned to be made in the foreseeable future. However, if a subsidiary makes payment for purchases from its parent but is continually indebted to the parent as a result of new purchases, then in these circumstances, since individual transactions are settled, no part of the inter-company balance is regarded as part of the net investment in the subsidiary. Accordingly, exchange differences on such balances are recognised in profit or loss.

These requirements are shown in the following Illustration.

Illustration 3-10: Receivables/payables included as part of net investment in a foreign operation

A UK entity, A, has a Belgian subsidiary, B. A has a receivable due from B amounting to £1,000,000. In each of the following scenarios, could the receivable be included as part of A's net investment in B?

Scenario 1

The receivable arises from the sale of goods, together with interest payments and dividend payments which have not been paid in cash but have been accumulated in the inter-company account. A and B agree that A can claim at any time the repayment of this receivable. It is likely that there will be a settlement of the receivable in the foreseeable future.

Although Section 30 states that trade receivables and payables are not included, we do not believe that it necessarily precludes deferred trading balances from being included. Such balances can be included as part of the net investment in the foreign operation, but only if cash settlement is not made or planned to be made in the foreseeable future.

In this scenario, the settlement of A's receivable due from B is not planned; however, it is likely that a settlement will occur in the foreseeable future. Accordingly, the receivable does not qualify to be treated as part of A's net investment in B. The term 'foreseeable future' is not defined and no specific time period is implied. It could be argued that the receivable is only considered as part of the net investment if it will be repaid only when the reporting entity disinvests from the foreign operation. However, it is recognised that in most circumstances this would be unrealistic and therefore a shorter time span must be considered in determining the foreseeable future.

Scenario 2

The receivable represents a loan made by A to B and it is agreed that the receivable will be repaid in 20 years. In this scenario, A's receivable due from B has a specified term for repayment. This suggests that settlement is planned. Accordingly, the receivable does not qualify to be treated as part of A's investment in B.

Scenario 3

A and B have previously agreed that the receivable under scenario 2 will be repaid in 20 years but A now decides that it will replace the loan on maturity either with a further inter-company loan or with an injection of equity. This approach is consistent with A's intention to maintain the strategic long-term investment in B.

In this scenario, the words from paragraph 12 of Section 30 "... settlement is neither planned nor likely to occur in the foreseeable future ..." are potentially problematic, since a loan with a fixed maturity must, *prima facie*, have a planned settlement. However, from the date A decides that it will re-finance the inter-company debt upon maturity with a further long-term instrument, or replace it with equity, the substance of the inter-company loan is that it is part of the entity's net investment in the foreign operation, and there is no actual 'intent' to settle the investment without replacement. On this basis, loans with a stated maturity may qualify to be treated in accordance with paragraph 13 of Section 30, with foreign currency gains and losses recognised in other comprehensive income and accumulated in a separate component of equity in the consolidated financial statements.

How we see it

However, in our view, management's intention to refinance the loan must be documented appropriately, for example in the form of a minute of a meeting of the management board or board of directors. In addition, there must not be any established historical pattern of the entity demanding repayment of such inter-company debt without replacement.

Consequently, when the purpose of the loan is to fund a long-term strategic investment then it is the entity's overall intention regarding the investment and ultimate funding thereof, rather than the specific terms of the inter-company loan funding the investment, that must be considered.

Scenario 4

The receivable arises from the sale of goods, together with interest payments and dividend payments which have not been paid in cash but have been accumulated in the inter-company account. However, in this scenario, A and B agree that A can claim the repayment of this receivable only if the subsidiary is disposed of. A has no plans to dispose of entity B.

In this scenario, the settlement of A's receivable due from B is not planned nor is it likely to occur in the foreseeable future. Although the term 'foreseeable future' is not defined, it will not go beyond a point of time after the disposal of a foreign operation. Accordingly, the receivable does qualify for being treated as part of a net investment in a foreign operation.

The question of whether a monetary item is as permanent as equity can, in certain circumstances, require the application of significant judgement.

3.6.5 Monetary items included as part of the net investment in a foreign operation - currency of the monetary item

When a monetary item is considered to form part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference will be recognised in the foreign operation's individual financial statements. If the item is denominated in the functional currency of the foreign operation, an exchange difference will be recognised in the reporting entity's separate financial statements, normally in profit or loss, although an unrealised gain is recognised in other comprehensive income (see 3.6.6 below).

In the financial statements that include the foreign operation and the reporting entity (i.e., financial statements in which the foreign operation is consolidated or accounted for using the equity method), such exchange differences are recognised in other comprehensive income and accumulated in a separate component of equity. [FRS 102.30.12, FRS 102.30.13].

Illustration 3-11: Monetary item in functional currency of either the reporting entity or the foreign operation

A UK entity has a Belgian subsidiary. On the last day of its financial year, 31 March 20X5, the UK entity lends the subsidiary £1,000,000. Settlement of the loan is neither planned nor likely to occur in the foreseeable future, so the UK entity regards the loan as part of its net investment in the Belgian subsidiary. The exchange rate at 31 March 20X5 was £1=€1.40. Since the loan was made on the last day of the year there are no exchange differences to recognise for that year. At 31 March 20X6, the loan has not been repaid and is still regarded as part of the net investment in the Belgian subsidiary. The relevant exchange rate at that date was £1=€1.50. The average exchange rate for the year ended 31 March 20X6 was £1=€1.45.

In the UK entity's separate financial statements, no exchange difference is recognised since the loan is denominated in its functional currency of pound sterling. In the Belgian subsidiary's financial statements, the liability to the parent is translated into the subsidiary's functional currency of euros at the closing rate at €1,500,000, giving rise to an exchange loss of €100,000, i.e., €1,500,000 less €1,400,000 (£1,000,000 @ £1=€1.40). This exchange loss is reflected in the Belgian subsidiary's profit or loss for that year. In the UK entity's consolidated financial statements, this exchange loss included in the subsidiary's profit or loss for the year will be translated at the average rate for the year, giving rise to a loss of £68,966 (£100,000 @ £1=€1.45). This will be recognised in other comprehensive income and accumulated in the separate component of equity together with an exchange gain of £2,299, being the difference between the amount included in the Belgian subsidiary's income statement translated at average rate, i.e., £68,966, and at the closing rate, i.e., £66,667 (£100,000 @ £1=€1.50). The overall exchange loss recognised in other comprehensive income is £66,667. This represents the exchange loss on the increased net investment of €1,400,000 in the subsidiary made at 31 March 20X5, i.e., £1,000,000 (£1,400,000 @ £1=€1.40) less £933,333 (£1,400,000 @ £1=€1.50).

If, on the other hand, the loan made to the Belgian subsidiary had been denominated in the equivalent amount of euros at 31 March 20X5, i.e., €1,400,000, the treatment would have been as follows:

In the UK entity's separate financial statements, the amount receivable from the Belgian subsidiary would be translated at the closing rate at £933,333 (£1,400,000 @ £1=€1.50), giving rise to an exchange loss of £66,667, i.e., £1,000,000 (£1,400,000 @ £1=€1.40) less £933,333, which is included in its profit or loss for the year. In the Belgian subsidiary's financial statements, no exchange difference is recognised since the loan is denominated in its functional currency of euros. In the UK entity's consolidated financial statements, the exchange loss included in its profit or loss for the year in its separate financial statements will be recognised in other comprehensive income and accumulated in the separate component of equity. As before, this represents the exchange loss on the increased net investment of €1,400,000 in the subsidiary made at 31 March 20X5, i.e., £1,000,000 (£1,400,000 @ £1=€1.40) less £933,333 (£1,400,000 @ £1=€1.40).

In most situations, intragroup balances for which settlement is neither planned nor likely to occur in the foreseeable future will be denominated in the functional currency of either the reporting entity or the foreign operation. However, this will not always be the case. If a monetary item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, the exchange difference arising in the reporting entity's separate financial statements and in the foreign operation's individual financial statements is also recognised in other comprehensive income, and accumulated in the separate component of equity, in the financial statements that include the foreign operation and the reporting entity (i.e., financial statements in which the foreign operation is consolidated or accounted for using the equity method).

3.6.6 Monetary items included as part of the net investment in a foreign operation - treatment in individual financial statements

The exception for exchange differences on monetary items forming part of the net investment in a foreign operation applies only in the consolidated financial statements. It does not normally apply to the reporting entity's separate financial statements or the financial statements of the foreign operation. Rather, the exchange differences will normally be recognised in profit or loss in the period in which they arise in the financial statements of the entity that has the foreign currency exposure. However, as an exception, an unrealised exchange gain is recognised in other comprehensive income. [FRS 102.30.12, FRS 102.30.13]. This treatment results from the general restriction in the CA 2006 from recognising unrealised profits in the profit and loss account. The ICAEW/ICAS Technical Release TECH 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006* (TECH 02/17BL) explains that a receivable for which settlement is neither planned nor likely to occur in the foreseeable future is not qualifying consideration and therefore any cumulative exchange gain on such an asset is not a realised profit (see 4 below). [TECH 02/17BL.3.11].

3.6.7 Monetary items becoming part of the net investment in a foreign operation

An entity's plans and expectations in respect of an intragroup monetary item may change over time and the status of such items must be assessed at each period. For example, a parent may decide that its subsidiary requires refinancing and instead of investing more equity capital in the subsidiary, the parent decides that an existing inter-company account, which has previously been regarded as a normal monetary item, is a long-term deferred trading balance and no repayment of such amount will be requested within the foreseeable future.

How we see it

In our view, such a 'capital injection' is regarded as having occurred at the time it is decided to redesignate the inter-company account. Consequently, the exchange differences arising on the account up to that date are recognised in profit or loss and the exchange differences arising thereafter would be recognised in other comprehensive income on consolidation. This is discussed further in the following Illustration.

Illustration 3-12: Monetary item becoming part of the net investment in a foreign operation

A UK entity has a wholly owned Canadian subsidiary whose net assets at 31 December 20X5 were C\$2,000,000. These net assets were arrived at after taking account of a liability to the UK parent of £250,000. Using the closing exchange rate of £1=C\$2.35 this liability was included in the Canadian company's balance sheet at that date at C\$587,500. On 30 June 20X6, when the exchange rate was £1=C\$2.45, the parent decided that in order to refinance the Canadian subsidiary it would regard the liability of £250,000 as a long-term liability which would not be called for repayment in the foreseeable future. Consequently, the parent thereafter regarded the loan as being part of its net investment in the subsidiary. In the year ended 31 December 20X6 the Canadian company made no profit or loss other than any exchange difference to be recognised on its liability to its parent. The relevant exchange rate at that date was £1=C\$2.56. The average exchange rate for the year ended 31 December 20X6 was £1=C\$2.50.

The financial statements of the subsidiary in C\$ and translated using the closing rate are as follows:

	31 December 20X6		31 December 20X5	
	C\$	£	C\$	£
<i>Balance sheet</i>				
Assets	2,587,500	1,010,742	2,587,500	1,101,064
Amount due to parent	(640,000)	(250,000)	(587,500)	(250,000)
Net assets	1,947,500	760,742	2,000,000	851,064
<i>Income statement</i>				
Exchange difference	(52,500)			

If the amount due to the parent is not part of the parent's net investment in the foreign operation, this exchange loss would be translated at the average rate and included in the consolidated profit and loss account as £21,000. As the net investment was C\$2,000,000 then there would have been an exchange loss recognised in other comprehensive income of £69,814, i.e., £851,064 less £781,250 (C\$2,000,000 @ £1=C\$2.56), together with an exchange gain of £492, being the difference between profit or loss translated at average rate, i.e., £21,000, and at the closing rate, i.e., £20,508.

However, the parent now regards the amount due as being part of the net investment in the subsidiary. The question then arises as to when this must be regarded as having happened and how the exchange difference on it must be calculated. No guidance is given in Section 30.

The 'capital injection' is regarded as having occurred at the time it is decided to redesignate the inter-company account. The exchange differences arising on the account up to that date is recognised in profit or loss. Only the exchange difference arising thereafter would be recognised in other comprehensive income on consolidation. The inter-company account that was converted into a long-term loan becomes part of the entity's (UK parent's) net investment in the foreign operation (Canadian subsidiary) at the moment in time when the entity decides that settlement is neither planned nor likely to occur in the foreseeable future, i.e., 30 June 20X6. Accordingly, exchange differences arising on the long-term loan are recognised in other comprehensive income and accumulated in a separate component of equity from that date. The same accounting treatment would have been applied if a capital injection had taken place at the date of redesignation.

At 30 June 20X6 the subsidiary would have translated the inter-company account as C\$612,500 (£250,000 @ £1=C\$2.45) and therefore the exchange loss up to that date was C\$25,000. Translated at the average rate this amount would be included in consolidated profit or loss as £10,000, with only an exchange gain of £234 recognised in other comprehensive income, being the difference between profit or loss translated at average rate, i.e., £10,000, and at the closing rate, i.e., £9,766. Accordingly, £11,000 (£21,000 less £10,000) offset by a reduction in the exchange gain on the translation of profit or loss of £258 (£492 less £234) would be recognised in other comprehensive income. This amount represents the exchange loss on the 'capital injection' of C\$612,500. Translated at the closing rate this amounts to £239,258 which is £10,742 less than the original £250,000.

Some might argue that an approach of regarding the 'capital injection' as having occurred at the beginning of the accounting period would have the merit of treating all of the exchange differences for this year in the same way. However, for the reasons provided above we do not regard such an approach as being acceptable.

Suppose instead of the inter-company account being £250,000, it was denominated in dollars at C\$587,500. In this case the parent would be exposed to the exchange risk; what would be the position?

The subsidiary's net assets at both 31 December 20X5 and 20X6 would be:

Assets	C\$2,587,500
Amount due to parent	(587,500)
Net assets	<u>C\$2,000,000</u>

As the inter-company account is expressed in Canadian dollars, there will be no exchange difference thereon in the subsidiary's profit or loss.

There will, however, be an exchange loss in the parent as follows:

C\$587,500	@ 2.35 =	£250,000
	@ 2.56 =	<u>£229,492</u>
		£20,508

In the consolidated financial statements, some of this amount must be recognised in other comprehensive income as the inter-company account is now regarded as part of the equity investment. For the reasons stated above, it is only the exchange differences that have arisen after the date of redesignation, i.e., 30 June 20X6, that must be recognised in other comprehensive income.

On this basis, the exchange loss would be split as follows:

C\$587,500	@ 2.35 =	£250,000	
	@ 2.45 =	<u>£239,796</u>	
			£10,204
	@ 2.45 =	£239,796	
	@ 2.56 =	<u>£229,492</u>	
			£10,304

The exchange loss up to 30 June 20X6 of £10,204 would be recognised in consolidated profit or loss and the exchange loss thereafter of £10,304 would be recognised in other comprehensive income. This is different from when the account was expressed in sterling because the 'capital injection' in this case is C\$587,500 whereas before it was effectively C\$612,500.

3.6.8 Monetary items ceasing to be part of the net investment in a foreign operation

The situation where a pre-existing monetary item was subsequently considered to form part of the net investment in a foreign operation was discussed at 3.6.7 above. However, what happens where a monetary item ceases to be considered part of the net investment in a foreign operation, either because the circumstances have changed such that it is now planned or is likely to be settled in the foreseeable future or indeed that the monetary item is in fact settled?

Where the circumstances have changed such that, the monetary item is now planned or is likely to be settled in the foreseeable future, then similar issues to those discussed at 3.6.4 above apply; i.e., are the exchange differences on the intragroup balance to be recognised in profit or loss only from the date of change or from the beginning of the financial year?

How we see it

For the same reasons as set out in Illustration 3-12 above, in our view the monetary item ceases to form part of the net investment in the foreign operation at the moment in time when the entity decides that settlement is planned or is likely to occur in the foreseeable future. Accordingly, exchange differences arising on the monetary item up to that date are recognised in other comprehensive income and accumulated in a separate component of equity. The exchange differences that arise after that date are recognised in profit or loss.

Consideration also needs to be given as to the treatment of the cumulative exchange differences on the monetary item that have been recognised in other comprehensive income, including those that had been recognised in other comprehensive income in prior years. The treatment of these exchange differences is to recognise them in other comprehensive income and accumulate them in a separate component of equity. [FRS 102.30.22]. The principal question is whether the change in circumstances or actual settlement in cash of the intragroup balance represents a disposal or partial disposal of the foreign operation and this is considered in more detail at 3.7 below.

3.6.9 Dividends

If a subsidiary pays a dividend to the parent during the year the parent records the dividend at the rate ruling when the dividend was declared. An exchange difference will arise in the parent's own financial statements if the exchange rate moves between the declaration date and the date the dividend is actually received. This exchange difference is required to be recognised in profit or loss and will remain there on consolidation.

The same will apply if the subsidiary declares a dividend to its parent on the last day of its financial year and this is recorded at the year-end in both entities' financial statements. There is no problem in that year as both the intragroup balances and the dividends will eliminate on consolidation with no exchange differences arising. However, as the dividend will not be received until the following year an exchange difference will arise in the parent's financial statements in that year if exchange rates have moved in the meantime. Again, this exchange difference will remain in consolidated profit or loss as it is no different from any other exchange difference arising on intragroup balances resulting from other types of intragroup transactions. It will not be recognised in other comprehensive income.

It may seem odd that the consolidated results can be affected by exchange differences on inter-company dividends. However, once the dividend has been declared, the parent now effectively has a functional currency exposure to assets that were previously regarded as part of the net investment. To minimise the effect of exchange rate movements, entities must, therefore, arrange for inter-company dividends to be paid on the same day the dividend is declared, or as soon after the dividend is declared as possible.

3.6.10 Share capital

Where an entity presents its financial statements in a currency other than its functional currency, the same issues arise as they do when an entity issues foreign currency share capital. In these circumstances it would also seem more appropriate that the entity's share capital (whether they are ordinary shares or are otherwise irredeemable and classified as equity instruments) are translated at historical rates of exchange.

Translation at an historical rate would imply using the rate ruling at the date of the issue of the shares, however, where a subsidiary is presenting its financial statements in the currency of its parent, it may be that the more appropriate historical rate for share capital that was in issue at the date it became a subsidiary would be that ruling at the date it became a subsidiary of the parent, rather than at earlier dates of issue.

How we see it

Where such share capital is retranslated at the closing rate, we do not believe that it is appropriate for the exchange differences to be recognised in other comprehensive income, but are either taken to retained earnings or some other reserve.

Consequently, whether such share capital is maintained at a historical rate, or is dealt with in this way, the treatment has no impact on the overall equity of the entity.

3.6.11 Other equity balances resulting from transactions with equity holders

In addition to share capital, an entity may have other equity balances resulting from the issue of shares, such as a share premium account (additional paid-in capital). Like share capital, the translation of such balances could be done at either historical rates or at the closing rate.

How we see it

There is no specific guidance on which rate to apply within FRS 102, however, in accordance with the hierarchy set out in Section 10 an entity could apply the guidance in IAS 21. Based on this guidance we believe that whichever method is adopted, it is to be consistent with the treatment used for share capital. Again, where exchange differences arise through using the closing rate, we believe that it is not appropriate for them to be recognised in other comprehensive income but are either taken to retained earnings or some other reserve as would be required by IAS 21.

3.6.12 Unrealised profits on intragroup transactions

The other problem area is the elimination of unrealised profits resulting from intragroup transactions when one of the parties to the transaction is a foreign subsidiary.

Illustration 3-13: Unrealised profits on intragroup transaction

A UK parent has a wholly owned Swiss subsidiary. On 30 November 20X6 the subsidiary sold goods to the parent for CHF1,000. The cost of the goods to the subsidiary was CHF700. The goods were recorded by the parent at £685 based on the exchange rate ruling on 30 November 20X6 of £1=CHF1.46. All of the goods are unsold by the year-end, 31 December 20X6. The exchange rate at that date was £1=CHF1.52. How must the intragroup profit be eliminated?

Neither Section 30 nor IAS 21 contain specific guidance on this matter. However, US GAAP requires the rate ruling at the date of the transaction to be used.

If the exchange rate ruling at the date of the transaction is used, the profit shown by the subsidiary is CHF300 which translated at £1=CHF1.46 equals £205. Consequently, the goods will be included in the balance sheet at:

Per parent company balance sheet	£685
Less unrealised profit eliminated	£(205)
	<u>£480</u>

It can be seen that the resulting figure for inventory is equivalent to the original CHF cost translated at the rate ruling on the date of the transaction. Whereas if the subsidiary still held the inventory, it would be included at £461 (CHF700 @ £1=CHF1.52).

If in the above example the goods had been sold by the UK parent to the Swiss subsidiary then the approach in US GAAP would say the amount to be eliminated is the amount of profit shown in the UK entity's financial statements. Again, this will not necessarily result in the goods being carried in the consolidated financial statements at their original cost to the group.

3.6.13 Non-coterminous period ends

Unlike IAS 21, Section 30 does not deal with situations where a foreign operation is consolidated on the basis of financial statements made up to a different date from that of the reporting entity. However, in accordance with the hierarchy set out in Section 10 an entity could apply the guidance in IAS 21. In such a case, IAS 21 initially states that the assets and liabilities of the foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation rather than at the date of the consolidated financial statements. However, it then goes on to say that adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity (i.e., the date of the consolidated financial statements). This approach is consistent with the requirements in paragraph 16(a) of Section 9 *Consolidated and Separate Financial Statements* which requires that adjustments be made for the effects of significant transactions that occur between the date of subsidiary financial statements and the date of the consolidated financial statements. The same approach is used in applying the equity method to associates and joint ventures in accordance with IAS 28 *Investments in Associates and Joint Ventures*.

3.6.14 Goodwill and fair value adjustments

Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as assets and liabilities of the foreign operation. Therefore, they are expressed in the functional currency of the foreign operation and translated at the closing rate in accordance with paragraph 30.18(a). [FRS 102.30.23].

If an entity acquires a single foreign entity this will be a straightforward exercise. Where, however, the acquisition is of a multinational operation comprising a number of businesses with different functional currencies this will not be the case. The goodwill needs to be allocated to the level of each functional currency of the acquired operation, however, the standard gives no guidance on how this is to be done.

In our experience, the most commonly applied way of allocating goodwill to different functional currencies is an economic value approach. This approach effectively calculates the goodwill relating to each different functional currency operation by allocating the cost of the acquisition to the different functional currency operations on the basis of the relative economic values of those businesses and then deducting the fair values that have been attributed to the net assets of those businesses as part of the fair value exercise in accounting for the business combination.

How we see it

We consider that any basis for allocating goodwill to different functional currencies other than one based on the economic value as set out above would need to be substantiated.

The level to which goodwill is allocated for the purpose of foreign currency translation may be different from the level at which the goodwill is tested for impairment under Section 27 *Impairment of Assets*. In many cases the allocation under Section 30 will be at a lower level. This will apply not only on the acquisition of a multinational operation but could also apply on the acquisition of a single operation where the goodwill is allocated to a larger cash generating unit that is made up of businesses with different functional currencies.

As a consequence of this different level of allocation one particular difficulty that entities are likely to face is how to deal with an impairment loss that is recognised in respect of goodwill under Section 27. If the impairment loss relates to a larger cash generating unit made up of businesses with different functional currencies, again some allocation of this impairment loss will be required to determine the amount of the remaining carrying amount of goodwill in each of the functional currencies for the purposes of translation under Section 30.

3.7 Disposal of a foreign operation

Exchange differences resulting from the translation of a foreign operation to a different presentation currency are to be recognised in other comprehensive income and accumulated within a separate component of equity (see 3.6.1 above).

On the disposal of a foreign operation, the exchange differences relating to that foreign operation that have been recognised in other comprehensive income and accumulated in the separate component of equity are not recognised in profit or loss. [FRS 102.30.13]. Instead, the cumulative exchange differences relating to the foreign operation that have accumulated in the separate component of equity are transferred directly to retained earnings on disposal. [FRS 102.9.18A, FRS 102.9.18B]. This is a clear difference to IAS 21 which requires reclassification of the exchange differences from equity to profit or loss on disposal of the foreign operation.

In addition to the disposal of an entity's entire interest in a foreign operation, an entity could have a circumstance where only a partial disposal has occurred.

How we see it

In the circumstances an entity recognises only a proportionate gain or loss in respect of the proportion disposed of, our view is that only a proportion of the accumulated exchange differences are transferred.

How we see it

In our view, entities will need to apply judgement and select an appropriate accounting policy for determining what constitutes a partial disposal, particularly whether an absolute reduction in ownership interest represents a partial disposal.

The treatment of exchange differences relating to an investment in an associate or joint venture that becomes a subsidiary in a business combination is not clearly specified in Section 30.

How we see it

In these circumstances, Section 30 requires the reclassification of equity accounted exchange differences of the net investment in a foreign operation that were recognised in other comprehensive income and, in our view, the same treatment applies to the exchange differences arising on the associate or joint venture itself.

Illustration 3-14: Disposal of a foreign operation

A UK entity has a Swiss subsidiary which was set up on 1 January 20X3 with a share capital of CHF200,000 when the exchange rate was £1=CHF1.55. The subsidiary is included in the parent's separate financial statements at its original cost of £129,032. The profits of the subsidiary, all of which it has retained, for each of the three years ended 31 December 20X5 were CHF40,000, CHF50,000 and CHF60,000 respectively, so that the net assets at 31 December 20X5 are CHF350,000. In the consolidated financial statements, the results of the subsidiary have been translated at the respective average rates of £1=CHF1.60, £1=CHF1.68 and £1=CHF1.70 and the net assets at the respective closing rates of £1=CHF1.71, £1=CHF1.65 and £1=CHF1.66. All exchange differences have been recognised in other comprehensive income and accumulated in a separate exchange reserve. The consolidated reserves have therefore included the following amounts in respect of the subsidiary:

	Retained profit	Exchange reserve
	£	£
1 January 20X3	-	-
Movement during 20X3	25,000	(13,681)
31 December 20X3	25,000	(13,681)
Movement during 20X4	29,762	5,645
31 December 20X4	54,762	(8,036)
Movement during 20X5	35,294	(209)
31 December 20X5	90,056	(8,245)

The net assets at 31 December 20X5 of CHF350,000 are included in the consolidated financial statements at £210,843.

On 1 January 20X6 the subsidiary is sold for CHF400,000 (£240,964), thus resulting in a gain on disposal in the parent entity's books of £111,932, i.e., £240,964 less £129,032.

In the consolidated financial statements for 20X5, Section 9 and Section 30 requires the cumulative exchange losses of £8,245 to be transferred directly to retained earnings without being recognised in profit or loss. The gain recognised in the consolidated financial statements would be £30,121 (the difference between the proceeds of £240,964 and net asset value of £210,843 at the date of disposal).

3.8 Tax effects of all exchange differences

Gains and losses on foreign currency transactions and exchange differences arising on translating the results and financial position of an entity (including a foreign operation) into a different currency may have tax effects to which Section 29 *Income Tax* applies. The requirements of Section 29 are discussed in Chapter 31. In broad terms the tax effects of exchange differences will follow the reporting of the exchange differences, i.e., they will be recognised in profit or loss except to the extent they relate to exchange differences recognised in other comprehensive income, in which case they will also be recognised in other comprehensive income. [FRS 102.29.22].

3.9 Change of presentation currency

Neither Section 30 nor IAS 21 address how an entity must approach presenting its financial statements if it changes its presentation currency. This is a situation that is commonly faced when the reporting entity determines that its functional currency has changed (see 3.6 above). However, because entities have a free choice of their presentation currency it can occur in other situations too.

How we see it

Changing presentation currency is, in our view, similar to a change in accounting policy, the requirements for which are set out in Section 10. Therefore, when an entity chooses to change its presentation currency, we consider it appropriate to follow the approach in Section 10 which requires retrospective application except to the extent it is impracticable [FRS 102.10.11] (see Chapter 9 at 3.3.1). Comparatives must be restated and presented in the new presentation currency. Further, they must be prepared as if this had always been the entity's presentation currency (at least to the extent practicable).

The following Illustration shows the impact of a change in presentation currency in a relatively simple group.

Illustration 3-15: Change of presentation currency

A UK parent, P, was established on 1 January 20X4 and issued new shares for £20 million. On the same date it established two wholly owned subsidiaries, S1 and S2 incorporated in the UK and Canada respectively and subscribed £10 million and C\$4.5 million for their entire share capital. The functional currency of each group company was determined to be its local currency, i.e., pound sterling for P and S1 and Canadian dollars for S2. During 20X4, S1 made a profit of £800,000, S2 made a profit of C\$350,000 and P made a loss of £25,000. On 30 September 20X4, P issued new shares for £10 million of which C\$4 million was used immediately to subscribe for additional shares in S2.

During 20X5, S1 made a profit of £700,000, S2 made a profit of C\$750,000 and P made a loss of £30,000 before dividends received from S2. On 30 June 20X5, S2 paid dividends (out of profits then made) of C\$700,000 to P and on 30 September 20X5 P paid dividends of £1,000,000 to its shareholders.

The relevant exchange rates for £1=C\$ were as follows:

1 January 2X4	2.10
30 September 20X4	2.28
31 December 20X4	2.35
Average for 20X4	2.24
30 June 20X5	2.55
30 September 20X5	2.63
31 December 20X5	2.40
Average for 20X5	2.52

Consequently, the statement of changes in equity in P's consolidated financial statements for 20X4 and 20X5 can be summarised as follows:

	Share capital	Retained earnings	Foreign exchange	Total
	£	£	£	£
1 January 20X4	-	-	-	-
Issue of shares	30,000,000	-	-	30,000,000
Comprehensive income	-	931,250	(287,536)	643,714
31 December 20X4	30,000,000	931,250	(287,536)	30,643,714
Comprehensive income	-	967,619	(80,733)	886,886
Dividends	-	(1,000,000)	-	(1,000,000)
31 December 20X5	30,000,000	898,869	(368,269)	30,530,600

The comprehensive income reflected within retained earnings represents the profit for each year, calculated as follows:

$$20X4: £800,000 + (C\$350,000 \div 2.24) - £25,000 = £931,250$$

$$20X5: £700,000 + (C\$750,000 \div 2.52) - £30,000 = £967,619$$

The foreign exchange differences recognised in other comprehensive income can be calculated as follows:

20X4				20X5		
	C\$	Rate	£	C\$	Rate	£
Opening net assets*	4,500,000	2.10	2,142,857	8,850,000	2.35	3,765,957
		2.35	1,914,893		2.40	3,687,500
Exchange loss			(227,964)			(78,457)
Additional capital	4,000,000	2.28	1,754,386	-	-	-
		2.35	1,702,128		-	-
Exchange loss			(52,258)			-
Dividend	-	-	-	(700,000)	2.55	(274,510)
		-	-		2.40	(291,667)
Exchange loss			-			(17,157)
Profit	350,000	2.24	156,250	750,000	2.52	297,619
		2.35	148,936		2.40	312,500
Exchange (loss)/gain			(7,314)			14,881
	8,850,000		(287,536)	8,900,000		(80,733)

* For 20X4, includes the proceeds received for issuing shares on 1 January.

For the year ended 31 December 20X6, P decided to change its presentation currency to Canadian dollars. (This may or may not have coincided with a change of P's functional currency.) The remainder of this example illustrates how one might determine the amounts to be included in respect of the comparative period in P's consolidated financial statements for the year ended 31 December 20X6.

The revised statement of changes in equity in P's consolidated financial statements can be summarised as follows and these are the amounts that will be reflected as comparative amounts in P's consolidated financial statements for the year ended 31 December 20X6:

	Share capital	Retained earnings	Foreign exchange	Total
	C\$	C\$	C\$	C\$
1 January 20X4	-	-	-	-
Issue of shares	64,800,000	-	-	64,800,000
Comprehensive income	-	2,086,000	5,126,729	7,212,729
31 December 20X4	64,800,000	2,086,000	5,126,729	72,012,729
Comprehensive income	-	2,438,400	1,452,311	3,890,711
Dividends	-	(2,630,000)	-	(2,630,000)
31 December 20X5	64,800,000	1,894,400	6,579,040	73,273,440

FRS 102 does not address the exchange rate to use when recording equity instruments issued such as share capital. In the example P uses the historical exchange rates at the date the equity instruments were issued on the basis that they are non-monetary items ($C\$64,800,000 = £20,000,000 \times 2.10 + £10,000,000 \times 2.28$). Even if P retranslated those amounts at year end rates any difference arising would simply be recorded in another component of equity and this difference would not affect profit or loss or other comprehensive income in any period.

The calculations showing how these amounts have been determined are shown below.

The comprehensive income reflected within retained earnings represents the profit for each year, calculated as follows:

$$20X4: (£800,000 \times 2.24) + C\$350,000 - (£25,000 \times 2.24) = C\$2,086,000$$

$$20X5: (£700,000 \times 2.52) + C\$750,000 - (£30,000 \times 2.52) = C\$2,438,400$$

In this case, the profit calculated in this way results in the same amount as translating the consolidated profit of £931,250 and £967,619 presented in sterling at the average rate for the period of £1=C\$2.24 and £1=C\$2.52 respectively. In practice minor differences can arise as a result of imperfections in the average rates used.

Similarly, the net assets presented above are the same as the amounts obtained by translating consolidated net assets of £30,643,714 and £30,530,600 at the closing rates at the end of the relevant period, £1=C\$2.35 and £1=C\$2.40 respectively. This is always the case.

However, the foreign exchange reserve is fundamentally different to that in the financial statements presented in sterling. In this case it represents exchange differences arising from the translation of both P's and S1's financial statements into Canadian dollars whereas previously it represented exchange differences arising from the translation of S2's financial statements into sterling.

The foreign exchange differences recognised in other comprehensive income can be calculated as follows:

20X4				20X5		
	£	Rate	C\$	£	Rate	C\$
Opening net assets*	17,857,143	2.10	37,500,000	26,877,757	2.35	63,162,729
		2.35	41,964,286		2.40	64,506,617
Exchange gain			4,464,286			1,343,888
Additional capital**	8,245,614	2.28	18,800,000	-	-	-
		2.35	19,377,193		-	-
Exchange gain			577,193			-
Dividend received	-	-	-	274,510	2.55	700,000
		-	-		2.40	658,824
Exchange loss			-			(41,176)
Dividend paid	-	-	-	(1,000,000)	2.63	(2,630,000)
		-	-		2.40	(2,400,000)
Exchange loss			-			230,000
Profit***	775,000	2.24	1,736,000	670,000	2.52	1,688,400
		2.35	1,821,250		2.40	1,608,000
Exchange gain			85,250			(80,400)
	26,877,757		5,126,729	26,822,267		1,452,311

- * For 20X4, includes the proceeds received for issuing shares on 1 January (£20,000,000) less amounts invested in S2 (£2,142,857 = C\$4,500,000 ÷ 2.10) on the same date.
- ** Reduced by the amounts invested in S2 on the same date (£10,000,000 - (C\$4,000,000 ÷ 2.28)).
- *** Profits of S1 (£800,000 and £700,000 in 20X4 and 20X5 respectively) less losses of P (£25,000 and £30,000 in 20X4 and 20X5).

In the Illustration above, it was reasonably straightforward to recreate the consolidated equity balances using the new presentation currency. This is because the group had a very simple structure with operations having only two functional currencies, a short history and few (external and internal) equity transactions. Whilst entities must strive for a theoretically perfect restatement, in practice it is unlikely to be such an easy exercise.

As noted above, where an accounting policy is changed, Section 10 requires retrospective application except to the extent that this is impracticable, in which case an entity must adjust the comparative information to apply the new accounting policy prospectively from the earliest practicable date. A similar approach is, appropriate when an entity changes its presentation currency.

How we see it

Applying a similar approach to that in Section 10 is, in our view, appropriate when an entity changes its presentation currency. In this context the most important component of equity to determine correctly (or as near correctly as possible) is normally the foreign exchange reserve because that balance, or parts of it, are transferred from equity to retained earnings in the event of any future disposal of the relevant foreign operation and could therefore affect future earnings.

3.10 Disclosure requirements

Section 30 requires an entity to disclose:

- (a) The amount of exchange differences recognised in profit or loss during the period, except for those arising on financial instruments measured at fair value through profit or loss in accordance with Section 11 and Section 12. [FRS 102.30.25(a)]. No specific line items are specified in terms of where exchange differences must be presented.

How we see it

In the light of this need to apply judgement, we recommend that entities in disclosing the amount of such exchange differences indicate the line item(s) in which they are included.

- (b) The amount of exchange differences recognised in other comprehensive income arising during the period. [FRS 102.30.25(b)].
- (c) FRS 102 requires:

Extract from Section 30

- 30.26** An entity shall disclose the currency in which the financial statements are presented. When the presentation currency is different from the functional currency, an entity shall state that fact and shall disclose the functional currency and the reason for using a different presentation currency. [FRS 102.30.26]

For this purpose, in the case of a group, the references to 'functional currency' are to that of the parent. [FRS 102.30.24].

- (d) When there is a change in the functional currency of either the reporting entity (the parent in the case of consolidated financial statements) or a significant foreign operation, that fact and the reason for the change in functional currency. [FRS 102.30.27].

4 UK company law matters

The CA 2006 contains a general prohibition against recognising unrealised profits in profit and loss, although there is an exception to this rule when the fair value provisions of the Act are applied.

TECH 02/17BL provides guidance on realised and distributable profits under the CA 2006. The main aspects of TECH 02/17BL that deal with foreign exchange are:

- (a) Unless there are doubts as to the convertibility or marketability of the currency in question, foreign exchange profits arising on the retranslation of monetary items are realised, irrespective of the maturity date of the monetary item. However, a profit on retranslation of a monetary asset will not be a realised profit where the underlying balance on which the exchange difference arises does not itself meet the definition of 'qualifying consideration' - e.g., some long-term intercompany balances. *[TECH 02/17BL.3.21]*. This principle is replicated in FRS 102, see 3.7.6 above.
- (b) Realised profits and losses are measured by reference to the functional currency of the company. *[TECH 02/17BL.11.7]*. Therefore, an accounting gain or loss arising from the retranslation of an entity's accounts from its functional currency to a presentation currency is not a profit or loss as a matter of law. It cannot therefore be a realised profit or loss. *[TECH 02/17BL.11.8]*.
- (c) The profit or loss arising on the necessary retranslation of an autonomous branch, from its functional currency into the functional currency of the company, is a realised profit or loss to the extent that the branch net assets were qualifying consideration when the profit or loss arose. *[TECH 02/17BL.11.12]*.
- (d) Where a company's shares, irrespective of whether those shares are classified as equity or debt for accounting purposes, are denominated in a currency other than the company's functional currency, the adjustment arising upon any translation for accounting purposes of the share capital is not a profit or loss at law. Therefore, it is not a realised profit or loss. *[TECH 02/17BL.11.18]*.
- (e) Where share capital is denominated in a currency other than the functional currency, it is fixed at that other currency amount. A distribution cannot be made if it would reduce the company's net assets below the level of the company's share capital. *[TECH 02/17BL.11.21]*. This needs to be considered when assessing the distribution that can be made.

5 Summary of GAAP differences

The key differences between FRS 102 and IFRS in accounting for foreign currency translation are set out below.

	FRS 102	IFRS
Disposal of a foreign operation	On disposal of a foreign operation, the exchange differences relating to that foreign operation that have been accumulated in the separate component of equity are not recognised in profit and loss. The cumulative exchange differences are transferred directly to retained earnings on disposal.	Exchange differences arising on translation of a foreign operation that have been accumulated in equity are reclassified to profit and loss on disposal of the net investment.
Exchange gains on intercompany balances forming part of the net investment in a foreign operation	Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation are recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate, except that any unrealised gain is recognised in other comprehensive income.	Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation are recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate.

Appendix A - Defined terms

Extracts from FRS 102

Appendix I Glossary

closing rate	The spot exchange rate at the end of the reporting period.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of FRS 102, the guidance in Section 2A <i>Fair Value Measurement</i> must be used in determining fair value.
financing activities	Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.
foreign operation	An entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.
functional currency	The currency of the primary economic environment in which the entity operates.
group	A parent and all its subsidiaries.
monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
net investment in a foreign operation	The amount of the reporting entity's interest in the net assets of that operation.
operating activities	The principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
presentation currency	The currency in which the financial statements are presented.

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Chapter 33

Hyperinflation

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Overview

Section 31 Hyperinflation sets out the accounting requirements for an entity whose functional currency is the currency of a hyperinflationary economy. It requires such an entity to prepare financial statements that have been adjusted for the effects of hyperinflation. [FRS 102.31.1].

The UK does not currently suffer from hyperinflation therefore the most likely scenario where this section would be applicable is that of a UK based group preparing consolidated financial statements under FRS 102, with a subsidiary that operates in and has a functional currency of a country subject to hyperinflation.

What you need to know

- Where a UK based group preparing consolidated financial statements under FRS 102 has a subsidiary that operates in, and has a functional currency of, a country subject to hyperinflation, the subsidiary's results and financial position must be adjusted using the procedures specified in Section 31 before translating them into a different presentation currency. These procedures are as follows:
 - All amounts (i.e., assets, liabilities, equity items, income and expenses, including comparatives) are translated at the closing rate at the date of the most recent statement of financial position.
 - However, when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts must be those that were presented as current year amounts in the relevant prior period financial statements.
- Section 31 does not establish an absolute level at which an economy is deemed hyperinflationary. An entity makes that judgement by considering all available information.
- When an economy ceases to be hyperinflationary and an entity discontinues the application of Section 31, it treats the amounts expressed in the presentation currency at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.
- There is little substantive difference between the accounting and disclosure requirements in Section 31 compared to IAS 29 *Financial Reporting in Hyperinflationary Economies*. However, IAS 29 does contain more application guidance.

1 Introduction

1.1 The concept of hyperinflation

Accounting standards are applied on the assumption that the value of money (the unit of measurement) is constant over time, which normally is an acceptable practical assumption. However, when the effect of inflation on the value of money is no longer negligible, the usefulness of historical cost based financial reporting is often significantly reduced. High rates of inflation give rise to a number of problems for entities that prepare their financial statements on a historical cost basis, for example:

- Historical cost figures expressed in terms of monetary units do not show the 'value to the business' of assets.
 - Holding gains on non-monetary assets that are reported as operating profits do not represent real economic gains.
 - Financial information presented for the current period is not comparable with that presented for the prior periods.
- And
- Real capital can be reduced because profits reported do not take account of the higher replacement costs of resources used in the period. Therefore, if calculating a nominal return on capital based on profit, and not distinguishing this properly from a real return of capital, the erosion of capital may go unnoticed in the financial statements. This is the underlying point in the concept of capital maintenance.

For entities used to working in economies with low inflation it is easy to overlook that there are countries where inflation is still a major economic concern. In some of these countries, inflation has reached such levels that the local currency is no longer a useful measure of value in the economy and the general population may prefer not to hold its wealth in the local currency. Instead, they hold their wealth in a stable foreign currency or in non-monetary assets. Such a condition is often referred to as hyperinflation.

1.2 Relevance in the UK

The UK does not suffer from hyperinflation, but it would be theoretically possible, although extremely unlikely, for a UK company to have the functional currency of a hyperinflationary economy. In that case, the requirements of Section 31 would apply in full to the accounting and disclosures in that company's own financial statements.

A more likely scenario would be that of a UK based group preparing consolidated financial statements under FRS 102 with a subsidiary that operates in, and has a functional currency of, a country subject to hyperinflation. This is discussed at 3.5 below.

2 Comparison between Section 31 and IFRS

There is little substantive difference between the accounting and disclosure requirements in Section 31 compared to IFRS (IAS 29). However, IAS 29 does contain more application guidance.

Where non-monetary items, such as property plant and equipment have been revalued at an earlier date, under Section 31, the revaluation reserve is not restated when adjustments are made for the effects of hyperinflation, the difference arising being included in retained earnings. This reflects the requirement under company law to maintain a revaluation reserve and is therefore a difference from IAS 29 (see 3.4.1 below).

3 Requirements of Section 31 for hyperinflation

3.1 A hyperinflationary economy

Extract from Section 31

- 31.2** This section does not establish an absolute rate at which an economy is deemed hyperinflationary. An entity shall make that judgement by considering all available information including, but not limited to, the following possible indicators of hyperinflation:
- (a) The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power.
 - (b) The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency.
 - (c) Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short.
 - (d) Interest rates, wages and prices are linked to a price index.
 - (e) The cumulative inflation rate over three years is approaching, or exceeds, 100%.
- [FRS 102.31.2]

Please refer to our publication *IFRS Developments Hyperinflationary economies*²⁴⁵, for an up to date assessment of countries that are considered to be hyperinflationary for IFRS purposes, as well as economies that are not currently hyperinflationary, but which should be monitored. As the IFRS criteria is the same as that under FRS 102, this provides a useful guide for entities reporting under FRS 102 in assessing whether an economy is hyperinflationary.

3.2 Measuring unit in the financial statements

Section 31 requires the following approach: [FRS 102.31.3].

- All amounts in the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy are stated in terms of the measuring unit current at the end of the reporting period (i.e., the accounting value is adjusted for a factor of current purchasing power).
And
- The comparative information in those financial statements for the previous period required by Section 3 *Financial Statement Presentation*, paragraph 14, and any information presented in respect of earlier periods, are also be stated in terms of the measuring unit current at the reporting date.

The restatement of financial statements in accordance with Section 31 requires the use of a general price index that reflects changes in general purchasing power. Section 31 says that in most economies there is a recognised general price index, normally produced by the government, which entities will follow.

[FRS 102.31.4].

In more extreme cases of hyperinflation such indices may not be available, especially if the prevailing circumstances that led to hyperinflation significantly impact the operation of governmental and/or social systems.

Section 31 provides no further guidance on what is meant by a general price index. It is generally accepted practice to use a Consumer Price Index (CPI) for this purpose, unless that index is clearly flawed. National statistical offices in most countries issue several price indices that potentially could be used for the purposes of Section 31. Important characteristics of a good general price index include the following:

- A wide range of goods and services has been included in the price index
 - Reflective of currency-wide, rather than regional, purchasing power
 - Continuity and consistency of measurement techniques and underlying assumptions
 - Free from bias
 - Frequently updated
- And
- Available for a long period

²⁴⁵ Available on [IFRS technical resources | EY - Global](#)

The entity must assess the above characteristics and select the most reliable and most readily available general price index and use that index consistently. It is important that the index selected is representative of the real position of the hyperinflationary currency concerned.

If the general price index is not available for all periods for which the restatement of long-lived assets is required, then FRS 102 offers no guidance. However, using the FRS 102 hierarchy, an entity is permitted to refer to IAS 29 which requires an entity to make an estimate of the price index. The entity could base the estimate, for example, on the movements in the exchange rate between the functional currency and a relatively stable foreign currency. [IAS 29.17].

Entities could use a similar approach to estimating a price index when they cannot find a general price index that is sufficiently reliable (e.g., if the national statistical office in the hyperinflationary economy is subject to significant political bias). However, this would only be acceptable if all available general price indices are fatally flawed.

It is noted that this method of determining the price index is only acceptable if the currency of the hyperinflationary economy is freely exchangeable, i.e., not subject to currency controls and 'official' exchange rates. Entities should be mindful that, especially in the short term, the exchange rate may fluctuate significantly in response to factors other than changes in the domestic price level.

How we see it

In a scenario where there is a wide spread consensus that all available general price indices do not meet the minimum criteria for reliability (e.g., because the national statistical office in the hyperinflationary economy may be subject to significant political bias) and thus are fatally flawed, or in the absence of a general price index, entities could use an estimate based on currency movements, similar to the approach to that described in paragraph 17 of IAS 29. In these instances, preparers must consider the reliability of the movements in the currency as an inflation proxy. Where this is also not appropriate, the use of other sources of economic data or even the use of experts may be required.

3.3 Procedures for restating historical cost financial statements

3.3.1 Statement of financial position

Amounts in the statement of financial position that are not expressed in terms of the measuring unit current at the end of the reporting period are restated by applying a general price index as discussed below. [FRS 102.31.5].

Monetary items (money held and items to be received or paid in money) are not restated because they are expressed in terms of the measuring unit current at the end of the reporting period. [FRS 102.31.6].

Assets and liabilities linked by agreement to changes in prices, such as index-linked bonds and loans, are adjusted in accordance with terms of the underlying agreement and presented at this adjusted amount in the restated statement of financial position. [FRS 102.31.7].

All other assets and liabilities are non-monetary: [FRS 102.31.8]

- (a) Some non-monetary items are carried at amounts current at the end of the reporting period, such as net realisable value and fair value, so they are not restated. All other non-monetary assets and liabilities are restated using the approach in (b) to (d) as appropriate.
- (b) Most non-monetary items are carried at cost or cost less depreciation; hence they are expressed at amounts current at their date of acquisition. The restated cost, or cost less depreciation, of each item is determined by applying to its historical cost and accumulated depreciation the change in a general price index from the date of acquisition to the end of the reporting period.
- (c) Some non-monetary items are carried at amounts that were current at dates other than that of acquisition or the reporting date, for example, property, plant and equipment that has been revalued at some earlier date. In these cases, the carrying amounts are restated by applying to the revalued amount the change in a general price index from the date of the revaluation to the end of the reporting period.
- (d) The restated amount of a non-monetary item is reduced, in accordance with Section 27 *Impairment of Assets* (see Chapter 29), when it exceeds its recoverable amount.

At the beginning of the first period of application of Section 31, the components of equity, except retained earnings and any revaluation surplus, are restated by applying a general price index from the dates the components were contributed or otherwise arose. Any revaluation surplus that arose in previous periods is not restated. This reflects the requirement under company law to maintain a revaluation reserve. Restated retained earnings are derived from all the other amounts in the restated statement of financial position, including the effect of not restating the revaluation reserve. Retained earnings is essentially the balancing figure after all other restatements. [FRS 102.31.9].

At the end of the first period in which hyperinflation arises and in subsequent periods, all components of owners' equity are restated by applying a general price index from the beginning of the period or the date of contribution, if later. The changes for the period in owners' equity are disclosed in accordance with Section 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings* (see Chapter 6). [FRS 102.31.10].

3.3.2 Statement of comprehensive income and income statement

All items in the statement of comprehensive income (and in the income statement, if presented) must be expressed in terms of the measuring unit current at the end of the reporting period. Therefore, all amounts need to be restated by applying the change in the general price index from the dates when the items of income and expenses were initially recognised in the financial statements. If general inflation is approximately even throughout the period, and the items of income and expense arose approximately evenly throughout the period, an average rate of inflation may be appropriate. [FRS 102.31.11].

How we see it

Inevitably, in practice there is some approximation in this process because of the assumptions that the entity is required to make, for example the use of weighted averages rather than more detailed calculations and assumptions as to the timing of the underlying transactions. A number of factors may need to be considered in determining the appropriate level of detail to be applied:

- The level of data available: most jurisdictions only make inflation statistics available on a monthly basis. In addition, when the hyperinflation process requires data from long ago e.g., for a property that was purchased decades ago), even monthly information may not be available.
- The materiality of the item being adjusted for inflation: a more detailed calculation should be performed for more material items. For example, revenue should be adjusted for inflation using a more detailed calculation than a low value expense account.
- Frequency of transactions: more specific inflation data would be more appropriate for one-off transactions, especially where these are material. For example, more attention should be paid to the inflation data on the date of a material business combination than to data related to purchases made relatively consistently throughout the year.

Other factors to be considered would include the regularity of transactions and the level of variation in the inflation rate.

3.3.3 Statement of cash flows

An entity must express all items in the statement of cash flows in terms of the measuring unit current at the end of the reporting period. [FRS 102.31.12].

3.3.4 Gain or loss on net monetary position

In a period of inflation, an entity holding an excess of monetary assets over monetary liabilities loses purchasing power, and an entity with an excess of monetary liabilities over monetary assets gains purchasing power, to the extent the assets and liabilities are not linked to a price level. An entity therefore includes in profit or loss the gain or loss on the net monetary position, except that any unrealised gain must be recognised in other comprehensive income. An entity must offset the adjustment to those assets and liabilities linked by agreement to changes in prices (see 3.3.1 above) against the gain or loss on net monetary position. [FRS 102.31.13].

3.3.5 Comparative information

As noted at 3.3 above, comparative information in financial statements is also stated in terms of the measuring unit current at the end of the reporting period. [FRS 102.31.3]. This means the comparative information will require restatement using the relevant general price index.

3.3.6 Economies ceasing to be hyperinflationary

When an economy ceases to be hyperinflationary and an entity discontinues the application of Section 31, it treats the amounts expressed in the presentation currency at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements. [FRS 102.31.14].

3.4 Accounting for a hyperinflationary subsidiary in consolidated financial statements

As previously mentioned, a more likely scenario relevant to FRS 102 would be that of a UK based group preparing consolidated financial statements under FRS 102 with a subsidiary that operates in, and has a functional currency of, a country subject to hyperinflation. Section 30 *Foreign Currency Translation* (see Chapter 32 at 3.6.2), requires the subsidiary's results and financial position to be adjusted using the procedures specified in Section 31 before translating them into a different presentation currency using the following procedures. [FRS 102.30.21].

- All amounts (i.e., assets, liabilities, equity items, income and expenses, including comparatives) are translated at the closing rate at the date of the most recent statement of financial position, except that
- When amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts are those that were presented as current year amounts in the relevant prior period financial statements.

4 Disclosures required by Section 31

An entity which applies Section 31 in its own financial statements must disclose the following: *[FRS 102.31.15]*

- The fact that financial statements and other prior period data have been restated for changes in the general purchasing power of the functional currency.
- The identity and level of the price index at the reporting date and changes during the current reporting period and the previous reporting period.

And

- The amount of gain or loss on monetary items.

5 Summary of differences between Section 31 and IFRS

The key differences between FRS 102 and IFRS in accounting for Hyperinflation are set out below.

FRS 102		IFRS
Situations where non-monetary items have been revalued at an earlier date such as PPE.	Under Section 31, the revaluation reserve is not restated when adjustments are made for the effects of hyperinflation, the difference arising being included in retained earnings. This reflects the requirement under Company Law to maintain a revaluation reserve.	Any revaluation surplus that arose in previous periods is eliminated.

Appendix A - Defined terms

Extract from FRS 102 Appendix 1 Glossary

Definitions

functional currency	The currency of the primary economic environment in which the entity operates.
monetary items	Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.
presentation currency	The currency in which the financial statements are presented.

Chapter 34 Events after the end of the reporting period

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Overview

Section 32 *Events after the End of the Reporting Period* applies to the recognition, measurement and disclosure of events after the end of the reporting period. In particular the section sets out the circumstances in which financial statements must be adjusted for events which have happened after the reporting period, the disclosures an entity must give about the date on which the financial statements were authorised for issue, and the required disclosures relating to events after the reporting period.

Events after the end of the reporting period are those events, both favourable and non-favourable, which occur between the last day of the reporting period and the date on which the financial statements are authorised for issue. Section 32 divides such events into two categories: adjusting and non-adjusting events. Adjusting events provide evidence of conditions which existed at the end of the reporting period and, consequently, an entity is required to adjust the amounts recognised in its financial statements to reflect those events. This may require the recognition of a previously unrecognised item. Conversely, no adjustment is made for non-adjusting events, though disclosures may be required for such events.

Section 32 does not permit an entity to prepare its financial statements on a going concern basis if events after the end of the reporting period indicate that the going concern assumption is no longer appropriate.

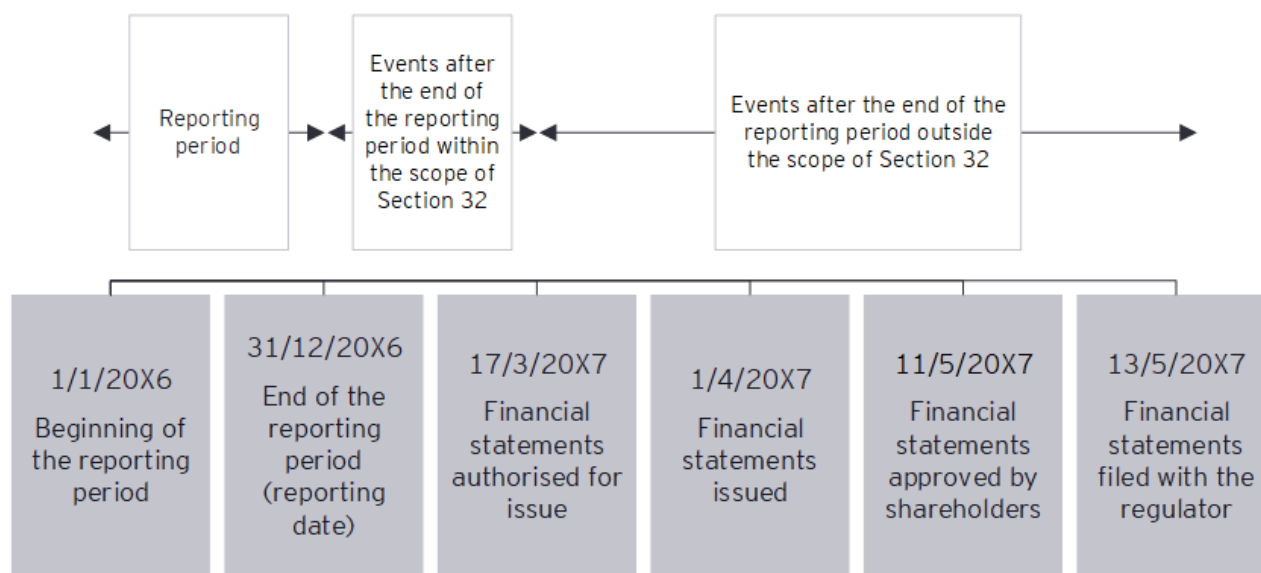
What you need to know

- Section 32 identifies two types of events after the end of the reporting period: adjusting and non-adjusting.
- Adjusting events are events which provide evidence of conditions which existed at the end of the reporting period; amounts recognised in financial statements are adjusted for such events.
- Non-adjusting events are indicative of conditions which arose after the end of the reporting period, but before the financial statements were authorised for issue; amounts recognised in the financial statements are not adjusted for such events, but those events may need to be disclosed.
- When the going concern basis becomes inappropriate after the end of the reporting period, an entity is required to change its basis of accounting.

1 Introduction

Section 32 deals with accounting for, and disclosure of “those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue”. [FRS 102.32.1, FRS 102.32.2]. This definition includes all events occurring between those dates. The principal issue is determining which of these events are required to be reflected in the financial statements as adjustments, which are material enough to require additional disclosure, and which require neither adjustment nor disclosure.

The following timeline illustrates events after the end of the reporting period that are within the scope of Section 32 for an entity with a 31 December year-end:



The financial statements of an entity present, among other things, its financial position at the end of the reporting period. Therefore, it is appropriate to adjust the financial statements for all events that offer greater clarity about conditions that existed at the end of the reporting period (reporting date), and which occur prior to the date the financial statements are authorised for issue, even if those events occur after the public announcement of profit or loss or other selected financial information. [FRS 102.32.3]. The standard, therefore, requires entities to adjust the amounts recognised in the financial statements for ‘adjusting events’, events that provide evidence of conditions that existed at the end of the reporting period. [FRS 102.32.2(a), FRS 102.32.4]. By the same reasoning an entity does not recognise in the financial statements those events that relate to conditions that arose after the reporting period (‘non-adjusting events’). However, if non-adjusting events are material (that is, non-disclosure of the event could reasonably be expected to influence decisions that the users of general-purpose financial statements make on the basis of those financial statements), certain disclosures are required. [FRS 102.32.2(b), FRS 102.32.6, FRS 102.32.7, FRS 102.32.10, FRS 102.32.11].

One exception to the general rule for non-adjusting events is when the going concern basis becomes inappropriate. This is always treated as an adjusting event. [FRS 102.32.7A, FRS 102.32.7B].

The requirements of Section 32 and some practical issues resulting from these requirements are dealt with in 3 and 4 below, respectively.

2 Comparison between Section 32 and IFRS

There are no key differences between Section 32 and the comparable IFRS accounting standard, IAS 10 *Events after the Reporting Period*.

3 Requirements of Section 32 for events after the end of the reporting period

3.1 Scope

Extract from FRS 102

Scope of this section

32.1 This section applies to the recognition, measurement and disclosure of events after the end of the reporting period. *[FRS 102.32.1].*

The financial statements of an entity present, among other things, its financial position at the end of the reporting period. Therefore, it is appropriate to adjust the financial statements for all events that offer greater clarity concerning the conditions that existed at the end of the reporting period, that occur prior to the date the financial statements are authorised for issue. Section 32 requires entities to adjust the amounts recognised in the financial statements for 'adjusting events' that provide evidence of conditions that existed at the end of the reporting period. *[FRS 102.32.2(a), FRS 102.32.4].* An entity does not recognise in the financial statements those events that relate to conditions that arose after the reporting period, 'non-adjusting events'. However, if non-adjusting events are material, Section 32 requires certain disclosures about them. *[FRS 102.32.10].*

Section 32 deals with the accounting for and the disclosure of events after the reporting period, which are defined as "those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue". *[FRS 102.32.2].* The definition includes all events that provide evidence of conditions that existed at the end of the reporting period (adjusting events) and those events that are indicative of conditions that arose after the end of the reporting period (non-adjusting events).

Events after the end of the reporting period include all events that occur up to the date the financial statements are authorised for issue, even if those events occur after the public announcement of profit or loss or other financial information. *[FRS 102.32.3].*

Section 32 does not permit an entity to prepare its financial statements on a going concern basis if events after the end of the reporting period indicate that the going concern assumption is not appropriate (see 3.2.2 below). *[FRS 102.32.7A].* The going concern basis is discussed in Chapter 6 at 8.3.

3.1.1 Date when financial statements are authorised for issue

Given the definition above, the meaning of 'the date when the financial statements are authorised for issue' is clearly important. Section 32 states that events after the end of the reporting period include all events up to the date that the financial statements are authorised for issue, even if those events occur after the public announcement of profit or loss or other selected financial information. *[FRS 102.32.3].*

The Illustration below shows a situation when an entity releases preliminary information, but not complete financial statements, before the date of the authorisation for issue.

Illustration 3-1: Release of financial information before date of authorisation for issue

The management of an entity completes the primary financial statements for the year to 31 December 20X6 on 21 January 20X7 but has not yet completed the explanatory notes. On 26 January 20X7, the board of directors reviews the primary financial statements and authorises them for public media release. The entity announces its profit and certain other financial information on 28 January 20X7. On 1 February 20X7 an error is discovered in the year-end stock valuation of £1m. On 11 February 20X7, management issues the financial statements (with full explanatory notes) to the board of directors, which approves the financial statements for filing on 18 February 20X7. The entity files the financial statements with a regulatory body on 21 February 20X7.

The financial statements are authorised for issue on 18 February 20X7 (date the board of directors approves the financial statements for filing). Therefore, the error discovered in the year-end stock valuation on 1 February 20X7, before the financial statements have been authorised for issue, is an adjusting event after the end of the reporting period which must be reflected, if material, in the 31 December 20X6 financial statements (see 3.2.1 below).

Illustration 3-1 shows that events after the end of the reporting period include all events up to the date when the financial statements are authorised for issue, even if those events occur after the public announcement of profit or of other selected financial information. Accordingly, the information in the financial statements might differ from the equivalent information in a preliminary announcement.

3.1.1.A Re-issuing financial statements

Section 32 does not address whether and how an entity may amend its financial statements after they have been authorised for issue. Generally, such matters are dealt with in local regulations. There are a number of reasons why financial statements may be re-issued after they have been authorised for issue, such a reason could be that the original financial statements were defective, or the entity is re-issuing financial statement for a listing.

If an entity reissues financial statements to correct an error, the UK *Companies (Revision of Defective Accounts and Reports) Regulation 2008 (SI 2008/373)* must be followed in correcting the defective financial statements. The regulations permit the defective financial statements to be either replaced or revised by a supplementary note. If the financial statements are replaced or revised by a supplementary note, they are required to appropriately reflect all adjusting events, by updating the amounts recognised in the financial statements, and non-adjusting events, to the date when the original financial statements were approved. This means that the financial statements do not reflect events that occurred between the date when the original financial statements were authorised for issue and the date the revised financial statements were authorised for re-issue.

3.1.2 Adjusting events

Adjusting events are “those that provide evidence of conditions that existed at the end of the reporting period.” [FRS 102.32.2(a)]. An entity must adjust the amounts recognised in its financial statements, including any related disclosures, to reflect adjusting events. [FRS 102.32.4].

The following are examples of adjusting events after the end of the reporting period that require amounts in the financial statements to be adjusted or to recognise items that were not previously recognised: [FRS 102.32.5]

- The settlement after the end of a reporting period of a court case that confirms that the entity had a present obligation at the end of the reporting period. In this situation, an entity adjusts any previously recognised provision related to this court case under Section 21 *Provisions and Contingencies* or recognises a new provision. Mere disclosure of a contingent liability is not sufficient because the settlement provides additional evidence of conditions that existed at the end of the reporting period that would give rise to a provision in accordance with Section 21 (see Chapter 24 at 3.2.1).
- The receipt of information after the end of the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example:
 - The bankruptcy of a customer that occurs after the end of the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable and that the entity needs to adjust the carrying amount of the trade receivable (see 4.3 below).
 - And
 - The sale of inventories after the end of the reporting period may give evidence about their selling price at the end of the reporting period for the purpose of assessing impairment at that date (see 4.1 below).
- The determination after the end of the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of the reporting period.
- The determination after the end of the reporting period of the amount of profit-sharing or bonus payments, if the entity had a legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date.
- And
- The discovery of fraud or errors that show that the financial statements are incorrect (see 4.4 below).

In addition, those entities that apply IAS 33 *Earnings per Share* (as adopted in the UK) as permitted by Section 1 *Scope*, are required to make adjustments to earnings per share for certain share transactions after the reporting period (such as bonus issues, share splits or share consolidations), even though the transactions themselves are non-adjusting events (see 3.1.3 below). IAS 33 is not discussed in detail in this publication. Instead, readers are referred to the EY publication, International GAAP®. When applying IAS 33, references made to other IFRS accounting standards within IAS 33 shall be taken to be references to the relevant section or paragraph in FRS 102. [FRS 102.1.7].

3.1.3 Non-adjusting events

Section 32 states that non-adjusting events are “those that are indicative of conditions that arose after the end of the reporting period”. [FRS 102.32.2(b)]. An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events. [FRS 102.32.6].

Examples of non-adjusting events are as follows: [FRS 102.32.7]

- A decline in market value of investments between the end of the reporting period and the date when the financial statements are authorised for issue. The decline in market value does not normally relate to the condition of the investments at the end of the reporting period but reflects circumstances that have arisen subsequent to the end of the reporting period.
- And
- An amount that becomes receivable as a result of a favourable judgement or settlement of a court case after the reporting date but before the financial statements are authorised for issue. This would be a contingent asset at the reporting date (see Chapter 24 at 3.5) and disclosure may be required. However, if an agreement is reached before the financial statements are authorised for issue, on the amount of damages for a judgement that was reached before the reporting date, but that was not previously recognised on the basis it could not be measured reliably, this may constitute an adjusting event.

The following are further examples of non-adjusting events after the end of the reporting period that would generally result in disclosure in the financial statements. The disclosures will reflect information that becomes known after the end of the reporting period but before the financial statements are authorised for issue:

- A major business combination or disposal of a major subsidiary (Section 19 *Business Combinations and Goodwill* does not require any specific disclosures in respect of business combinations occurring after the reporting date).
- Announcing a plan to discontinue an operation.
- Major purchases of assets, disposals or plans to dispose of assets, or expropriation of major assets by governments.
- The destruction of a major production plant by a fire.
- Announcing, or commencing the implementation of a major restructuring.
- The issue or repurchase of an entity's debt or equity instruments.
- Abnormally large changes in asset prices or foreign exchange rates.
- Changes in tax rates or tax laws enacted or announced that have a significant effect on current and deferred tax assets and liabilities.
- Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees.
- And
- Commencing major litigation arising solely out of events that occurred after the end of the reporting period. [FRS 102.32.11].

3.1.3.A Dividends

Extract from FRS 102

- 32.8** If an entity declares dividends to holders of equity after the end of the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period because no obligation exists at that time. The amount of the dividend may be presented as a segregated component of retained earnings at the end of the reporting period. [FRS 102.32.8].

Dividends are only recognised as a liability if declared by the end of the reporting period. Dividends declared by an entity to holders of its equity instruments after the end of the reporting period are not adjusting events as no obligation exists at the end of the reporting period. However, although dividends declared after the reporting date are not liabilities, entities may present the amount of dividends declared after the end of the reporting period, as a segregated component of retained earnings. [FRS 102.32.8]. This allows entities to show the amount of retained earnings that are set aside for future dividends, as at the date the financial statements are authorised for issue.

The accounting for dividends in FRS 102 reflects the legal status of dividends under the Companies Act 2006. ICAEW/ICAS Technical Release 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006* (TECH 02/17BL) states that a distribution is made when it becomes a legally binding liability, regardless of the date on which it is to be settled. In the case of a final dividend, the legally binding liability arises at the time the dividend is declared by the company in a general meeting or, for private companies, by the members passing a general resolution. In the case of interim dividends authorised under common articles of association, normally no legally binding liability is established prior to payment being made. In such cases, dividends are normally recognised when they are paid although TECH 02/17BL also provides guidance in determining whether an interim dividend is a legally binding liability at a date earlier than when payment is made. [TECH 02/17BL.2.10].

The examples of non-adjusting events discussed at 3.1.3 above do not include declared dividends. However, the Companies Act requires disclosure of any dividends proposed before the date of approval of the financial statements (see 3.4.2 below).

3.2 The treatment of adjusting events

3.2.1 Events requiring adjustment to the amounts recognised, or disclosures in the financial statements

Section 32 requires that an entity must adjust the amounts recognised in the financial statements, including related disclosures, to take account of adjusting events after the end of the reporting period. [FRS 102.32.4].

3.2.2 Events indicating that the going concern basis is not appropriate

If management determines after the reporting period (but before the financial statements are authorised for issue) either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so, the financial statements must not be prepared on the going concern basis. [FRS 102.32.7A].

Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, Section 32 states that the effect is so pervasive that it results in a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting. [FRS 102.32.7B]. Section 3 *Financial Statement Presentation* contains guidance and specific disclosure requirements when the financial statements are not prepared on a going concern basis or when there are uncertainties that cast significant doubt upon an entity's ability to continue as a going concern (see Chapter 6 at 8.3).

3.3 The treatment of non-adjusting events

Section 32 prohibits the adjustment of amounts recognised in the financial statements to reflect non-adjusting events. [FRS 102.32.6]. However, an entity must disclose the following in the financial statements for each category of non-adjusting event after the end of the reporting period:

- The nature of the event.
- And
- An estimate of its financial effect, or a statement that such an estimate cannot be made. [FRS 102.32.10].

Examples of non-adjusting events after the end of the reporting period that would generally result in disclosures are provided at 3.1.3 above. It is important to note that the list of examples of non-adjusting events in Section 32 and summarised at 3.1.3 above, is not an exhaustive one; Section 32 requires disclosure of any material non-adjusting event.

3.3.1 Breach of a long-term loan covenant and its subsequent rectification

The rectification of the breach or default of a loan payable, or the renegotiation of the terms of the loan, subsequent to the reporting date is not an adjusting event and therefore does not change the classification of the liability in the statement of financial position from current to non-current. This is further discussed in Chapter 6 at 4.1.2.D.

When a breach or default of a loan payable exists at the reporting date, an entity discloses the following:

- Details of the breach or default.
 - The carrying value of the related loans at the reporting date.
- And
- Whether the breach or default was remedied, or whether the terms of the loan payable were renegotiated, before the financial statements were authorised for issue. *[FRS 102.11.47]*.

These disclosures are not required for qualifying entities that are non-financial institutions.

3.4 Other disclosure requirements

The disclosures required in respect of non-adjusting events are discussed in 3.3 above.

3.4.1 Date when financial statements are authorised for issue

An entity is required to disclose the date when the financial statements were authorised for issue and who authorised the financial statements for issue. *[FRS 102.32.9]*.

3.4.2 Additional Companies Act 2006 disclosure requirements in respect of reserves and dividends

The following disclosures in respect of reserves and dividends intended to be distributed after the reporting period are required for large and medium sized companies, as defined by The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 as amended (the Regulations):

- Any amount set aside or proposed to be set aside to, or withdrawn, or proposed to be withdrawn from, reserves.
- And
- The aggregate amount of dividends that are proposed before the date of approval of the financial statements. *[1 Sch 43, 2 Sch 56, 3 Sch 64]*.

4. Practical issues

Although Section 32 does not use the term ‘practical issues’, it alludes to practical issues such as those discussed below. For example, Section 32 asserts that the bankruptcy of a customer that occurs after the reporting period usually confirms that a loss on a trade receivable existed at the end of the reporting period (see 3.1.2 above). It also states that a decline in fair value of investments after the reporting period does not normally relate to conditions at the end of the reporting period (see 3.1.3 above). Judgement of the facts and circumstances is required to determine whether an event that occurs after the reporting period provides evidence about a condition that existed at the end of the reporting period, or whether the condition arose subsequent to the reporting period.

4.1 Valuation of inventory

The sale of inventories after the reporting period is normally a good indicator of their selling price at that date. Section 32 states that such sales “may give evidence about their selling price at the end of the reporting period” (see 3.1.2 above). [FRS 102.32.5(b)(ii)]. However, in some cases, selling prices decrease because of conditions that did not exist at the end of the reporting period.

Therefore, it is important to determine why the selling price decreased. Did it decrease because of circumstances that existed at the end of the reporting period, which subsequently became known, or did it decrease because of circumstances that arose after the end of the reporting period? A decrease in price is merely a response to changing conditions so it is important to assess the reasons for these changes.

Some examples of changing conditions are as follows:

- Price reductions caused by a sudden increase in cheap imports
Whilst it is arguable that the ‘dumping’ of cheap imports after the reporting period is a condition that arises subsequent to that date, it is more likely that this is a reaction to a condition that already existed such as overproduction in other parts of the world. Thus, it might be more appropriate in such a situation to adjust the value of inventories based on its subsequent selling price.
- Price reductions caused by increased competition
The reasons for price reductions and increased competition do not generally arise overnight but normally occur over a period. For example, a competitor may have built up a competitive advantage by investing in machinery that is more efficient. In these circumstances, it is appropriate for an entity to adjust the valuation of its inventories because its own investment in production machinery is inferior to its competitor’s and this situation existed at the end of the reporting period.
- Price reductions caused by the introduction of an improved competitive product
It is unlikely that a competitor developed and introduced an improved product overnight. Therefore, it is more appropriate to adjust the valuation of inventories to their selling price after that introduction because the entity’s failure to maintain its competitive position in relation to product improvements that existed at the end of the reporting period.

Price reductions after the reporting period caused by increased competition are generally evidence of conditions that developed over a period and existed at the end of the reporting period. For certain types of inventories, there may be clear evidence of a price at the end of the reporting period. If this is the case, it is inappropriate to adjust the price of that inventory to reflect a subsequent decline. An example is inventories for which there is a price on an active commodities market. In addition, inventory may be physically damaged or destroyed after the reporting period (e.g., by fire, flood, or other disaster). In these cases, the entity does not adjust the financial statements. However, the entity may be required to disclose the subsequent decline in selling price of the inventories if the impact is material (see 3.3 above).

4.2 Over time measurement of progress

Events after the reporting period frequently give evidence about the profitability of contracts with customers, which are in progress at the end of the reporting period and where revenue is recognised over time.

Section 23 *Revenue from Contracts with Customers* requires an assessment to be made of the progress towards complete satisfaction of performance obligations satisfied over time (see Chapter 25 at 8.1). [FRS 102.23.100]. In such an assessment, consideration must be given to events that occur after the reporting period and a determination must be made as to whether they are adjusting or non-adjusting events for which the financial effect is included in the method used to measure progress over time.

4.3 Insolvency of a debtor

The insolvency of a debtor or inability to pay debts usually builds up over a period. Section 32 states that the “bankruptcy of a customer that occurs after the end of the reporting period usually confirms that a loss existed at the end of the reporting period” (see 3.1.2 above). [FRS 102.32.5(b)(i)]. If, however, there is evidence to show that the insolvency of the debtor resulted solely from an event occurring after the reporting period, then the event is a non-adjusting event. If the impact is material, the entity will be required to disclose the impact of the debtor’s default.

4.4 Discovery of fraud after the end of the reporting period

The timing of when fraud is discovered will affect the accounting considerations. When fraud is discovered after the end of the reporting period, but before the financial statements have been authorised for issue, the discovery of fraud is often an adjusting event, i.e., an event that provides evidence of conditions that existed at the reporting date. However, the discovery of fraud may also be a non-adjusting event. For example, for investments, the discovery of fraud may affect the fair value of the assets subsequent to the discovery of the fraud, but not their fair values on the reporting date.

When fraud is discovered after the financial statements have been authorised for issue this may indicate prior period errors. Application of the definition of a ‘prior period error’ (see Chapter 9 at 3.5) in Section 10 *Accounting Policies, Estimates and Errors* in the case of a fraud requires judgement. Facts and circumstances must be evaluated to determine if the discovery of fraud resulted from a previous failure to use, or misuse of, reliable information, or from new information.

4.5 Valuation of donations in the form of legacies to public benefit entities

Section 34 *Specialised Activities* requires public benefit entities or entities within a public benefit entity group to recognise donations in the form of legacies when it is probable that the legacy will be received, and the value can be reliably measured. The ability to meet these criteria may be affected by events such as disputes and valuations. These entities are required to consider the requirements of Section 32 to determine whether the receipt of evidence about a legacy after the reporting date is an adjusting event after the end of the reporting period. [FRS 102.PBE34.70A].

Appendix A - Defined terms

Extract from FRS 102	
Appendix I	
Glossary	
reporting date	The end of the latest period covered by financial statements or by an interim financial report.
reporting period	The period covered by financial statements or by an interim financial report.

Appendix B - Index of Illustrations

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Chapter 35

Related party disclosures

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Overview

This chapter addresses the requirements of Section 33 *Related Party Disclosures*. The standard defines related party relationships and transactions and sets out the relevant disclosure requirements. It is important to note that the standard does not address the accounting for related party transactions. Related party transactions are accounted for under the relevant section of FRS 102.

The aim of Section 33 is to ensure that an entity's financial statements contain the necessary disclosures required to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

What you need to know

- Section 33 of FRS 102 is a disclosure standard only. Transactions within its scope are accounted for under the relevant section of FRS 102.
- Section 33 requires an entity to include in its financial statements the disclosures necessary to draw attention to the possibility that its financial position and profit or loss have been affected by the existence of related parties and by transactions and outstanding balances with such parties.
- A related party is a person or entity which is related to the entity that is preparing its financial statements; Section 33 provides a wide-ranging definition of what constitutes a related party.
- Information must be disclosed about related party transactions, outstanding balances and commitments. Section 33 also requires disclosure about key management personnel compensation.

1 Introduction

Section 33 requires an entity to include in its financial statements the disclosures necessary to draw attention to the possibility that its financial position and profit or loss have been affected by the existence of related parties and by transactions and outstanding balances with such entities. [FRS 102.33.1].

Section 33 requires disclosures only. It does not establish any recognition or measurement requirements. Related party transactions are accounted for in accordance with the requirements of the section of FRS 102 applicable to the transaction. The disclosures required by Section 33 are in addition to those required by other sections. For example, a loan to a related party will also be subject to the disclosure requirements of Section 11 *Basic Financial Instruments*.

1.1 Scope of Section 33

Section 33 applies to all financial statements prepared under FRS 102 including both group and individual financial statements. However, disclosure is not required in consolidated financial statements, of any transactions or balances between group entities that have been eliminated on consolidation (see 1.1.1 below).

In addition to the above, disclosures required by Section 33 need not be given in individual or separate financial statements of transactions entered into between two members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member (see 1.1.2 below).

[FRS 102.33.1A].

1.1.1 Transactions eliminated on consolidation

Although Section 33 does not specifically include a paragraph stating that intra-group transactions eliminated on consolidation are not required to be disclosed in the consolidated financial statements of an entity, this is not so much an exemption as a statement of the obvious since, so far as the group accounts are concerned, such items do not exist. The effect is that no related party disclosures between subsidiary undertakings are required in group accounts. However, disclosure is still required in respect of transactions or balances with associates or joint ventures since these are not 'eliminated' on consolidation, although they may be subject to consolidation adjustments. This would also apply to the parts of transactions which have been eliminated when applying equity accounting.

1.1.2 Transactions between wholly-owned subsidiary undertakings

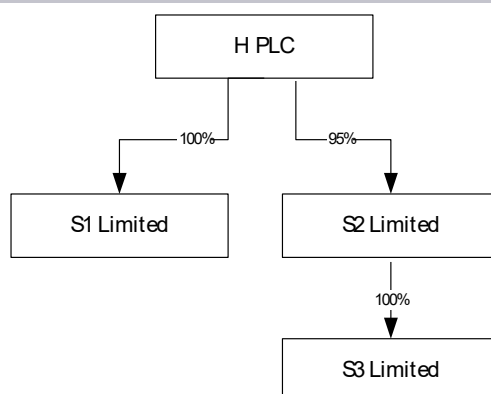
The wording of the exemption from disclosure of transactions between wholly-owned subsidiary undertakings has been taken directly from UK company law. The exemption may be applied to transactions between entities within a sub-group where the transacting subsidiary is wholly-owned by the intermediate parent of that sub-group, even if that intermediate parent is not wholly-owned by the ultimate parent.

[FRS 102.A3.40D, FRS 102.A3.40E].

The Basis for Conclusions clarifies that this disclosure exemption applies only to transactions between wholly owned subsidiary undertakings and not to outstanding balances between those entities. This is because UK company law requires disclosure of outstanding balances in aggregate for group undertakings and, separately, for undertakings in which the company has a participating interest. Therefore, it is not possible to provide an exemption from the disclosure of outstanding balances with group undertakings, although the requirement is for the balances to be disclosed only in aggregate. This disclosure should be met through the compliance with the requirements of Section 4 *Statement of Financial Position* (see Chapter 6). [FRS 102.BC.B33.2].

The Note on Legal Requirements clarifies that, in the FRC's view, the exemption may not be applied to transactions between entities in an intermediate parent's sub-group (including the intermediate parent itself) and the entities in the larger group if the intermediate parent is not wholly-owned by the parent of that larger group. Otherwise, related party transactions could be obscured by a partly-owned intermediate parent creating a wholly-owned subsidiary and passing transactions through it. [FRS 102.A3.40F].

Illustration 1-1 below illustrates the application of the disclosure exemption based on the interpretation above.

Illustration 1-1: Application of the exemption from disclosure of transactions between wholly-owned subsidiary undertakings

Because H PLC only owns 95% of S2 Limited, the wholly owned subsidiaries exemption cannot be used in (a) the individual company financial statements of H PLC in respect of transactions with S2 Limited and S3 Limited, (b) the individual financial statements of S1 Limited in respect of transactions with S2 Limited and S3 Limited (c) the consolidated and/or individual financial statements of S2 Limited in respect of any transactions with H PLC and S1 Limited or (d) the individual financial statements of S3 Limited in respect of any transactions with H PLC and S1 Limited.

The exemption can be used for any transactions in individual financial statements between H PLC and S1 Limited and between S2 Limited and S3 Limited.

However, if the remaining 5% of S2 Limited (not directly held by H PLC) was held by another wholly owned subsidiary undertaking of H PLC, then S2 Limited would be a wholly owned subsidiary undertaking of H PLC. In those circumstances, the exemption from disclosing transactions with the other entities in the group must be available in the individual financial statements of H PLC, S1 Limited, S2 Limited and S3 Limited and the consolidated financial statements of S2 Limited (as S1 Limited, S2 Limited and S3 Limited would all be wholly owned subsidiary undertakings of the H PLC group).

The exemption has no other conditions: it can be applied, for example, to an entity with an overseas parent, an entity whose parent does not prepare publicly available consolidated financial statements or to an entity whose parent does not prepare consolidated financial statements.

2 Comparison between Section 33 and IFRS

The principal differences between Section 33 and IAS 24 - *Related Party Disclosures* - are in respect of:

- The scope exemption for wholly-owned subsidiaries (see 2.1 below).
- The government-related exemption (see 2.2 below).
- Disclosure of key management compensation (see 2.3 below).
- Aggregation of disclosures (see 2.4 below).

And

- Disclosure of commitments (see 2.5 below).

In summary, the disclosure requirements of Section 33 are less onerous to a reporting entity than those of IAS 24.

2.1 Scope exemption for wholly-owned subsidiaries

Section 33 has an exemption from disclosure of transactions entered into between two members of a group, provided that any subsidiary which is a party to the transaction is wholly-owned by such a member (see 1.1.2 above). IAS 24 does not have such an exemption.

2.2 Government-related exemption

Section 33 exempts an entity from disclosing information about related party transactions with a related party that is a government or another entity related because that same government has control, joint control or significant influence over it (see 4.3.3 below).

IAS 24 has a similar but not identical exemption for government-related entities. However, the IAS 24 exemption is conditional on disclosure of (i) the nature and amount of each individually significant transaction; and (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their type. [IAS 24.25, IAS 24.26]. In addition, under IAS 24, the reporting entity must disclose the name of the government and the nature of its relationship with the reporting entity. In contrast, Section 33 does not require these additional disclosures, and the reporting entity is only obliged to disclose the name of the government if the government is the parent of the reporting entity. [FRS 102.33.11]. Therefore, a government with significant influence over a reporting entity need not be named in FRS 102 financial statements, nor will any transactions and balances with that government be disclosed.

2.3 Disclosure of key management compensation

Section 33 requires key management compensation to be disclosed only in total. [FRS 102.33.7].

In addition, when an entity is subject to a legal or regulatory requirement to disclose directors' remuneration (or equivalent), it is exempt from the requirement to disclose key management personnel compensation if the key management personnel and directors are the same. [FRS 102.33.7A].

Directors' remuneration is subject to additional company law requirements (see 4.4 below).

IAS 24 requires key management compensation to be disclosed in total and also split between short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits and share-based payment. [IAS 24.17].

2.4 Aggregation of disclosures

Section 33 requires related party transaction disclosures to be made in aggregate for the following separate categories (a) entities with control, joint control or significant influence over the reporting entity; (b) entities over which the entity has control, joint control or significant influence (c) key management personnel of the entity or its parent (in the aggregate); (d) entities that provide key management personnel services to the entity and (e) other related parties. [FRS 102.33.10].

IAS 24 has a similar requirement but requires the disclosures to be made separately for seven categories instead of four. [IAS 24.19].

2.5 Disclosure of commitments

Section 33 states that information about 'commitments' must be disclosed if necessary for an understanding of the potential effect of the related party relationship on the financial statements.

[FRS 102.33.9].

IAS 24 states explicitly that 'commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised)' are transactions requiring disclosure if they are with a related party. In addition, a commitment is listed as an example of a related party transaction requiring disclosure. *[IAS 24.21(i)].*

3 Requirements of Section 33 for related party disclosures

Section 33 defines a related party and then requires various disclosures of related party transactions, balances and relationships.

3.1 Definition of a related party

A related party is defined as 'a person or entity that is related to the entity that is preparing its financial statements (the reporting entity)'. [FRS 102.33.2]. Preparers must use this definition of 'related party' when applying concepts elsewhere in FRS 102 where this term or similar terms are used and not otherwise defined.

In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form. [FRS 102.33.3].

A related party transaction is defined as 'a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged'. [FRS 102.33.8].

The following are considered to be related parties of the reporting entity:

- A person or a close member of that person's family, if that person has either control, joint control, or significant influence over the reporting entity, or is a member of the key management personnel of the reporting entity, or of a parent of the reporting entity (see 3.1.1 below).
 - Entities that are members of the same group (see 3.1.2 below).
 - Entities that are associates or joint ventures (see 3.1.3 below).
 - Entities that are joint ventures of the same third party (see 3.1.4 below).
 - Entities that are joint ventures and associates of the same third entity (see 3.1.5 below).
 - Post-employment benefit plans (see 3.1.6 below).
 - Entities under control or joint control of certain categories of persons or close members of such a person's family (see 3.1.7 below).
 - Entities under significant influence of certain categories of persons or close members of such a person's family (see 3.1.8 below).
- And
- Entities, or any member of a group of which they are a part, that provide key management personnel services to the reporting entity or its parent (see 3.1.9 below).

3.1.1 Persons or close members of a person's family that are related parties

A person or close member of that person's family is related to a reporting entity if that person:
[FRS 102.33.2(a)]

- (i) Has control or joint control over the reporting entity.
 - (ii) Has significant influence over the reporting entity.
- Or
- (iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

'Control', 'joint control' and 'significant influence' have the same meanings here as in Section 9 - *Consolidated and Separate Financial Statements*, Section 14 - *Investments in Associates* - and Section 15 - *Investments in Joint Ventures*.

3.1.1.A Close members of a family

Close members of a family of a person are defined as 'those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity' including: [FRS 102 Appendix I]

- (a) That person's children and spouse or domestic partner.
 - (b) Children of that person's spouse or domestic partner.
- And
- (c) Dependants of that person or that person's spouse or domestic partner.

This list of family members is non-exhaustive and does not preclude other family members from being considered as close members of the family of a person. As well as those specific family members described in (a) to (c) above, the definition also applies to any other family members who may be expected to influence or be influenced by that person in their dealings with the reporting entity. For example, this may include parents, siblings or relatives who are even more distant.

The IFRS Interpretations Committee confirmed in May 2015, that the definition of close members of a family of a person under IFRS (which is identical to the definition in FRS 102) appears to provide no scope to argue that there are circumstances in which the specific family members described in (a) to (c) above are not related parties. Dependants are not limited to children and may include other relatives depending on the facts and circumstances.

The Interpretations Committee observed that the definition of close members of the family of a person:

- Is expressed in a principle-based manner and involves the use of judgement to determine whether members of the family of a person (including that person's parents) are related parties or not.
- And
- Includes a list of family members that are always considered close members of the family of a person.

The IFRS IC further noted that the list of family members that are always considered close members is non-exhaustive and does not preclude other family members from being considered as close members of the family of a person. Consequently, other family members, including parents or grandparents, could qualify as close members of the family depending on the assessment of specific facts and circumstances.²⁴⁶

3.1.1.B Key management personnel

Key management personnel are those persons with authority and responsibility for planning, directing and controlling the activities of an entity, directly or indirectly, including any director (whether executive or otherwise) of that entity. [FRS 102.33.6]. A director of a reporting entity is automatically a member of key management personnel, even if they are not paid for their services by the reporting entity - thus, a director of a subsidiary is still a member of key management personnel of the subsidiary, even if their services are paid for by the parent.

A related party includes all key management personnel of a reporting entity and of a parent of the reporting entity. This means that all key management personnel of all parents (i.e., the immediate parent, any intermediate parent and the ultimate parent) of a reporting entity are related parties of the reporting entity. When the reporting entity's financial statements represent a group, key management personnel of subsidiaries might not be key management personnel of the group if those persons do not have the authority or responsibility for planning, directing and controlling the activities of the group.

Some entities may have more than one level of key management. For example, some entities may have a supervisory board, whose members have responsibilities similar to those of non-executive directors, as well as a board of directors that sets the overall operating strategy.

How we see it

In our view, all members of either board constitute key management personnel, as both levels of management have authority and responsibility for planning, directing and controlling the activities of the entity directly or indirectly.

The definition of key management personnel is not restricted to directors. It also includes other individuals with authority and responsibility for planning, directing and controlling the activities of an entity. For example, a chief financial officer or a chief operating officer may not be directors but could meet the definition of key management personnel. Other examples of the type of persons who are not directors but may meet the definition of key management personnel include a divisional chief executive or a director of a major trading subsidiary of the entity, but not of the entity itself, who nevertheless participates in the management of the reporting entity. A reference to individuals who are not directors in a reporting entity's strategic review might indicate that those persons are considered to be key management personnel.

Key management personnel are normally employees of the reporting entity (or of another entity in the same group). However, the definition does not restrict itself to employees. Therefore, seconded staff and persons engaged under management or outsourcing contracts may also have a level of authority or responsibility such that they are key management personnel.

²⁴⁶ IFRIC Update, May 2015, IASB.

A related party of a reporting entity also includes an entity that provides key management personnel services to that reporting entity (see 3.1.9 below). However, it is unclear whether individuals employed by that management entity (e.g., key management personnel of the management entity) can be key management personnel of the reporting entity. IAS 24, which has an identical definition of a related party to FRS 102, does not require a reporting entity to look through a management entity to the compensation paid or payable by the management entity to the management entity's employees or directors on the grounds that it is impracticable to access the detailed information required. [IAS 24.17A, IAS 24.BC51].

How we see it

In our view, as FRS 102 provides no specific guidance on whether a reporting entity can look through a management entity to the management entity's employees or directors, an entity could use the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* (see Chapter 9) in order to apply the guidance in IAS 24 and not disclose any remuneration paid by a management entity to its employees or directors.

3.1.2 Entities that are members of the same group

Extract from Section 33

33.2(b) An entity is related to a reporting entity if:

- (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). [FRS 102.33.2(b)(i)]

'Parent' and 'subsidiary' have the same meanings as in Section 9. Therefore, all entities that are controlled by the same ultimate parent are related parties. This would include entities where the reporting entity holds less than a majority of the voting rights but which are still considered to be subsidiaries. There are no exceptions to this rule although transactions between wholly-owned subsidiaries are not required to be disclosed (see 1.1.2 above). Conversely, a group would not include entities where the reporting entity holds a majority of the voting rights but which are not subsidiaries (for example, because the group does not have control), though these could be related parties of the reporting entity as they may fall into other categories of related party, such as associates.

3.1.3 Entities that are associates or joint ventures

Extract from Section 33

33.2(b) An entity is related to a reporting entity if:

- (ii) one entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member). [FRS 102.33.2(b)(ii)]

'Associate' and 'joint venture' have the same meanings as in Sections 14 and 15 respectively.

In the definition of a related party, an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture. Therefore, for example, an associate's subsidiary and the investor that has significant influence over the associate are related to each other. [FRS 102.33.4A].

The definition also means that an associate of a reporting entity's parent is also a related party of the reporting entity.

However, the definition does not cause investors in a joint venture to be related to each other (see 3.1.10 below).

3.1.4 Entities that are joint ventures of the same third party

Extract from Section 33

33.2(b) An entity is related to a reporting entity if:

- (iii) both entities are joint ventures of the same third party. [FRS 102.33.2(b)(iii)]

As discussed at 3.1.3 above, a joint venture includes subsidiaries of the joint venture. [FRS 102.33.4A]. Therefore, for example, a joint venture's subsidiary and the investor that has joint control over the joint venture are related parties of one another.

3.1.5 Entities that are joint ventures and associates of the same third entity

Extract from Section 33

- 33.2(b)** An entity is related to a reporting entity if:
- (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity. *[FRS 102.33.2(b)(iv)]*

This definition treats joint ventures in a similar manner to subsidiaries. Therefore, an associate and a joint venture are related parties where they have an investor in common. This is because joint control exists in one leg of the indirect relationship between the investees.

3.1.6 Post-employment benefit plans

Extract from Section 33

- 33.2(b)** An entity is related to a reporting entity if:
- (v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. *[FRS 102.33.2(b)(v)]*

The definition is quite wide-ranging and includes post-employment benefit plans of any entity related to the reporting entity. This includes, for example, post-employment benefit plans of an associate or joint venture of the reporting entity or a post-employment benefit plan of an associate of the reporting entity's parent.

The related party relationship would not extend to investment managers of the pension fund, provided that their acting for the fund was the only relationship. Any fees paid by the sponsoring employers (for example, to the investment manager) on behalf of the pension fund would be a related party transaction. 'Sponsoring employers' is not defined in FRS 102, but is generally taken to mean the entity which has a legal duty to ensure that funds are available in the pension fund when the payment of pensions falls due.

Sponsoring employers are also related parties of a post-employment benefit plan.

3.1.7 Entities under control or joint control of certain persons or close members of their family

Extract from Section 33

- 33.2(a)** A person or a close member of that person's family is related to a reporting entity if that person:
- (i) has control or joint control over the reporting entity;
 - (ii) has significant influence over the reporting entity; or
 - (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity *[FRS 102.33.2(a)]*
- 33.2(b)** An entity is related to a reporting entity if any of the following conditions apply:
- (vi) The entity is controlled or jointly controlled by a person identified in (a). *[FRS 102.33.2(b)(vi)]*

This is intended to address situations in which an entity is controlled or jointly controlled by a person or close family member of that person and that person or close family member also controls, jointly controls, has significant influence or is a member of key management personnel of the reporting entity, or of the parent of the reporting entity.

3.1.8 Entities under significant influence of certain persons or close members of their family

Extract from Section 33

- 33.2(a)** A person or a close member of that person's family is related to a reporting entity if that person:
- (i) has control or joint control over the reporting entity; [FRS 102.33.2(a)(i)]
- 33.2(b)** An entity is related to a reporting entity if any of the following conditions apply:
- (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). [FRS 102.33.2(b)(vii)]

This is the reciprocal of 3.1.7 above and covers situations where a reporting entity is controlled or jointly controlled by a person, or close family member of that person and that person, or close member of that person's family, has significant influence or is a member of key management personnel of the entity (or of a parent of the entity).

Entities that have a director or other member of key management personnel in common are not *de facto* related parties. Similarly, if a member of key management personnel of one entity has significant influence over another entity, this does not make the two entities related parties in the absence of any control or joint control by those persons (see 3.1.10 below).

3.1.9 Entities, or any member of the group of which they are a part, that provide key management personnel services

Extract from Section 33

- 33.2(b)** An entity is related to a reporting entity if any of the following conditions apply:
- (viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity. [FRS 102.33.2(b)(viii)]

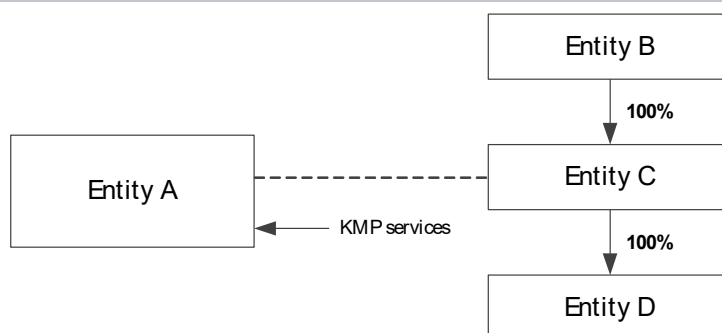
This is intended to address situations in which an entity (described as a 'management entity'), or a member of its group, provides key management personnel services to the reporting entity and is most commonly seen in the fund management sector.

How we see it

As discussed at 3.1.1.B above, in our view, an entity could look to apply the guidance in IAS 24 and not disclose any remuneration paid by a management entity to its employees or directors.

The definition of key management personnel is 'those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise)'. [FRS 102.33.6]. It therefore follows that to determine whether an entity is providing key management personnel services to another entity, the same attributes would need to be considered.

The effect of the requirement is included in the following Illustration.

Illustration 3-1: Entities that provide key management personnel services to a reporting entity

Entity C provides key management personnel (KMP) services to Entity A. For Entity A's financial statements, Entities B, C and D are all related parties. For the financial statements of Entities B, C and D, there is no related party relationship with Entity A. The related party relationship between the management entity and the reporting entity is not symmetrical. In the absence of any other indicator of a related party relationship, the reporting entity (Entity A) cannot affect the management entity's (Entity C's) activities, financial position or profit or loss.

In addition, an entity is required to disclose separately transactions with entities that provide key management personnel services. [FRS 102.33.10(d)]. The type of transactions that require disclosure are discussed at 4.3 below.

3.1.10 Parties that are not related parties

Having included such a detailed definition of related parties, Section 33 clarifies that the following are not related parties: [FRS 102.33.4]

Extract from Section 33

33.4 In the context of this FRS, the following are not related parties:

- (a) Two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity
- (b) Two venturers simply because they share joint control over a joint venture.
- (c) Any of the following simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process):
 - (i) providers of finance;
 - (ii) trade unions;
 - (iii) public utilities; and
 - (iv) government departments and agencies.
- (d) A customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence.

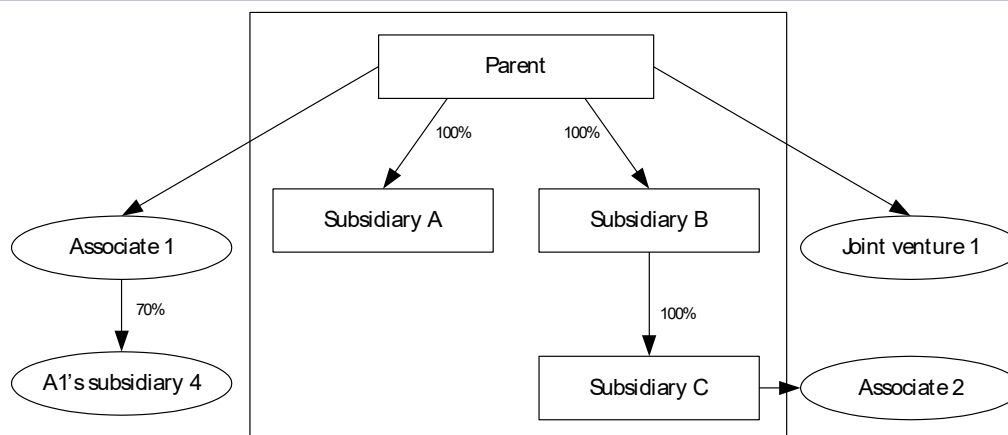
The reason for these exclusions is that, without them, many entities that are not normally regarded as related parties could fall within the definition of related party. For example, a small clothing manufacturer selling 90% of its output to a single customer could be under the effective economic control of that customer.

These exclusions are effective only where these parties are 'related' to the reporting entity simply because of the relationship noted above. If there are other reasons why a party is a related party, the exclusions do not apply.

3.1.11 Illustrative examples of related party relationships

The following Illustrations, based on examples in IAS 24 which has the same definition of a related party as Section 33, show the related party relationships discussed at 3.1.1 to 3.1.8 above.

Illustration 3-2: Related party relationships between entities



In Parent's consolidated financial statements, Subsidiaries A, B and C, Joint Venture 1, Associates 1 and 2 and Associate 1's subsidiary (referred hereafter as 'Associate 4') are related parties to the group. However, Parent's consolidated financial statements need not disclose transactions entered into with Subsidiaries A, B and C as they would be eliminated on consolidation (see 1.1.1 above).

In Parent's individual financial statements, Subsidiaries A, B and C, Joint Venture 1 and Associates 1, 2 and 4 are related parties. However, Parent need not disclose transactions entered into with Subsidiaries A, B and C as they are 100% owned by Parent (see 1.1.2 above).

For Subsidiary B's consolidated financial statements, Parent, Subsidiary A, Subsidiary C, Joint Venture 1 and Associates 1, 2 and 4 are related parties. However, Subsidiary B need not disclose transactions with Parent or Subsidiaries A and C as both Subsidiary B and Subsidiaries A and C are 100% owned by Parent (see 1.1.2 above).

For Subsidiary A, Subsidiary B and Subsidiary C's individual financial statements, Parent, all fellow subsidiaries, Joint Venture 1 and Associates 1, 2 and 4 are related parties. However, the subsidiaries need not disclose transactions entered into with Parent or the other subsidiaries as all entities party to the any transaction are 100% owned by a member of the group (see 1.1.2 above).

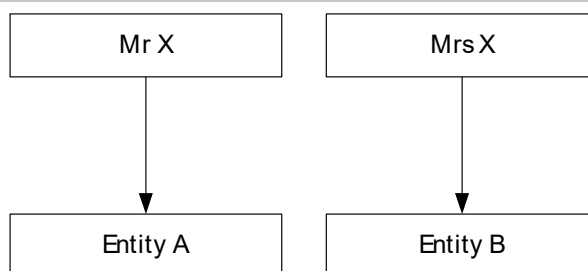
For Joint Venture 1's individual financial statements, Parent, Subsidiaries A, B and C and Associates 1, 2 and 4 are related parties.

For Associate 1's consolidated financial statements, Parent, Subsidiaries A, B and C, Associate 4 and Joint Venture 1 are related parties. However, Associate 1's consolidated financial statements need not disclose transactions entered into with Associate 4 as they would be eliminated on consolidation (see 1.1.1 above). Associate 2 is not a related party.

For Associate 1's individual financial statements, Parent, Subsidiaries A, B and C, Joint Venture 1 and Associate 4 are related parties. Associate 2 is not a related party. Associate 1 must disclose transactions with Associate 4 as Associate 4 is not 100% owned by Associate 1 (see 1.1.2 above).

For Associate 2's individual financial statements, Parent, Subsidiaries A, B and C and Joint Venture 1 are related parties. Associates 1 and Associate 4 are not related to Associate 2.

For Associate 4's individual financial statements, Associate 1, Parent, Subsidiaries A, B and C and Joint Venture 1 are related parties. Associate 2 is not a related party. Subsidiary 4 must disclose transactions with Associate 1 as Subsidiary 4 is not 100% owned by Associate 1 (see 1.1.2 above).

Illustration 3-3: Close members of the family holding investments

Mr X is the spouse of Mrs X. Mr X has an investment in Entity A and Mrs X has an investment in Entity B.

For Entity A's financial statements, if Mr X controls or jointly controls Entity A, Entity B is related to Entity A when Mrs X has control, joint control or significant influence over Entity B.

For Entity B's financial statements, if Mrs X controls or jointly controls Entity B, Entity A is related to Entity B when Mr X has control, joint control or significant influence over Entity A.

If Mr X has significant influence (but not control or joint control) over Entity A and Mrs X has significant influence (but not control or joint control) over Entity B, Entities A and B are not related to each other.

If Mr X is a member of the key management personnel of Entity A but does not have control or joint control over Entity A and Mrs X is a member of the key management personnel of Entity B, but does not have control or joint control over Entity B then Entities A and B are not related to each other.

4 Disclosures of related party transactions, balances and relationships

The following disclosures are required:

- Controlling party relationships (see 4.1 below).
 - Key management personnel compensation (see 4.2 below).
- And
- Related party transactions and balances (see 4.3 below).

There is no requirement to disclose information about related party transactions in one comprehensive note. However, it may be more useful to users of the financial statements to present information this way.

Section 3 - *Financial Statement Presentation* - requires that, except when FRS 102 permits otherwise (which Section 33 does not), comparative information in respect of the previous period must be disclosed for all amounts reported in the current period's financial statements. [FRS 102.3.14].

4.1 Disclosure of controlling party relationships

The standard requires the following disclosures in respect of relationships with controlling parties: [FRS 102.33.5]

Extract from Section 33

33.5 Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been related party transactions. An entity shall disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so (if any) shall also be disclosed.

The use of the word 'party' means that the disclosure applies to both individuals and to entities. Disclosure must be made even if the parent or ultimate controlling party does not prepare financial statements.

The ultimate controlling party could be a group of individuals or entities acting together. Section 33 is silent on the issue of individuals or entities acting together to exercise joint control as a result of contractual relationships. Two venturers are not related parties simply because they share joint control over a joint venture. [FRS 102.33.4(b)]. Section 33 is also silent on whether a group of individuals acting in an informal way could be considered to be the ultimate controlling party of an entity. However, it is likely that such an informal arrangement would at least give such individuals acting collectively significant influence over the reporting entity and as such those individuals collectively would be related parties to the reporting entity.

It is stressed that these relationships between a parent and its subsidiary must be disclosed irrespective of whether there have been related party transactions. [FRS 102.33.5].

4.2 Disclosure of key management personnel compensation

An entity is required to disclose key management compensation in total. [FRS 102.33.7].

Compensation includes all employee benefits (as defined in Section 28 - *Employee Benefits*) including those in the form of share-based payments. Employee benefits includes all forms of consideration paid, payable or provided by the entity, or on behalf of the entity (e.g., by its parent or shareholder), in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of goods and services provided to the entity. [FRS 102.33.6].

A related party includes all key management personnel of a reporting entity and of a parent of the reporting entity. This means that all key management personnel of all parents (i.e., the immediate parent, any intermediate parent and the ultimate parent) of a reporting entity are related parties of the reporting entity. When the reporting entity's financial statements represent a group, key management personnel of subsidiaries might not be key management personnel of the group if those persons do not participate in the management of the group.

Disclosure is required only of key management compensation in total. There is no need to split the amount into its constituent parts. There is also no requirement to disclose individual key management compensation or to name those individuals considered to be key management. In addition, when an entity is subject to a legal or regulatory requirement to disclose directors' remuneration (or equivalent), it is exempt from the requirement to disclose key management personnel compensation if the key management personnel and directors are the same. [FRS 102.33.7A].

One practical difficulty for an entity in a group is that the disclosure of its key management personnel compensation is for the services rendered to the reporting entity. Accordingly, where key management personnel of the reporting entity also provide services to other entities within the group, an apportionment of the compensation is necessary. Likewise, where the reporting entity receives services from key management personnel that are also key management personnel of other entities within the group, the reporting entity may have to impute the compensation received. Such apportionments and allocations require judgement, and an assessment of the time commitment involved.

How we see it

As discussed in 3.1.1.B above, in our view, an entity could look to apply the guidance in IAS 24 and not disclose any remuneration paid by a management entity to its employees or directors.

Company law requires disclosures in respect of directors' remuneration which are in addition to the requirement to disclose key management personnel compensation (see 4.4 below).

4.3 Disclosure of related party transactions and balances

4.3.1 Definition of and examples of related party transactions

A related party transaction 'is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged'.

Examples of related party transactions include but are not limited to:

- Transactions between an entity and its principal owner(s).
- Transactions between an entity and another entity when both entities are under the common control of a single entity or person.

And

- Transactions in which an entity or person that controls the reporting entity incurs expenses directly that would have been borne by the reporting entity. [FRS 102.33.8].

Section 33 provides the following examples of transactions that must be disclosed if they are with a related party:

- Purchases or sales of goods (finished or unfinished).
- Purchases or sales of property and other assets.
- Rendering or receiving of services.
- Leases.
- Transfers of research and development.
- Transfers under licence agreements.
- Transfers under finance arrangements (including loans and equity contributions in cash or in kind).
- Provisions of guarantees or collateral.
- Commitments to do something if a particular event occurs or does not occur in the future.
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

And

- Participation by a parent or a subsidiary in a defined benefit plan that shares risks between group entities. [FRS 102.33.12].

This list is not intended to be exhaustive. Information about commitments must be disclosed if necessary for an understanding of the potential effect of the related party relationship on the financial statements. [FRS 102.33.9].

Items of a similar nature may be disclosed in aggregate except where separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of an entity.

[FRS 102.33.14].

4.3.2 Disclosures required in respect of related party transactions and outstanding balances

If an entity has related party transactions of the type described at 4.3.1 above, it must disclose the nature of the related party relationship as well as information about the transactions, outstanding balances and commitments necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to the requirements to disclose key management personnel compensation (see 4.2 above). However, when, an entity takes advantage of the exemption from disclosing key management personnel compensation (see 4.2 above) it is not required to provide additional disclosure about directors' share-based payment arrangements.

At a minimum, disclosures must include:

- The amount of the transactions.
 - The amount of the outstanding balances and commitments, and:
 - Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement.

And

 - Details of any guarantees given or received.
 - Provisions for uncollectible receivables related to the amount of outstanding balances.
- And
- The expense recognised during the period in respect of bad or doubtful debts due from related parties. *[FRS 102.33.9].*

The disclosures required above must be made in aggregate for each of the following separate categories:

- Entities with control, joint control or significant influence over the entity.
 - Entities over which the entity has control, joint control or significant influence.
- Key management personnel of the entity or its parent (in the aggregate).
- And
- Other related parties. *[FRS 102.33.10].*

Section 33 stresses that an entity must not state that related party transactions were made on terms equivalent to those that prevail in arm's length transactions unless such terms can be substantiated. *[FRS 102.33.13].* However, there is no requirement to state that transactions have not been made on an arm's length basis. There is no exemption from disclosure on the grounds of confidentiality. However, since there is no requirement to disclose the name of a related party (apart from the name of the parent, or if different, the ultimate controlling entity), this lack of exemption is likely to be less of a concern.

In determining whether an entity discloses related party transactions in financial statements, the general concept of materiality is applied. Section 33 does not refer specifically to materiality since this qualitative characteristic is described in Section 2 - *Concepts and Pervasive Principles*. Omissions or misstatements of items are material if they 'individually or collectively, could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor'. *[FRS 102.2.6].*

This may have the effect that any related party transaction whose disclosure is considered sensitive (for tax reasons perhaps) is by definition material because it is expected by the reporting entity to influence a user of the financial statements.

How we see it

It may not be possible to avoid disclosing sensitive related party transactions on the grounds that they are quantitatively immaterial. In addition, a transaction conducted at advantageous terms to either the related party or the reporting entity is more likely to be material than one conducted at arm's length. Since Section 33 requires disclosure of related party transactions irrespective of whether consideration is received, disclosure cannot be avoided on the argument that, since there is no consideration, the transaction must be immaterial.

Section 33 is also unclear whether disclosure of outstanding balances at the reporting date is required in situations where an entity ceases to be a related party during the reporting period. In such situations, one view is that outstanding balances are not disclosable since the entity is not a related party as at the reporting date. A second view is that if the outstanding balances as at the reporting date comprise of amounts related to the transactions when the entities were related, such outstanding balances must be included in related party disclosures.

How we see it

In our view, either view is acceptable. However, if an entity becomes a related party during the year, outstanding balances as at the reporting date, that include amounts related to transactions entered into when the entities were unrelated, are disclosable.

In the case that entities become related after the reporting date, but before the financial statements were authorised for issue, it may be necessary to disclose the relationship, if it is considered by management to be a material non-adjusting event, in accordance with Section 32 *Events after the Reporting Period*. See Chapter 34 for further details.

4.3.3 Disclosure exemption for government-related entities

An entity is exempt from the disclosure requirements discussed at 4.3.1 above in relation to:

- A government that has control, joint control or significant influence over the reporting entity.
And
- Another entity that is a related party because the same government has control, joint control or significant influence over both the reporting entity and the other entity.

This is a generous exemption as there is no requirement to give even an indication of the type of transactions with the government or other government-related entity that is a related party.

However, the entity must still disclose a controlling party relationship as discussed at 4.1 above.

[FRS 102.33.11].

4.4 Additional UK company law disclosures

UK company law requires disclosures of transactions with directors including disclosure of directors' remuneration and disclosure of directors' advances, credits and guarantees.

These disclosures are in addition to the disclosure of key management personnel compensation discussed at 4.2 above.

4.4.1 Disclosure of directors' remuneration - all companies

Disclosure of directors' remuneration is required for all entities and disclosures are required for both individual and group financial statements. The requirements are contained in Schedule 5 of *The Large and Medium-sized Companies and Groups (Accounts and Report) Regulations 2008* (SI 2008/410) (The Regulations). It is beyond the scope of this publication to address the requirements at length which differ slightly between AIM listed and unquoted entities that are not AIM listed. The following summarises the major points: [5 Sch 1-15]

- Disclosure is required of:
 - The aggregate amount of remuneration paid to or receivable by directors (i.e., all directors including non-executive directors) in respect of qualifying services.
 - Gains made by directors on share options in aggregate (as well as the number of directors who exercised share options).
 - The aggregate of the amount of money paid to or receivable by directors and the net value of assets (other than money or share options) received or receivable by directors under long term incentive plans in respect of qualifying services (as well as the number of directors in respect of whose qualifying services shares were received or receivable under long term incentive schemes).
 - The aggregate value of any company contributions paid, or treated as paid, to a pension scheme in respect of directors' qualifying services and contributions by reference to which the rate or amount of any money purchase benefits that may become payable will be calculated.
- And

- The number of directors to whom retirement benefits are accruing in respect of qualifying services under both money purchase and defined benefit schemes.
- When aggregate remuneration of all directors, share option gains and amounts receivable on long-term incentive plans exceeds £200,000 disclosures are required of the total of those aggregates for the highest paid director of:
 - The amount of remuneration, share option gains and amounts receivable on long-term incentive plans.
 - The amount of any company contributions paid into a money purchase pension scheme.
 - The accrued pension and the amount of the accrued lump sum in respect of any defined benefit pension plan.
- And
- Whether the director has exercised any share options and whether any shares were received or receivable by that director in respect of qualifying services under a long-term incentive scheme.
- Disclosure is required in aggregate of any excess retirement benefits paid or receivable by directors or past directors (compared to their entitlement when the benefits first became payable or as at 31 March 1997, whichever is the later).
- Disclosure is required of the aggregate amount of compensation paid to directors or past directors for loss of office (which includes loss of office as director, loss of any other office in connection with management of the company's affairs and any office as director or otherwise in connection with the management of the affairs of any subsidiary undertaking of the company).
- Disclosure is required of the aggregate amount of any consideration paid to or receivable by third parties (i.e., a person other than the director or a person connected with him or a body corporate controlled by him or the company or any of its subsidiary undertakings) for making available the services of any person as a director of the company or, while a director of the company, as director of any of its subsidiary undertakings or otherwise in connection with the management of the affairs of the company or any of its subsidiary undertakings.

'Qualifying services' are defined as a person's services as director of a company and his services at any time while he is a director of the company as a director of any of its subsidiary undertakings or otherwise in connection with the management of the affairs of the company or any of its subsidiary undertakings.

'Remuneration' means salary, fees, bonuses, sums paid by way of expense allowance (chargeable to UK income tax) and the estimated money value of other benefits received otherwise than in cash. It does not include the value of share options, gains made on exercise of share options, company contributions paid into a pension scheme or amounts paid/receivable under a long term incentive plan.

All amounts disclosed must include sums paid by or receivable from the company, its subsidiary undertakings or any other person. In other words, disclosures are required, regardless of who actually pays the director.

Payments made to persons connected with the director or persons connected with a body corporate 'controlled' by a director (as defined in sections 252-255 of CA 2006) are required to be included in the aggregate remuneration disclosed.

In group financial statements, the directors' remuneration disclosure requirements only extend to directors of the holding company.

In group situations, it is common practice for a holding company, whose directors also act as directors of subsidiary companies, to remunerate the directors in respect of their services to the subsidiary companies. In this situation, remuneration disclosures are still required in the subsidiary company's financial statements and there must be an apportionment of the remuneration received for qualifying services to each subsidiary. It may also be possible that, given the level of services required by each subsidiary company, the remuneration for qualifying services is £nil.

However, in the rare cases that the directors believe that it is not practicable to make such an apportionment, we believe that full disclosure of the total amount received as remuneration would be required, accompanied by a statement that it is not practicable to allocate this amount between services as directors of the company and services as directors of holding and fellow subsidiary companies. The note to the financial statements must explain that the charge disclosed as remuneration has been borne by the holding company or other group company.

It may be the case that a blanket management charge has been charged by a holding company to its subsidiaries in respect of a variety of expenditure incurred on its subsidiaries' behalf, including the remuneration of the subsidiaries' directors. The reporting company must seek to analyse the expenditure between types and thereby arrive at a figure for directors' remuneration.

4.4.2 Directors' remuneration report - quoted companies only

Quoted companies are required to prepare a directors' remuneration report. A quoted company is a company whose equity share capital is included in the official list of the UK Listing Authority, officially listed in an EEA state or admitted to dealing on either the New York Stock Exchange or NASDAQ. [s385(2)]. AIM and OFEX companies are not quoted.

The contents of a directors' remuneration report are specified by Schedule 8 of The Regulations.

4.4.3 Disclosure of directors' advances, credits and guarantees - all companies

Disclosure of directors' advances, credits and guarantees is required by section 413 of the CA 2006 for all entities. [s413]. These disclosures are required for each credit, advance or guarantee.

Disclosure is required in respect of all transactions during the reporting period as well as balances outstanding at the reporting date. Disclosure is required of transactions with any person who was a director of the company at any time during the period, irrespective of whether that person was a director at such time that the transaction or arrangement was made. See Chapter 6 at 7.9 for further detail.

4.5 Stock exchange requirements

In addition to the requirements of the Companies Act, there are explicit statutory, London Stock Exchange (LSE) and Disclosure and Transparency Rules (DTR) requirements and reliefs regarding disclosure of certain related party transactions and relationships. These disclosure requirements are not addressed in detail in this chapter and reference must be made to the original regulatory requirements. These disclosure requirements go beyond those required by FRS 102.

Both the LSE and AIM have definitions of a related party which differ from the definition in FRS 102. For related party transactions meeting certain thresholds, the Listing Rules require the company to make notification of the related party transaction, and to send a circular containing specified details to shareholders, and to obtain shareholder approval. There are modified rules for smaller related party transactions. AIM Rules 13 and 16 also require notification of related party transactions meeting certain thresholds. Disclosure of certain related party transactions can be required in the financial statements.

4.6 Disclosure of commitments

Section 33 provides no definition of commitments, though definitions relating to commitments are present in other sections of the standard. The appendix to FRS 102 defines a firm's commitment as a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. A performance related condition in respect of funding commitments is also defined in the appendix to FRS 102 as a condition under which entitlement to resources is conditional on the performance of:

- (a) A specified activity.

Or

- (b) A particular level of service or units of output to be delivered. [FRS 102 Appendix I].

Commitments must however be considered more widely than these definitions. The words "commitments to do something if a particular event occurs or does not occur in the future" can potentially have a wide application and does not limit itself to contractual commitments required to be disclosed by other sections of the standard.

Section 33 requires a disclosure of commitments to do something if a particular event occurs or does not occur in the future when it is with a related party. [FRS 102.33.12(hA)].

With respect to the details of commitment to be disclosed, FRS 102 requires an entity that has made a commitment to disclose the following: [FRS 102.33.9(b)]

The amount of outstanding balances and commitments, and:

- (i) Their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement;

And

(ii) Details of any guarantees given or received.

The above disclosures may be made in aggregate, provided that such aggregation does not obscure significant information. However, separate disclosure must be made for recognised and unrecognised commitments.

Provisions of guarantees including a financial guarantee contract which are a form of commitment also require separate disclosures.

5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

FRS 102		IFRS
Transactions between wholly owned subsidiaries	Disclosure exemption available.	No disclosure exemption available.
Disclosure of key management personnel compensation	Disclose in total only. However, no disclosure is required if there is a legal or regulatory requirement to disclose directors' remuneration and the key management personnel and the directors are the same.	Disclose in total and by five categories.
Government-related parties	Disclosure exemption available.	Disclosure exemption conditional on certain additional disclosures being made.
Aggregation of disclosures by category	Disclosure by five categories. ▪ Entities with control, joint control or significant influence over the entity. ▪ Entities over which the entity has control, joint control or significant influence. ▪ Key management personnel of the entity or its parent (in the aggregate). ▪ Entities that provide key management personnel services to the entity; and ▪ Other related parties. Under FRS 102 entities can aggregate transactions: With a controlling party together with those with joint control or significant influence. With entities for which the entity has control, joint control or significant influence (i.e., subsidiaries and associates).	Disclosure by seven categories. ▪ The parent. ▪ Entities with joint control of, or significant influence over, the entity. ▪ Subsidiaries. ▪ Associates. ▪ Joint ventures in which the entity is a joint venturer. ▪ Key management personnel of the entity or its parent; and ▪ Other related parties.
Disclosure of commitments	Disclose required if necessary for understanding of relationship.	Explicit statement that the commitment is a type of related party transaction.

Appendix A - Defined terms

Extract from FRS 102

Appendix I

Glossary

related party	A related party is a person or entity that is related to the entity that is preparing its financial statements (the reporting entity). (a) A person or a close member of that person's family is related to a reporting entity if that person: (i) has control or joint control over the reporting entity; (ii) has significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions apply: (i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others). (ii) one entity is an associate or joint venture of the other entity (or of a member of a group of which the other entity is a member). (iii) both entities are joint ventures of the same third entity. (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity. (v) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. (vi) the entity is controlled or jointly controlled by a person identified in (a). (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). (viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.
related party transaction	A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.
key management personnel	Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.
government	Government, government agencies and similar bodies whether local, national or international.

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Chapter 36

Specialised activities

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1 Introduction

This chapter covers (unless stated otherwise below) the financial reporting requirements for entities applying FRS 102 involved in the following types of specialised activities:

- Agriculture (see 2 below)
- Extractive Activities (see 3 below)
- Service Concession Arrangements (see 4 below)
- Heritage Assets (see 5 below)
- Public Benefit Entities, including incoming resources from non-exchange transactions, public benefit entity business combinations and public benefit concessionary loans (see 6 below)
- Financial Institutions (see Chapter 15 at 4.1.4)
- Funding Commitments (see Chapter 19 at 3.10)

These are all dealt with in Section 34 *Specialised Activities*.

Accounting by retirement benefit plans is outside the scope of this publication.

2 Agriculture

2.1 Overview

Section 34 sets out the recognition, measurement and disclosure requirements for agricultural activities. While these requirements are based on the *IFRS for SMEs* Accounting Standard, the FRC included in FRS 102 an accounting policy choice to apply either a fair value model or a cost model.

What you need to know

- Agricultural activity is defined as the management by an entity of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets.
- Each entity engaged in agricultural activity is required to determine an accounting policy to use either the fair value model or the cost model for each class of biological asset and its related agricultural produce.

2.2 Introduction

The requirements in Section 34 for agricultural activities were originally proposed to be based on the fair value model in line with IAS 41 *Agriculture*. However, concerns were raised that fair value information was inconsistent with the way most agricultural businesses are managed and would not benefit the users of financial statements. Therefore, an accounting policy choice between a cost model and a fair value model was introduced for biological assets. The use of the cost model for agricultural produce is limited to those entities that had chosen the cost model for biological assets. Such entities also have the choice of using the fair value model for their agricultural produce. [FRS 102.BC.B34A.1, FRS 102.BC.B34A.2, FRS 102.BC.B34A.4]. The accounting policy choice between the cost model and the fair value model is one of the key differences with IAS 41 and is discussed further at 2.3 below.

2.3 Key differences to IFRS

There are three principal differences between Section 34 and IAS 41:

- The first relates to the measurement basis for biological assets and related agricultural produce (see 2.3.1 below).
- The second relates to the concept of bearer plants (see 2.3.2 below).
- The third relates to the scope of government grants related to biological assets (see 2.3.3 below).

2.3.1 Measurement basis

Section 34 permits an accounting policy choice between the fair value model and the cost model. See 2.6 below.

IAS 41 requires the measurement of biological assets at fair value less costs to sell, unless at initial recognition the entity cannot reliably measure the fair value, in which case the entity would measure the biological asset or agricultural produce at historic cost less any accumulated depreciation and any accumulated impairment losses until fair value becomes reliably measurable. [IAS 41.12, IAS 41.30].

2.3.2 Bearer plants

Section 34 does not make a distinction between biological assets and bearer plants. Therefore, bearer plants are treated as biological assets and accounted for in accordance with Section 34.

IAS 41 distinguishes between biological assets and bearer plants. IAS 41 defines a bearer plant as a living plant which is used in the production or supply of agricultural produce, is expected to bear produce for more than one period and has a remote chance of being sold as agricultural produce, except for incidental scrap sales. [IAS 41.5]. Bearer plants are scoped out of IAS 41 and instead fall in the scope of IAS 16 *Property, Plant and Equipment* however, the produce growing on a bearer plant remains within the scope of IAS 41. [IAS 41.2]

2.3.3 Government grants related to biological assets

Government grants related to biological assets are not within the scope of Section 34. Government grants are recognised and measured in accordance with Section 24 *Government Grants*.

Government grants involving biological assets that are within the scope of IAS 41 (i.e., excluding bearer plants, which are specifically scoped out of IAS 41) are only accounted for under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* if the biological asset is measured at its cost less any accumulated depreciation and any accumulated impairments losses. IAS 41 applies to government grants relating to all other biological assets (including produce growing on a bearer plant) accounted for at fair value less costs to sell.

2.4 Scope

Agricultural activity is the management by an entity of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets. It covers a wide range of activities. FRS 102 provides no examples of agricultural activity. However, IAS 41 provides examples of raising livestock, forestry, annual or perennial cropping, cultivating orchards and plantations, floriculture, and aquaculture (including fish farming). [IAS 41.6].

The table below, which appears in IAS 41, provides examples of biological assets, agricultural produce and products that are the result of processing after harvest. [IAS 41.4]

Biological assets	Agricultural produce	Products that are the result of processing after harvest
Sheep	Wool	Yarn, carpet
Trees in a plantation	Felled trees	Logs, lumber
Plants	Cotton Harvested cane	Thread, clothing Sugar
Dairy cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Bushes	Leaf	Tea, cured tobacco
Vines	Grapes	Wine
Fruit trees	Picked fruit	Processed fruit

An entity that is engaged in agricultural activity must determine an accounting policy for each class of biological asset and its related agricultural produce. [FRS 102.34.2]. In addition, leases of biological assets within the scope of Section 34 held by a lessee must be measured in accordance with Section 34.

[FRS 102.20.1(b)].

Biological assets may be outside the scope of Section 34 when they are not used in agricultural activity. For example, animals in a zoo (or game park) that does not have an active breeding programme and rarely sells any animals or animal products would be outside the scope of the standard. Another example is activities in the pharmaceutical industry that involve the culture of bacteria. Such activity would not fall within the scope of Section 34. While the bacteria may be considered a biological asset, the development of a culture by a pharmaceutical company would not constitute agricultural activity.

Prior to harvest, agricultural produce is not distinguished from the biological asset to which it is related. [FRS 102.34.3C]. Once harvested, agricultural produce is no longer within the scope of Section 34. At that point, it is measured at its fair value less costs to sell and this measurement becomes the cost at that date when applying Section 13 *Inventories* or another applicable section of FRS 102. [FRS 102.34.5].

2.4.1 Trees held to generate carbon offsets for use or sale

Climate change and carbon emissions are a global concern. In an effort to offset some of their emissions, entities might buy or plant trees that will absorb carbon dioxide (i.e., act as carbon sinks) and thereby generate carbon offsets. Similarly, forestry companies might change their business models to defer, or cease, planned harvests of trees to generate carbon offsets.

Entities that directly own such trees will need to determine whether the trees are:

- Biological assets related to agricultural activity to which Section 34 applies.

Or

- Assets not related to agricultural activity, in which case, it is likely an entity would apply the requirements in Section 17 *Property Plant and Equipment*.

Trees are living plants and therefore, meet the definition of a biological asset. However, to be within the scope of Section 34, they must relate to agricultural activity.

Considering the definition of agricultural activity, by their very nature, trees will be subject to biological transformation (growth, degeneration, production and procreation processes), which will result in qualitative and quantitative changes. For there to be agricultural activity, as defined by Section 34, there needs to be the management of change and the harvest of agricultural produce.

- Management of change
For trees, management normally includes silviculture activities, such as planting, pruning, thinning, and fertilising. Harvesting unmanaged sources (deforestation) will not meet the definition of agricultural activity.
- Harvest of agricultural produce
Section 34 limits the definition of agricultural produce to that which can be harvested. This includes harvesting produce growing on, or in the trees (e.g., fruit, latex) and felling the trees.

How we see it

While carbon dioxide is absorbed and oxygen is produced by the trees, the oxygen cannot be captured at the point of production and detached in the manner contemplated by the definition of agricultural produce in Section 34. Similarly, in our view, carbon offsets are not agricultural produce of trees.

No guidance is provided on the extent of harvest needed to qualify as an agricultural activity. If the entity actively manages the trees, thinning the trees will involve harvesting some trees to give space for others to grow. Trees can also be felled to create, or maintain, an access road. Even if the entity does not plan to harvest, a wind or water event might naturally fell the trees. It is not clear the extent to which such felling might constitute harvesting of agricultural produce (and, therefore agricultural activity) if the entity were to sell (e.g., at stump) or use the logs.

The considerations discussed above will, in turn determine the nature of the asset.

Nature of the asset	Agricultural activity	Example
Biological asset related to agricultural activity	Yes	Trees in a plantation forest with deferred harvest to allow generation of carbon offsets.
Asset not related to agricultural activity	No	Trees held to generate carbon offsets that are unmanaged and/or not harvested.

How we see it

If the trees are held solely to generate carbon offsets, whether sold or used, determining the nature of the asset may require judgement.

After initial recognition, it is not clear whether reassessment might be required if circumstances change. For example, assume an entity had no intention of felling the trees, but that subsequently changed for some of the trees due to windthrow. If these circumstances were to arise, an entity would need to apply the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* to develop an appropriate policy.

2.5 Recognition

An entity must recognise a biological asset or an item of agricultural produce only when:

- The entity controls the asset as a result of past events.
 - It is probable that future economic benefits associated with the asset will flow to the entity.
- And
- The fair value or cost of the asset can be measured reliably. [FRS 102.34.3].

As discussed at 2.4 above, Section 34 only applies to agricultural produce (i.e., harvested product) at the point of harvest and not prior or subsequent to harvest. Unharvested agricultural produce is considered to be part of the biological asset from which it will be harvested. Therefore, before harvest, agricultural produce must not be recognised separately from the biological asset from which it comes. For example, grapes on the vine are accounted for as part of the vines themselves right up to the point of harvest.

2.6 Measurement

For each class of biological asset and its related agricultural produce, Section 34 provides an entity an accounting policy choice to use either: *[FRS 102.34.3A]*

- The fair value model set out at 2.7 below.

Or

- The cost model set out at 2.8 below.

However, once an entity has elected to use the fair value model for a class of biological asset and its related agricultural produce, it is not subsequently permitted to change its accounting policy to the cost model.

[FRS 102.34.3B].

The Regulations and the LLP Regulations state that if the fair value model is adopted by an entity, it must be adopted for all living animals and plants where their fair value can be reliably determined. *[1 Sch 39(2), 2 Sch 47(2), 3 Sch 33(2), 1 Sch 39(2)(LLP)]*. However, the Note on legal requirements to FRS 102 states that the ability of an entity to subdivide biological classes such that some classes may be at measured cost and others at fair value is consistent with the most reasonable and common-sense interpretation of the Regulations. *[FRS 102.A3.37D].*

2.7 Fair value model

2.7.1 Measurement

If an entity applies the fair value model, it must measure a biological asset on initial recognition and at each reporting date at its fair value less costs to sell. Changes in fair value less costs to sell must be recognised in profit or loss. *[FRS 102.34.4]*. Agricultural produce harvested from an entity's biological assets is measured at the point of harvest at its fair value less costs to sell. This then becomes the cost at that date when applying Section 13 or another applicable section of FRS 102. *[FRS 102.34.5]*.

Fair value is defined as "the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date". *[FRS 102.2A.2]*.

Costs to sell are not defined in FRS 102. However, IAS 41 defines costs to sell as "the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes". *[IAS 41.5]*.

Therefore, of all the costs that are necessary for a sale to occur, costs to sell only include those costs that would not otherwise arise. However, costs already included within the fair value measurement, such as transportation costs, are excluded from costs to sell. Examples of costs to sell include brokers' and dealers' commissions, levies by regulatory agencies and commodity exchanges, transfer taxes and duties.

[IAS 41.BC3, IAS 41.B22]

Section 2A *Fair value measurement* provides guidance on fair value measurement which is applicable to the measurement of a biological asset when the fair value model is applied (see Chapter 10). The application of fair value techniques may involve sector benchmarks such as the value of an orchard expressed per export tray, bushel, or hectare, or the value of cattle expressed per kilogram of meat. *[FRS 102.34.6]*.

2.7.2 Fair value of a biological asset that is not reliably measurable

If an entity cannot measure the fair value of a biological asset reliably then it must apply the cost model (see 2.8 below) to that biological asset until such time that the fair value can be reliably measured.

[FRS 102.34.6A].

Valuation techniques or the use of multiple techniques can result in a range of reasonable valuations which require judgement to be applied when determining the most appropriate fair value within the range.

[FRS 102.2A.20]. If the range of reasonable fair value measures is significant and the probabilities of the various measures within the range cannot be reasonably assessed, the entity is precluded from measuring the asset at fair value. *[FRS 102.2A.22]*. For agricultural produce, the FRC's view is that agricultural produce must be capable of measurement at fair value without undue cost or effort and must provide more relevant information for users. *[FRS 102.BC.B34A.4]*.

2.8 Cost model

2.8.1 Measurement

2.8.1.A Biological assets

An entity that applies the cost model must measure biological assets at cost less any accumulated depreciation and any accumulated impairment losses. [FRS 102.34.8].

Impairment losses on biological assets measured under the cost model are within the scope of Section 27 *Impairment of Assets* (see Chapter 24 at 3.1).

2.8.1.B Agricultural produce

Section 34 requires that in applying the cost model, agricultural produce harvested from an entity's biological assets are measured at the point of harvest at either: [FRS 102.34.9]

- The lower of cost and estimated selling price less costs to complete and sell.
- Or
- Its fair value less costs to sell. Any gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell is included in profit or loss for the period in which it arises.

That amount is then the cost at that date when applying Section 13 or another applicable section of FRS 102.

Therefore, if an entity elects to measure its biological assets under the cost model, it will still be allowed to measure agricultural produce under the fair value model. However, the converse would not be true, if an entity measures its biological assets under the fair value model, then it must measure the resulting agricultural produce under the fair value model as well.

2.8.1.C Elements of cost

The cost of a biological asset comprises all of the following: [FRS 102.34.9A]

- Purchase price, including legal and brokerage fees, import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- The initial estimate of the costs, recognised and measured in accordance with Section 21 *Provisions and Contingencies*, of removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period.
- And
- Any borrowing costs capitalised in accordance with Section 25 *Borrowing Costs*.

2.9 Disclosures required by Section 34

2.9.1 Disclosures for each class of biological asset that is measured using the fair value model

An entity must disclose the following information for each class of biological asset that is measured using the fair value model: [FRS 102.34.7]

- A description of each class of biological asset.
- The methods and significant assumptions applied in determining the fair value of each class of biological asset.
- And
- A reconciliation of changes in the carrying amount of each class of biological asset between the beginning and the end of the current period which includes:
 - The gain or loss arising from changes in fair value less costs to sell
 - Increases resulting from purchases
 - Decreases attributable to sales

- Decreases resulting from harvest
- Increases resulting from business combinations
- And
- Other changes

This reconciliation need not be presented for prior periods.

A class of assets is a grouping of assets of a similar nature and use in an entity's operations. *[FRS 102 Appendix I]*. In grouping biological assets into classes in order to make the disclosures above, an entity may consider distinguishing between different types of assets, such as consumable biological assets, bearer biological assets or mature and immature assets. In particular, it must be noted that for the purposes of the reconciliation noted above, it would be unhelpful to combine information about annual crops (which are akin to inventory) with that on bearer plant or long-lived biological assets (which are more like property, plant and equipment).

If an entity measures any individual biological assets at cost because fair value cannot be measured reliably (see 2.7.2 above), it must explain why fair value cannot be reliably measured. If the fair value of such a biological asset becomes reliably measurable during the current period, an entity must explain why fair value has become reliably measurable and the effect of the change. *[FRS 102.34.7A]*.

Finally, an entity must disclose the methods and significant assumptions applied in determining the fair value at the point of harvest of each class of agricultural produce. *[FRS 102.34.7B]*.

2.9.2 Disclosures for each class of biological asset that is measured using the cost model

For each class of biological asset measured under the cost model, an entity discloses the following: *[FRS 102.34.10]*

- A description of each class of biological asset
- The depreciation method used
- The useful lives or the depreciation rates used
- And
- A reconciliation of changes in the carrying amount of each class of biological asset between the beginning and the end of the current period which includes:
 - Increases resulting from purchases
 - Decreases attributable to sales
 - Decreases resulting from harvest
 - Increases resulting from business combinations
 - Impairment losses recognised or reversed in profit or loss in accordance with Section 27
 - And
 - Other changes

This reconciliation need not be presented for prior periods.

In addition, an entity must disclose, for any agricultural produce measured at fair value less costs to sell, the methods and significant assumptions applied in determining the fair value at the point of harvest of its agricultural produce. *[FRS 102.34.10A]*.

The comments at 2.9.1 above regarding classes of assets also apply.

2.10 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

FRS 102		IFRS
Measurement	Accounting policy choice of either the fair value model or the cost model. If the measurement of a class of biological assets and its related agricultural produce is changed from the cost model to the fair value model, this change in accounting policy is to be dealt with as a change in fair value less costs to sell, rather than retrospectively as a change in accounting policy in accordance with Section 10.	Entities must measure biological assets and agricultural produce at fair value less costs to sell unless the fair value cannot be reliably measured at initial recognition. In the latter case, the entity would measure at cost less accumulated depreciation and accumulated impairment losses. There is a presumption in IAS 41 that the fair value of all biological assets can be measured reliably. This presumption can only be rebutted on initial recognition for a biological asset (not agricultural produce). Once fair value becomes reliably measurable, the fair value model is applied from that date.
Bearer plants	Definition does not exist in Section 34.	Defined as a living plant used in the production or supply of agricultural produce, expected to bear produce for more than one period and has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales. Such plants are accounted for under IAS 16.
Government grants	Accounting for government grants related to biological assets is not in the scope of Section 34.	Accounting for government grants related to biological assets measured at fair value less costs to sell is set out in IAS 41. Grants related to biological assets measured at cost are in the scope of IAS 20.

2.11 Defined terms

Extract from FRS 102 Appendix 1 Glossary

Definitions

agricultural activity	The management by an entity of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets.
agricultural produce	The harvested product of the entity's biological assets.
biological asset	A living animal or plant that may or may not be intended for use on a continuing basis in the entity's activities.

3 Extractive activities

3.1 Overview

FRS 102 does not contain its own guidance in respect of the accounting for extractive activities.

What you need to know

- Entities engaged in the exploration for and/or evaluation of mineral resources (extractive activities), such as oil and gas upstream entities and mining entities, must apply the requirements of IFRS 6 *Exploration for and Evaluation of Mineral Resources* (as adopted in the UK).
- Activities outside the E&E phase are outside the scope of IFRS 6, and therefore an entity must apply the requirements of the relevant sections in FRS 102.

3.2 Introduction

An entity applying FRS 102 which is engaged in the exploration for and/or evaluation of mineral resources (extractive activities) must apply the requirements of IFRS 6 (as adopted in the UK). [FRS 102.34.11].

Exploration for and evaluation of mineral resources is defined in IFRS 6 as “the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.” [IFRS 6 Appendix A].

IFRS 6 covers the accounting for exploration and evaluation (E&E) expenditures, which are defined as “expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable”. E&E assets are defined as “exploration and evaluation expenditures recognised as assets in accordance with the entity’s accounting policy”. [IFRS 6 Appendix A]. IFRS 6 is limited to accounting for E&E expenditures and does not address the other aspects of accounting for entities engaged in these activities. This section will therefore not apply to expenditures incurred before the exploration for, and evaluation of, mineral resources (e.g., expenditures incurred before the entity has obtained legal rights to explore in a specific area) or after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. [IFRS 6.5]. Equipment used in the E&E phase, e.g., property, plant and equipment and any other intangible assets such as software, are not in the scope of IFRS 6, instead they are in the scope of Sections 17 and 18, respectively.

The scope and objectives of IFRS 6 are covered in further detail in EY’s publication, International GAAP®.

Activities outside the E&E phase which are not covered by IFRS 6, may be covered by the following sections of FRS 102:

- Section 13 *Inventories*
 - Section 16 *Investment Property*
 - Section 17 *Property, Plant and Equipment*
 - Section 18 *Intangible Assets other than Goodwill*
- Or
- Section 20 *Leases*

In many of these sections ‘minerals and mineral reserves’ are excluded from their scope, although the exact wording of the scope exclusions differs between standards.

3.3 Requirements of Section 34 for extractive activities

As noted at 3.2 above, FRS 102 requires an entity engaged in extractive activities to apply the requirements of IFRS 6 to account for E&E expenditures. [FRS 102.34.11].

IFRS 6 is not discussed in detail in this publication. Instead, readers are referred to EY’s publication, International GAAP®.

IFRS 6 contains within it a number of references to other IFRS Accounting Standards. In applying FRS 102, the references within IFRS 6 are taken to mean the relevant section or paragraph of FRS 102.

[FRS 102.34.11A]. For example, paragraph 6 of IFRS 6 refers to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The relevant section of FRS 102 in this case would be Section 10 *Accounting Policies, Estimates and Errors*.

However, when applying paragraph 21 of IFRS 6, which deals with the allocation of E&E assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment, Section 34 states that the cash-generating unit or group of cash-generating units cannot be larger than an operating segment as defined by FRS 102 and the reference to IFRS 8 *Operating Segments* is ignored. [FRS 102.34.11B].

If on first-time adoption, an entity determines that it is impractical to apply any of the requirements related to the assessment of exploration and evaluation assets for impairment to previous comparative amounts, an entity must disclose this fact. [FRS 102.34.11C].

On transition to FRS 102, an entity which previously accounted for exploration and development costs for oil and gas properties in the development or production phases under the full cost accounting method may elect to measure these assets on the following basis:

- Exploration and evaluation assets at the amount determined under the entity's previous financial reporting framework.
- And
- Assets in the development or production phases at the amount determined for the cost centre under the entity's previous financial reporting framework. The entity shall allocate this amount to the cost centre's underlying assets *pro rata* using reserve volumes or reserve values as of that date.

Both E&E assets and assets in the production and development phases must be tested for impairment, at the date of transition, in accordance with Section 34 (IFRS 6) or Section 27, respectively. [FRS 102.35.10(j)].

This transitional provision eliminates the requirement for a restatement for companies which had previously adopted the full cost method and make the process of allocating E&E assets into cash-generating units required easier under FRS 102.

3.4 Practical implementation issues

Practical issues in the extractive industries are covered in EY's publication, International GAAP®.

3.5 Defined terms

Extract from FRS 102 Appendix 1 Glossary

Definitions

cash-generating unit	The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.
operating segment	An operating segment is a component of an entity: (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); (b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and (c) for which discrete financial information is available.

Extract from IFRS 6

Definitions

exploration and evaluation assets

Exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

exploration and evaluation expenditures

Expenditures incurred by an entity in connection with the **exploration for and evaluation of mineral resources** before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

exploration for and evaluation of mineral resources

The search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical flexibility and commercial viability of extracting the mineral resource.

4 Service concession arrangements

4.1 Overview

Section 34 *Specialised Activities - Service Concession Arrangements* requires entities to determine whether an arrangement meets the definition of a service concession and then directs entities to the relevant sections of FRS 102 to be applied to each component of the transaction.

What you need to know

- Service concession arrangements (SCAs) are used as a mechanism for procuring public services using private sector finance and management expertise. An SCA is an arrangement whereby a public sector body or public benefit entity contracts with a private sector entity to construct, operate, and maintain infrastructure assets for a specified period of time.
- Given the range of activities which may fall under an SCA, accounting issues arise in a number of areas, including accounting for revenue, property, plant and equipment, leasing, intangible assets, financial instruments, and borrowing costs.
- Section 34 requires a grantor to account for its interest in an SCA as a lease liability and recognise the infrastructure assets applying the initial measurement criteria as if they were right-of-use assets. The lease liability is subsequently accounted for as if the grantor were a lessee, according to the requirements of Section 20 *Leases*. The infrastructure assets are subsequently accounted for as property, plant and equipment or intangibles, according to the requirements of Section 17 *Property, Plant and Equipment* and Section 18 *Intangible Assets other than Goodwill* respectively.
- An operator in an SCA has a right to access the infrastructure assets, but does not control them, and therefore they do not recognise the infrastructure assets. Revenue for the services performed, which may include construction or upgrade services and operating services, is accounted for under Section 23 *Revenue from Contracts with Customers*. An SCA will give the operator the right to receive consideration (cash or non-cash consideration) in return for its services - that consideration will be accounted for either as:
 - A financial asset - representing an unconditional right to receive a specified or determinable amount of cash or another financial asset.
 - Or
 - An intangible asset - representing the right to charge (in the future) for the use of the infrastructure assets.
- Sometimes an SCA may entitle the operator to both types of consideration - a financial asset and an intangible asset.
- The nature of the consideration determines its subsequent accounting, but both types of consideration are accounted for as a contract asset during the construction period.

4.2 Introduction

Service concession arrangements have been developed in many countries as a mechanism for procuring public services using private sector finance and management expertise. Under a service concession arrangement (SCA), private capital is used to provide major economic and social facilities for public use. The concept is that, rather than having bodies in the public sector taking on the entire responsibility and risk of funding and building infrastructure assets such as roads, bridges, railways, hospitals, prisons and schools, some of these are contracted out to private sector entities. In the UK, such arrangements are referred to as Public Private Partnerships and formerly as arrangements under the Private Finance Initiative.

SCAs are contractual arrangements between the public sector body and the private sector operator which set out the rights of each party, the related performance obligations and measures and the mechanisms for payment. The transactions involved in a typical service concession are wide-ranging and include the construction or refurbishment of infrastructure assets, the delivery of operating and maintenance services, collection of revenues from the public, and the receipt of payments from the public sector body (some of which may have been deferred). As a result, the accounting issues raised by service concessions range across a number of areas, including accounting for revenue, property, plant and equipment, leasing, intangible assets, financial instruments, and borrowing costs (as these arrangements are often financed by borrowings of the operator).

The requirements of Section 34 related to service concessions require an entity to determine whether an arrangement meets the definition of a service concession and then directs that entity to the other sections of FRS 102 that are applied to each component of the transaction. Central to the definition of an SCA is whether the public sector body (or grantor) has control over the infrastructure, by virtue of both its rights under the contract to direct how the assets are used during the concession and thereafter by controlling any significant residual interest in the assets. [FRS 102.34.12A].

Only minor changes were made to the Service Concession Arrangements part of Section 34 by the Periodic Review March 2024 of FRS 102, primarily being consequential amendments to the Section in connection with the introduction into Section 23 of the five-step revenue recognition model based on IFRS 15 *Revenue from Contracts with Customers*, reflecting similar amendments made to IFRIC 12 *Service Concession Arrangements* by IFRS 15. [FRS 102.BC.B34C.1].

4.3 Key differences to IFRS

Under IFRS, two Interpretations apply to the treatment of service concession arrangements: IFRIC 12, and SIC-29 *Service Concession Arrangements: Disclosures*.

Unlike IFRIC 12, FRS 102 sets out requirements for accounting by the public sector body grantor in an SCA, requiring it to recognise a lease liability and related asset, initially measured in accordance with the initial measurement guidance for lease liabilities and right-of-use assets respectively within Section 20 of FRS 102. Applying this guidance, if the grantor has not recognised a liability, it does not recognise an infrastructure asset. [FRS 102.34.12F]. IFRIC 12 does not specify the accounting by grantors. [IFRIC 12.9].

For operators in a service concession, Section 34 applies the same control criteria as IFRIC 12 (see 4.4.2 below). However, whilst the resulting accounting principles are very similar to those established in IFRIC 12, the requirements set out in FRS 102 are very much a simplification of the Interpretation and there is no guidance on how the control criteria might be interpreted in different situations; exactly what is meant by services 'for the benefit of the public' (see 4.4.1.A below); and how to classify arrangements where only part of the infrastructure is controlled by the grantor (see 4.4.1.B below). In addition, Section 34 does not consider situations where the following features exist in a service concession arrangement:

- Assets of the operator are used in the service concession.
- Payments are made by the operator to the grantor (for example rentals payable for assets retained by the grantor or for other services provided by the public sector body).
- Payments under the service concession contract are variable.
- Where both an intangible asset and a financial asset exists.
- Major upgrade, replacement or maintenance works are required at intervals during the concession term.

IFRIC 12 also provides a number of examples, tables and flow charts to assist entities in implementing its requirements. None of these are included in Section 34.

4.4 Requirements of FRS 102 for service concession arrangements

4.4.1 Scope

An SCA arises from an agreement whereby a public sector body or public benefit entity (the grantor) contracts a private sector entity (the operator) to construct or upgrade, operate and maintain infrastructure assets for a specified period of time (the concession period). The operator is paid for its services over the period of the arrangement. [FRS 102.34.12]. Such payments are often referred to as 'unitary charges' because the amounts to be paid under the contract compensate the operator for both services in constructing or upgrading the infrastructure assets and for their maintenance and operation over a longer period.

A common feature of an SCA is the public service nature of the obligation undertaken by the operator, whereby the arrangement contractually obliges the operator to provide services to, or on behalf of, the grantor for the benefit of the public. [FRS 102.34.12]. This feature, that the operator is providing services to the public or for public benefit, is often applied to distinguish a service concession from the provision by a private sector entity of outsourcing, leasing or other services to a public sector body or public benefit entity (see 4.4.1.A below).

Extract from Section 34

34.12A Specifically an arrangement is a service concession arrangement when the following conditions apply:

- (a) the grantor controls or regulates what services the operator must provide using the infrastructure assets, to whom, and at what price; and
- (b) the grantor controls, through ownership, beneficial entitlement or otherwise, any significant residual interest in the infrastructure assets at the end of the term of the arrangement. *[FRS 102.34.12A].*

As noted above, classification as a service concession arrangement requires that the grantor controls or regulates, what services the operator must provide using the infrastructure assets, to whom, and at what price. The control or regulation of services does not have to be governed by contract as it could include control via an industry regulator. Control also extends to circumstances in which the grantor buys all the output as well as those in which it is bought by other users. The grantor and relevant related parties must be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any independent regulators acting in the public interest, are to be regarded as related to the grantor. 'Price' can mean the amount at which the grantor buys the service or the amount that the operator charges members of the public or a combination of both.

Unlike Section 34, IFRIC 12 stresses that the grantor does not need to have complete control of the price. It is sufficient for the price to be regulated, which could be by way of a capping mechanism (regulated utilities are usually free to charge lower prices). Other 'caps' may not be so apparent. A contract may give the operator freedom to set its prices, but any excess is clawed back by the grantor, e.g., through setting a maximum return on an agreed investment in the infrastructure. In such a case, the operator's return is capped, and the price element of the control test is substantively met. However, care must be taken to look to the substance of the agreements, so a cap that only applies in remote circumstances will be ignored. *[IFRIC 12.AG3].* As Section 34 applies the same control criteria as IFRIC 12 in defining an SCA, we believe that this guidance in IFRIC 12 will also be relevant to entities applying Section 34.

How we see it

In our view, a requirement in the agreement for the grantor to review or approve prices would also generally be sufficient to determine that the grantor controls the price. It would not be appropriate to assume that such approvals are insubstantial or 'rubber stamps' that could be disregarded by the operator.

In practice, it is not uncommon for the use of the infrastructure assets to be partly regulated and partly unregulated. This is discussed further at 4.4.1.B below.

Where the infrastructure assets have no significant residual value at the end of the term of the arrangement (i.e., the arrangement is for the entire useful life of the infrastructure assets), then the arrangement is accounted for as a service concession if the grantor controls or regulates the services provided using the infrastructure as described at (a) above. *[FRS 102.34.12A].*

For the purpose of condition (b) above, the grantor's control over any significant residual interest will both restrict the operator's practical ability to sell or pledge the infrastructure assets and give the grantor a continuing right of use throughout the concession period. *[FRS 102.34.12A].* Control over the residual interest does not require that the infrastructure is returned to the grantor at the end of the concession. It is sufficient that the deployment of the infrastructure is controlled by the grantor, as shown in the Illustration below.

Illustration 36-1: Residual arrangements

A gas transmission system is being operated under a concession arrangement with the State Gas Authority. At the end of the term, the grantor will either acquire the infrastructure assets at their net book value, determined on the basis of the contract, or it may decide to grant a new SCA on the basis of a competitive tender, which will exclude the current operator. If the grantor elects to do the latter, the operator will be entitled to the lower of the following two amounts:

- (a) The net book value of the infrastructure, determined on the basis of the contract.
- And

- (b) The proceeds of a new competitive bidding process to acquire a new contract.

Although the operator cannot enter the competitive tender, it also has the right to enter into a new concession term but, in order to do so, it must match the best tender offer made. It has to pay to the grantor the excess of the best offer (b) above the amount in (a); if the tender offer be lower than (a), it will receive an equivalent refund.

In this arrangement, the grantor will control the residual. It can choose to take over the activities of the concession itself or it can allow potential operators, including the incumbent, to bid for a second term. The price that might be received by the operator, or paid by the grantor, is not relevant.

FRS 102 states that a concession may contain a group of contracts and sub-arrangements as elements of the SCA as a whole. Such an arrangement is treated as a whole when the group of contracts and sub-arrangements are linked in such a way that the commercial effect cannot be understood without reference to them as a whole. Accordingly, the contractual terms of certain contracts or arrangements may meet both the scope requirements of an SCA under Section 34, as noted above, and the definition of a lease under Section 20. Where this is the case, the requirements of Section 34 prevail. *[FRS 102.34.12C]*.

4.4.1.A Public service nature of the obligation

A common feature of a service concession arrangement is the public service nature of the obligation undertaken by the operator, whereby the operator is contractually obliged to provide services to, or on behalf of, the grantor for the benefit of the public. *[FRS 102.34.12]*. Whilst neither FRS 102 nor IFRIC 12 provide a definition of the term 'public service nature of the obligation', IFRIC 12 refers to examples of service concession arrangements and identifies roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and communication networks as examples of infrastructure used for public services. *[IFRIC 12.1]*.

How we see it

In our view, it is not necessary for the operator to have direct involvement with the public in order to be providing services to, or on behalf of, the grantor for the benefit of the public.

Service concessions are not the only contractual arrangements between public sector bodies and private sector providers of services. Public sector bodies lease buildings or other property, plant and equipment from private sector entities for their own use. The private sector entity might also be engaged to construct the buildings or other property before it is occupied by the public sector body. The public sector also engages independent subcontractors to perform procurement services or to outsource the operation of its internal activities and functions. It is important to consider whether the infrastructure is being used by the operator to provide services for the benefit of the public (such as in the case of a water treatment facility, for example), rather than to the grantor for its own benefit. Where the operator is contracted to provide services to the grantor for its own benefit (rather than providing infrastructure services to the public), depiction of the arrangement as a lease could be more appropriate. For example, where a government department has outsourced its information technology function to a private sector operator, it would be more usual to account for this arrangement as an IT services contract rather than a service concession. However, where an arrangement meets the scope requirements of paragraphs 12 and 12A of Section 34, and the definition of a lease in Section 20, the requirements of Section 34 prevail. *[FRS 102.34.12C]*.

4.4.1.B Partially regulated assets

As noted at 4.4.1 above, to be an SCA in scope of Section 34, the grantor must control or regulate what services the operator must provide using the infrastructure assets, to whom, and at what price. *[FRS 102.34.12A]*. In practice, it is not uncommon for the use of infrastructure to be partly regulated and partly unregulated. Section 34 gives no guidance on whether such arrangements are accounted for using Section 34. Entities therefore must apply the hierarchy in Section 10 *Accounting Policies, Estimates and Errors* to develop an appropriate policy in this area. *[FRS 102.10.4, FRS 102.10.6]*. As Section 34 applies the same control criteria as IFRIC 12 (see 4.4.12 above) in defining an SCA, we believe that the guidance in IFRIC 12 will be relevant to entities developing an accounting policy for partially regulated assets.

How we see it

In our view:

- Any infrastructure that is physically separable and meets the definition of a cash-generating unit as defined in FRS 102 must be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.
- When purely ancillary activities (such as a hospital shop) are unregulated, the control tests must be applied as if those services did not exist, because in cases in which the grantor controls the services in the manner described in paragraph 12A of Section 34 of FRS 102, the existence of ancillary activities does not detract from the grantor's control of the infrastructure.

In both cases set out above, the grantor may have given to the operator a right to use the unregulated asset in question. This right may be in substance a lease from the grantor to the operator; if so, this is to be accounted for in accordance with Section 20. Determining whether the right is, in substance, a lease would involve using the principles in Section 20 (see Chapter 23 at 4.1).

IFRIC 12 gives no guidance on how an entity might interpret the term 'purely ancillary' in evaluating whether an unregulated activity is ignored for the purposes of determining if the control criteria are met or considered to detract from the grantor's control of the asset. The hospital shop is clearly insignificant by virtue of its size relative to the whole hospital, the proportion of cash flows attributable to it and the fact that the existence of a shop has no direct impact on the function of the infrastructure in the provision of regulated services. However, it is not clear at what point a secondary activity would become or cease to be 'purely ancillary'. This will be a matter of judgement, as demonstrated by Illustration 36-2 below.

Illustration 36-2: Partially regulated assets - Airport

Entity A has been contracted by the government department of transport to construct a regional airport and operate it for a period of 25 years.

Entity A will have the right to charge airlines using the airport fees for aeronautical services provided by Entity A, such as landing fees, passenger fees, terminal fees and fees for gate and ground services. These aeronautical services and fees will be subject to regulation by the department of transport. Entity A expects 55% of its income from the airport over the contract period to come from aeronautical fees and expects the remainder of its income over the term of the contract to arise from unregulated non-aeronautical activities within the airport, such as rent for concessions, retail and parking.

Whilst some of the areas of the airport used to provide concession, retail and parking services are physically separable, Entity A concludes that they do not meet the definition of a cash-generating unit because the cash inflows from these areas are not largely independent of the cash inflows from other parts of the airport infrastructure, because the users of those services are also passengers of the airlines to whom Entity A provides aeronautical services.

As the use of the airport infrastructure is partially regulated and partially unregulated, Entity A will need to apply judgement to assess whether the non-aeronautical activities are purely ancillary.

Entity A could base this judgement on a qualitative assessment. Entity A could take the view that, although the non-aeronautical services are outside the primary purpose of the airport infrastructure, they are important to managing the flow of passengers through the airport, and do not significantly impact the function of the infrastructure in the provision of the regulated aeronautical services. Entity A could therefore conclude that the non-aeronautical services are purely ancillary and apply the control test in paragraph 12A(a) of Section 34 as if those services did not exist.

Alternatively, Entity A could base its judgement on a quantitative assessment, comparing total estimated revenues from regulated services over the life of the arrangement to estimated revenues from unregulated services. Under this approach, Entity A could conclude that the unregulated non-aeronautical services are not ancillary as the proportion of cash flows attributable to those services is not clearly insignificant. Entity A could conclude that the extent of unregulated services provided using the airport infrastructure is such that the grantor is not considered to control the infrastructure.

Regardless of which approach is used or the emphasis placed by the entity on qualitative or quantitative factors, there may be judgement involved in making the determination of whether non-aeronautical services are ancillary. Entity A must apply a consistent approach and determine its judgements consistently to all similar contractual arrangements.

In practice, there are concession agreements that include unregulated services that are neither purely ancillary nor delivered by using a physically separable portion of the total infrastructure. For example, a grantor may control prices charged to children, pensioners and the unemployed who use a sports facility, but the amounts charged to other adults are not controlled. The same facility is being used by all, regardless of the amount that they pay. Alternatively, price regulation could apply only to services provided at certain times of the day rather than to different classes of user.

Illustration 36-3: Partially regulated assets - Rail transportation

Entity B has been contracted by the government department of transport to build and operate a regional rail network for 10 years.

Entity B will operate the trains across the regional network, employ the required staff, and manage the railway stations and depots across the regional network. The department of transport will specify the level of train services to be provided, set certain specifications of trains to be used, and establish overall performance targets. Train fares charged by Entity B to rail passengers will consist of regulated fares (for peak-time rail tickets), and unregulated fares (for off-peak time rail tickets). Entity B expects 60% of rail fare revenue over the term of the contract to come from regulated fares, and 40% from unregulated fares.

The same rail infrastructure will be used to provide both peak-time and off-peak services. Entity B will therefore need to apply judgement in assessing the criteria (a) in paragraph 34.12A of FRS 102 ("The grantor controls or regulates the services that the operator must provide using the infrastructure, to whom, and at what price"). [FRS 102.34.12A(a)].

In this case, Entity B could base its judgement on a quantitative assessment, comparing total estimated revenues from regulated fares over the life of the arrangement to estimated revenues from unregulated fares. As Entity B expects 40% of its revenue over the term of the contract to come from unregulated fares, Entity B could conclude that although the department of transport may control the services that the operator must provide with the rail infrastructure, they do not control the price given that a significant portion of non-regulated rail fare revenue is expected to be generated by Entity B. In this case, the arrangement is not in scope of Section 34. Entity B could reach a different conclusion if the proportion of non-regulated rail fare income was expected to be clearly insignificant.

In practice, there may be judgement involved in making the determination of whether enough of the service or process for the service is unregulated in order to demonstrate that the grantor is not considered to control the infrastructure. Whilst we do not believe that there are any clear cut-off points or bright lines in making this judgement, entities must apply a consistent approach and determine its judgements consistently to all similar contractual arrangements.

How we see it

When a concession agreement includes unregulated services that are neither purely ancillary, nor delivered by using a physically separable portion of the total infrastructure, it will be a matter of judgement whether enough of the service is unregulated in order to demonstrate that the grantor is not considered to control the asset, which would lead to the arrangement as a whole falling out of the scope of Section 34. We would expect entities to apply these judgements consistently to similar arrangements.

The assessment of whether enough of the service is unregulated in order to demonstrate that the grantor is not considered to control the asset will be made at the beginning of the contract and will not be revisited unless errors were made in the original assessment, i.e., it will not be revisited simply because there are significantly more or fewer unregulated users than originally anticipated. In practice, partial price regulation is often a reason for an arrangement to fall outside the scope of Section 34.

However, if it transpires that there are significantly fewer unregulated users than anticipated then it is likely that the contract will be renegotiated. This is because of the public service obligation, which means that the grantor will want the service to continue to be provided to the public albeit under new terms. Whilst Section 34 does not address changes to concession arrangements, it would be necessary to look to the requirements of other sections of FRS 102 that Section 34 indicates would be relevant (such as Section 18, Section 23, and Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues*) in order to determine the impact on the accounting for the concession, including the impact on any assets and liabilities recognised in respect of the concession. Similar considerations apply where there is a change in regulation that impacts whether the grantor controls or regulates the services that the operator must provide using the infrastructure, to whom it must provide them, and at what price, and/or whether grantor controls any significant residual interest in the infrastructure at the end of the concession term.

4.4.1.C Accounting for arrangements determined not to be SCAs under FRS 102

Where an arrangement does not meet both the definition of an SCA and the control criteria noted at 4.4.1 above, Section 34 does not apply and the arrangement is accounted for in accordance with Section 17, Section 18, Section 20 or Section 23, as appropriate, based on the nature of the arrangement.

[FRS 102.34.12D].

4.4.2 Accounting by grantors - Lease liability model

Section 34 requires a grantor to account for its interest in a service concession contract using a lease liability model.

Therefore, the infrastructure assets are recognised as assets of the grantor together with a liability for its obligation under the concession. [FRS 102.34.12E]. The grantor initially recognises the liability associated with the infrastructure assets applying the initial measurement rules for a lease liability in paragraphs 49 to 54 of Section 20, and recognises the infrastructure assets by applying the initial measurement rules for a right-of-use asset in paragraphs 46 to 48 of Section 20. [FRS 102.34.12F]. Initial measurement of lease liabilities and right-of-use assets are discussed in Chapter 23 at 6.2.2 and 6.2.1 respectively.

The liability is recognised as a lease liability and subsequently accounted for by applying the subsequent measurement rules for a lease liability in paragraphs 62 to 64 of Section 20, as if the grantor were a lessee. [FRS 102.34.12G]. The infrastructure assets are recognised as property, plant and equipment or as intangible assets, as appropriate, and subsequently accounted for in accordance with Section 17 or Section 18.

[FRS 102.34.12H]. This includes the determination of useful lives and amortisation methods for the assets, the estimation of residual values, as discussed in Chapters 20 and 21 for property, plant and equipment and for intangible assets respectively, and also includes accounting for impairment as discussed in Chapter 29.

If the grantor is not required to recognise a liability to make payments to the operator, for example, because the operator is expected to charge the users of the infrastructure directly, the grantor does not recognise the infrastructure assets. [FRS 102.34.12F]. In other words, the grantor recognises an asset only to the extent of its obligation to make payments to the operator for the construction of the infrastructure, its upgrade or its residual value at the end of the concession.

4.4.3 Accounting by operators

Accounting by the operator is more complicated, because its involvement in the concession comprises transactions relating to the construction of the infrastructure or its upgrade; the provision of services to the public using the infrastructure; and the collection of payments from either the grantor, users of the service or a combination of both.

4.4.3.A Consideration for services provided

Most service concession agreements are for both construction (or upgrade) services and operating services. Operators almost always negotiate a single contract with the grantor and, although Section 34 does not refer to this, this will usually include a single payment mechanism throughout the concession term, sometimes called a 'unitary payment'. The operator is unlikely to be remunerated separately for its different activities.

Section 34 requires that the operator recognises and measures revenue in accordance with Section 23 for the services it performs, which may include construction or upgrade services and operating services.

[FRS 102.34.12J]. This requires:

- Identifying who is the customer(s) of the service concession arrangement (see Chapter 25 at 3.1.3).
 - Identifying the performance obligations under the contract with the customer (see Chapter 25 at 5).
 - Determining the transaction price under the contract(s) (see Chapter 25 at 6).
 - Allocating that transaction price to the performance obligations in the contract (see Chapter 25 at 7).
- And
- Recognising revenue when, or as, the operator satisfies a performance obligation (see Chapter 25 at 8).

Section 34 notes that the operator accounts for construction or upgrade services, and operating services in accordance with Section 23. *[FRS 102.34.12K, FRS 102.34.16]*. This suggests that the operator would typically identify at least construction services, upgrade services and operating services as separate performance obligations. In practice, operators may often sub-contract some or all the construction activities under a service concession arrangement. In such cases, the operator applies the guidance in Section 23 to determine whether it is acting as principal or agent for the provision of construction services. This determination will impact whether the operator's performance obligation under the contract is to provide construction services, or to arrange for another party to provide construction services. Principal versus agent considerations under Section 23 are discussed in Chapter 25 at 5.4.

How we see it

It is important that entities understand and assess the facts and circumstances of their own arrangements in order to determine whether their current service concession accounting is supported under the 5-step model within Section 23.

4.4.3.B Determining the accounting model

As the grantor controls the use of the assets during the concession term and any significant residual interest in them after the contract has ended, *[FRS 102.34.12A]*, an operator in an arrangement determined to be a service concession does not recognise the infrastructure assets as property, plant and equipment because the operator does not have a right to control the use of the infrastructure. The operator has only a right of access to the assets in order to provide the public service on behalf of the grantor in accordance with the terms specified in the concession. *[FRS 102.34.12I]*.

A service concession contract gives the operator the right to consideration in return for meeting its obligations to construct, upgrade, operate and maintain the infrastructure assets controlled by the grantor. If an operator provides construction or upgrade services, Section 34 sets out two principal categories of concession consideration:

- In one, the operator receives a financial asset - an unconditional contractual right to receive a specified or determinable amount of cash or another financial asset from, or at the direction of, the grantor in return for constructing (or upgrading) the infrastructure assets and then operating and maintaining the asset for a specified period of time. This category includes guarantees by the grantor to pay for any shortfall between amounts received from users of the public service and specified or determinable amounts. *[FRS 102.34.13(a)]*.

And

- In the other, the operator receives an intangible asset - a right to charge for the use of the infrastructure assets that it constructs (or upgrades) and then operates and maintains for a specified period of time. A right to charge users is not an unconditional right to receive cash because the amounts are contingent on the extent to which the public uses the service. *[FRS 102.34.13(b)]*.

Sometimes an SCA may entitle the operator to both types of consideration - a financial asset and an intangible asset. *[FRS 102.34.13]*. To the extent that the grantor has given an unconditional guarantee of payment for the construction (or upgrade) of the infrastructure assets, the operator has a financial asset; to the extent that the operator receives a right to charge the public for using the service, the operator has an intangible asset. The nature of the consideration determines the subsequent accounting, as discussed at 4.3.4.C and 4.3.4.D below. However, both types of consideration are classified as a contract asset during the construction or upgrade period in accordance with Section 23. *[FRS 102.34.12J, FRS 102.34.13A]*.

The boundary between the financial and the intangible asset models is based on the operator's unconditional contractual right to receive cash from, or at the direction of, the grantor. *[FRS 102.34.13(a)]*.

The grantor does not need to pay the cash to the operator directly. Fees or tolls received from users are viewed as essentially no more than collections on behalf of the grantor if they are part of an overall arrangement under which the grantor bears ultimate responsibility. If the grantor pays but the amounts are wholly based on usage of the infrastructure and there is no minimum guaranteed payment, the entity has no unconditional contractual right to receive cash, as the amounts receivable are contingent on the extent to which the public uses the service. In this case, the intangible asset model will apply.

The operator will recognise a financial asset to the extent that it has a contractual right to receive cash or other financial assets from the grantor for the construction services, where the grantor has little, if any, discretion to avoid payment. This is usually because the agreement is legally enforceable. *[FRS 102.34.13(a)]*. The recognition of a financial asset is not affected by the fact that the operator's contractual right to receive cash may be contingent on performance standards. *[FRS 102.34.14]*.

The analysis between the different models can be seen in the following table:

	<i>Arrangement</i>	<i>Applicable model</i>
1	Operator receives fixed payments from grantor	Financial asset
2	Operator receives payments from grantor which vary with demand	Intangible asset
3	Operator receives payments from users which vary with demand and from grantor guaranteed amounts	Financial asset or bifurcated (part financial, part intangible)
4	Operator receives payments from users which vary with demand until it achieves specified return	Intangible asset
5	Operator receives payment from users which vary with demand - no grantor guarantees	Intangible asset

Common examples of arrangements that fall within (3) above are transport concessions where the operator collects revenue from users but is entitled to an agreed return on capital invested in the infrastructure, guaranteed by the grantor. The fees or tolls up to this amount are considered to be collections on behalf of the grantor. There will be a financial asset to the extent of the guaranteed return. There may be an intangible asset as well if the value of the financial asset is less than the fair value of the construction services.

However, arrangements of the type in (4) above remain to be treated as intangible assets even if the overall risk to the operator of not obtaining a specified result is very low. For example, an arrangement where an operator enters into a toll bridge concession and is permitted to collect revenues from users or the grantor until it achieves a 6% return on its agreed infrastructure spend (at which point the arrangement comes to an end), would be accounted for under the intangible asset model.

In commercial terms, the toll bridge concession may be virtually identical to a transaction that falls within (3) above, e.g., where the users pay tolls but the grantor guarantees a minimum 6% return. The crucial difference is the grantor's guarantee. The distinction between the financial asset and intangible asset models is linked less to the transfer of commercial risk, but more to the existence (or not) of an unconditional contractual right to cash flows.

How we see it

An arrangement that effectively caps revenue collected from users once an agreed level of return is reached, is not a contractual right to cash but a right to collect revenues from users and it is not relevant that the risk is low or that the operator will, in effect, get a fixed return.

4.4.3.C Financial asset model

The operator recognises a financial asset to the extent it has an unconditional contractual right to receive a specified or determinable amount of cash or another financial asset from, or at the direction of, the grantor for the construction (or upgrade) services. The operator accounts for the financial asset in accordance with Section 11 and Section 12. [FRS 102.34.14].

Whether the financial asset represents a basic financial instrument within the scope of Section 11 or other financial instrument within the scope of Section 12 will depend on the terms of the concession and judgement is required (see Chapter 11). In classifying the financial asset as basic or other, a payment being contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements does not prevent its classification as basic. [FRS 102.34.14].

The following Illustration is based on Illustrative Example 1 in IFRIC 12.

Illustration 36-4: Financial asset model - recording the construction asset

Table 1 Concession terms

The terms of the arrangement require an operator to construct a road - completing construction within two years - and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the concession also require the operator to resurface the road at the end of year 8. At the end of year 10, the arrangement will end. Assume that the operator identified three performance obligations, for construction services, operating services and road resurfacing. The operator estimates that the costs it will incur to fulfil its obligations will be:

	Year	£
Construction services (per year)	1-2	500
Operating services (per year)	3-10	10
Road resurfacing	8	100

The terms of the concession require the grantor to pay the operator £200 per year in years 3-10 for making the road available to the public.

For the purpose of this Illustration, it is assumed that all cash flows take place at the end of the year.

Table 2 Contract revenue

The operator recognises contract revenue and costs in accordance with Section 23. Revenue - the amount of consideration to which the operator expects to be entitled from the grantor for the services provided - is recognised when (or as) the performance obligations are satisfied.

The total consideration (£200 in each of years 3-8) is allocated to the performance obligations based on the relative stand-alone selling prices of the construction services, operating services and road resurfacing, taking into account the effects of the time value of money, as follows:

Transaction price allocation (including effect of the time value of money)	
Construction (a)	£1,050
Operating services (b)	£96
Road resurfacing (c)	£110
Market rate of interest (d)	6.18% per year

(a) The operator estimates the relative stand-alone selling price by reference to forecast cost plus 5%.

(b) The operator estimates the relative stand-alone selling price by reference to forecast cost plus 20%.

(c) The operator estimates the relative stand-alone selling price by reference to forecast cost plus 10%.

(d) The operator concludes that the arrangement is a financing transaction and estimates that the market rate of interest is 6.18%.

Financial asset

During the first two years, the operator recognises a contract asset and accounts for effects of the time value of money in accordance with Section 23. Once construction is complete, the amounts due from the grantor are accounted for as a receivable in scope of Section 11. The arrangement is considered to constitute a financing transaction, so the receivable is measured initially at the present value of the future payments discounted at a market rate of interest. It is subsequently measured at amortised cost, i.e., the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.

Table 3 Measurement of contract asset/receivable

	£
Amount due for construction in year 1	525
Contract asset at end of year 1*	525
Effective interest in year 2 on contract asset at the end of year 1 (6.18% × £525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	1,082
Effective interest in year 3 on receivable at the end of year 2 (6.18% × £1,082)	67
Amount due for operation in year 3 (£10 × (1 + 20%))	12
Cash receipts in year 3	(200)
Receivable at end of year 3	961

* No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year.

4.4.3.D Intangible asset model

Under this accounting model, the operator recognises an intangible asset reflecting a right (a licence) to charge users of the public service. The operator accounts for the intangible asset in accordance with Section 18. [FRS 102.34.15]. The following Illustration is based on Example 2 in IFRIC 12.

Illustration 36-5: Intangible asset model - recording the construction asset**Arrangement terms**

The terms of a service arrangement require an operator to construct a road - completing construction within two years - and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of the year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1 Contract costs

	Year	£
Construction services (per year)	1-2	500
Operating services (per year)	3-10	10
Road resurfacing	8	100

The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of £200 in each of years 3-10.

For the purpose of this Illustration, it is assumed that all cash flows take place at the end of the year.

Intangible asset

The operator provides construction services to the grantor in exchange for an intangible asset, i.e., a right to collect tolls from road users in years 3-10. In accordance with Section 23, the operator measures this non-cash consideration at fair value. In this case, the operator determines the fair value indirectly by reference to the stand-alone selling price of the construction services delivered.

During the construction phase of the arrangement the operator's contract asset (representing its accumulating right to be paid for providing construction services) is presented as an intangible asset (licence to charge users of the infrastructure). The operator estimates the stand-alone selling price of the construction services to be equal to the forecast construction costs plus 5% margin. It is also assumed that the operator adopts the allowed alternative treatment in Section 25 *Borrowing Costs* and therefore capitalises the borrowing costs, estimated at 6.7%, during the construction phase:

Table 2 Initial measurement of intangible asset

	£
Construction services in year 1 ($£500 \times (1 + 5\%)$)	525
Capitalisation of borrowing costs	34
Construction services in year 2 ($£500 \times (1 + 5\%)$)	525
Intangible asset at end of year 2	1,084

The intangible asset is amortised over the period in which it is expected to be available for use by the operator, i.e., years 3-10. In this case, the directors determine that it is appropriate to amortise using a straight-line method. The annual amortisation charge is therefore £1,084 divided by 8 years, i.e., £135 per year.

Construction costs and revenue

The operator recognises the revenue in accordance with Section 23. It measures contract revenue at the fair value of the non-cash consideration received or receivable. Thus, in each of years 1 and 2 it recognises in its income statement construction costs of £500, construction revenue of £525 (cost plus 5%) and, hence, construction profit of £25.

Toll revenue

The road users pay for the public services at the same time as they receive them, i.e., when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

How we see it

We believe that amortisation of the intangible asset recognised by the operator in exchange for construction services would likely commence once construction is complete, and the operator can begin using the licence received in exchange for construction services in order to generate revenues.

4.4.3.E Construction or upgrade services

Section 34 requires the operator to account for revenue relating to the construction or upgrade services it performs in accordance with Section 23. [FRS 102.34.12K]. As discussed at above, this will involve recognising revenue when, or as, the operator satisfies the construction or upgrade performance obligation. See Chapter 25 at 8 for discussion on satisfaction of performance obligations under Section 23.

4.4.3.F Operating services

Section 34 requires the operator to account for revenue relating to the operating services it performs in accordance with Section 23. [FRS 102.34.16]. As discussed at above, this will involve recognising revenue when, or as, the operator satisfies the performance obligation(s) relating to operating services. See Chapter 25 at 8 for discussion on satisfaction of performance obligations under Section 23.

4.4.3.G Borrowing costs incurred during the construction or upgrade phase

Many operators will borrow funds to finance the up-front construction or upgrade costs associated with the SCA. Only under the intangible asset model will an operator have the option to capitalise any borrowing costs. Otherwise, borrowing costs attributable to the concession are recognised as an expense. Entities must account for their borrowing costs in accordance with Section 25. [FRS 102.34.16A]. Accounting for borrowing costs is discussed in Chapter 27.

4.4.3.H 'Bifurcation' - single arrangements that contain both financial and intangible assets

Section 34 notes that sometimes an SCA may entitle the operator to both types of consideration - a financial asset and an intangible asset. [FRS 102.34.13]. However, the section provides no further guidance on such arrangements.

The following Illustration, based on Illustrative Example 3 in IFRIC 12, illustrates how an entity may account for a service concession arrangement under the bifurcated model.

Illustration 36-6: The bifurcated model - recording the construction asset

Arrangement terms

The terms of a service arrangement require an operator to construct a road - completing construction within two years - and maintain and operate the road to a specified standard for eight years (i.e., years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of the year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1 Contract costs

	Year	£
Construction services (per year)	1-2	500
Operating services (per year)	3-10	10
Road resurfacing	8	100

The operator estimates the consideration in respect of construction services to be £1,050 by reference to the stand-alone selling price of those services, which it estimates at forecast cost plus 5%. The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of £700 and interest at a specified rate of 6.18% to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of £200 in each of years 3 to 10. All cash flows occur at the end of the year.

Dividing the arrangement

The contractual right to receive cash from the grantor for the services and the right to charge users for the public services are regarded as two separate assets. Therefore, in this arrangement it is necessary to divide the operator's contract asset during the construction phase into two components - a financial asset component based on the guaranteed amount and an intangible asset for the remainder. When the construction services are complete, the two components of the contract asset would be classified and measured as a financial asset and an intangible asset accordingly.

Table 2 Dividing the operator's consideration

Year	Total	Financial asset	Intangible asset
Construction services in year 1	525	350	175
Construction services in year 2	525	350	175
Total construction services	1,050	700	350
	100%	67%	(a) 33%
Finance income, at specified rate of 6.18% (see Table 3)	22	22	-
Borrowing costs capitalised (interest paid in years 1 and 2 × 33%)	11	-	11
Total fair value of the operator's consideration	1,083	722	361

(a) Amount guaranteed by the grantor as a proportion of the construction services.

Financial asset

During the first two years, the entity recognises a contract asset and accounts for the effects of the time value of money in the arrangement in accordance with Section 23. Once the construction is complete, the amount due from, or at the direction of, the grantor in exchange for the construction services is accounted for in accordance with Sections 11 and 12 as a receivable.

Table 3 Measurement of the contract asset/receivable

	£
Construction services in year 1 allocated to the contract asset	350
Contract asset at end of year 1	350
Construction services in year 2 allocated to the contract asset	350
Interest in year 2 on contract asset at end of year 1 (6.18% × CU350)	22
Receivable at end of year 2	722
Interest in year 3 on receivable at end of year 2 (6.18% × CU722)	45
Cash receipts in year 3 (see table 5)	(117)
Receivable at end of year 3	650

Intangible asset

In accordance with Section 18, the operator recognises the intangible asset at cost, i.e., the fair value of the consideration received or receivable. During the construction phase of the arrangement, the portion of the operator's contract asset that represents its accumulating right to be paid amounts in excess of the guaranteed amount for providing construction services is presented as a right to receive a licence to charge users of the infrastructure. The operator estimates the stand-alone selling price of the construction services as equal to the forecast construction costs plus 5%, which the operator concludes is consistent with the rate that a market participant would require as compensation for providing the construction services and for assuming the risk associated with the construction costs. It is also assumed that, in accordance with Section 25, the operator capitalises the borrowing costs, estimated at 6.7%, during the construction phase.

Table 4 Initial measurement of the intangible asset

	£
Construction services in year 1	175
Borrowing costs (interest paid in years 1 and 2 × 33%)	11
Construction services in year 2	175
Intangible asset at the end of year 2	361

In accordance with Section 18, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, i.e., years 3-10. The depreciable amount of the intangible asset (£361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore £361 divided by 8 years, i.e., £45 per year.

Revenue and costs

The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator accounts for the construction services in accordance with Section 23. Thus, in each of years 1 and 2 it recognises in profit or loss construction costs of £500 and construction revenue of £525.

Toll revenue

The road users pay for the public services at the same time as they receive them, i.e., when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset.

4.4.4 Disclosures relating to service concession arrangements

An operator and a grantor must disclose information that enables users of the entity's financial statements to evaluate the nature and extent of relevant risks arising from service concession arrangements. This information typically includes, but is not limited to:

- A description of the arrangement including any rights, obligations or options arising.
And
- Any significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows. *[FRS 102.34.16B].*

In addition, an operator is required to disclose the amount of revenue, profits or losses and other income recognised in the period on exchanging construction services for a financial asset or an intangible asset. *[FRS 102.34.16C].*

Significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows can include the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined.

In addition to the disclosures required by Section 34, the disclosure requirements of other Sections relevant to the SCA will also need to be considered, including the disclosure requirements of Sections 11 and 12, Section 17, Section 18, Section 20, Section 23, and Section 25.

4.5 Summary of GAAP differences

The following table shows the differences between Section 34 in relation to service concession arrangements and IFRS.

	FRS 102	IFRS
Accounting by Grantor	Recognise a lease liability and related asset to the extent that there is a contractual obligation to pay for the infrastructure assets.	Not specified in IFRIC 12.

4.6 Defined terms

Extract from FRS 102 Appendix I Glossary

Definitions

borrowing costs	Interest and other costs incurred by an entity in connection with the borrowing of funds.
financial asset [extract]	An asset that is: (a) cash; (c) a contractual right: (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; ...
infrastructure asset	Infrastructure for public services, such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunications networks.
intangible asset	An identifiable non-monetary asset without physical substance. Such an asset is identifiable when: (a) it is separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
public benefit entity	An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.
residual value (of an asset)	The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.
revenue	Income arising in the course of an entity's ordinary activities.
service concession arrangement (SCA)	An arrangement whereby a public sector body or public benefit entity (the grantor) contracts with a private sector entity (the operator) to construct (or upgrade), operate and maintain infrastructure assets for a specified period of time (the concession period).
useful life	The period over which an asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity.

5 Heritage assets

5.1 Overview

Paragraphs 49 to 56 of Section 34 of FRS 102 contain guidance on the accounting for the recognition, measurement and disclosure of heritage assets. A heritage asset is a separate class of asset which requires separate disclosures from those required for similar types of assets that are not heritage assets.

Recognition and measurement of heritage assets follows the appropriate section of FRS 102 which reflects the nature of the asset (i.e., property plant and equipment, intangible assets or right-of-use assets).

What you need to know

- FRS 102 defines heritage assets as tangible and intangible assets with historic, artistic, scientific, technological, geophysical or environmental qualities that are held and maintained principally for their contribution to knowledge and culture. Assets held by commercial companies for other purposes, such as a historic building held as an investment property, are not heritage assets.
- Heritage assets are accounted for in accordance with the requirements of Section 17 *Property, Plant and Equipment*, Section 18 *Intangible Assets other than Goodwill* or Section 20 *Leases*, with a modification for heritage assets acquired in a non-exchange transaction for which the fair value cannot be measured reliably.
- Heritage assets have different disclosure requirements from those required for other assets accounted for in accordance with sections 17, 18 and 20.

5.2 Introduction

There have been some changes and clarifications to reflect amendments made to other sections of FRS 102. These include the following:

- The applicable recognition and measurement sections of FRS 102 for heritage assets have been expanded to apply to right-of-use assets under Section 20. Separate disclosure of heritage assets that are right-of-use assets is now required. The FRC does not expect right-of-use heritage assets to be common.
- A clarification has been added that an investment property is unlikely to be a heritage asset.
- Assets with the characteristics of a heritage asset, but which are used by the entity itself and are therefore not heritage assets, are accounted for in accordance with the applicable section of FRS 102 but an entity is still encouraged to provide the disclosures specified by Section 34.

If a heritage asset is acquired in a non-exchange transaction, the entity usually measures the asset at fair value on initial recognition. If, in exceptional cases, the fair value of such a heritage asset cannot be reliably measured, the entity should state the reason for this.

5.3 Key differences to IFRS

Unlike FRS 102, IFRS has no specific measurement or disclosure requirements for heritage assets.

Therefore, heritage assets are accounted for and disclosed according to their nature under either IFRS 16 *Leases*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*.

5.4 Requirements of FRS 102 for heritage assets

5.4.1 Terms used in Section 34 on heritage assets

Heritage assets are “tangible and intangible assets with historic, artistic, scientific, technological, geophysical, or environmental qualities that are held and maintained principally for their contribution to knowledge and culture”. [FRS 102 Appendix I].

5.4.2 Scope

FRS 102 defines heritage assets according to their intended use (‘maintained principally for their contribution to knowledge and culture’) rather than according to their nature as a tangible or intangible asset.

Heritage assets must be accounted for according to the requirements of Section 34. *[FRS 102.34.49]*.

Extract from FRS 102

- 34.50** In determining whether an asset is a heritage asset, the entity's management shall use its judgement to assess the characteristics of the asset and whether it is held and maintained principally for its contribution to knowledge and culture. For example:
- (a) works of art and similar objects are sometimes held by commercial entities but are not heritage assets because they are not maintained principally for their contribution to knowledge and culture entity; and
 - (b) An investment property is unlikely to be a heritage asset because it is held to earn rentals or for capital appreciation or both. *[FRS 102.34.50]*.

An asset with the characteristics of a heritage asset, but which is used by the entity itself, for example historical buildings used for teaching by an education establishment, does not meet the definition of a heritage asset. Such assets are accounted for in accordance with the applicable section of FRS 102. However, an entity is encouraged to provide the disclosures set out in 5.4.4 below in respect of such assets, in addition to the disclosures required by the applicable section of FRS 102. *[FRS 102.34.50A]*.

5.4.3 Recognition and measurement of heritage assets

Heritage assets must be recognised and measured in accordance with the FRS 102 sections on property plant and equipment, intangible assets or right-of-use assets as appropriate, subject to the requirements on non-exchange transactions discussed below. *[FRS 102.34.51]*. Accounting for property plant and equipment, intangible assets and right-of-use assets is discussed in Chapters 20, 21 and 23, respectively. No option is given to measure heritage assets under Section 16 since it is considered that an investment property is unlikely to meet the definition of a heritage asset (see 5.4.2 above).

It is observed in the Basis for Conclusions that the FRC gave consideration as to whether a right-of-use asset could be a heritage asset. The FRC concluded that there is nothing in principle that would prevent a right-of-use asset from meeting the definition of a heritage asset. However, the FRC does not expect right-of-use heritage assets to be common. *[FRS 102.BC.B34F.2]*.

When a heritage asset is acquired in a non-exchange transaction, the asset must usually be measured at its fair value on initial recognition. In exceptional cases, if the fair value of a heritage asset cannot be measured reliably at a cost that is commensurate with the benefit to users of the financial statements, the heritage asset must not be recognised in the financial statements. In these circumstances, certain disclosures are required (see 5.4.4 below). *[FRS 102.34.53]*.

At each reporting date, an entity must apply the requirements of Section 27 *Impairment of Assets* to determine whether a heritage asset is impaired and, if so, how to recognise and measure the impairment loss. Physical deterioration, breakage or doubts arising as to an asset's authenticity are examples of impairment indicators for heritage assets. *[FRS 102.34.54]*. The requirements of Section 27 are discussed in Chapter 29.

5.4.4 Presentation and disclosures required for heritage assets

Heritage assets must be presented in the statement of financial position separately from other assets. *[FRS 102.34.54A]*.

An entity must disclose the following for all heritage assets it holds, showing separately heritage assets held as a right-of-use asset: *[FRS 102.34.55]*

- (a) An indication of the nature and scale of heritage assets held.
- (b) The policy for the acquisition, preservation, management and disposal of heritage assets (including a description of the records maintained by the entity of its collection of heritage assets and information on the extent to which access to the assets is permitted).
- (c) The accounting policies adopted for heritage assets, including details of the measurement bases used.
- (d) For heritage assets that have not been recognised in the statement of financial position, the notes to the financial statements must:
 - (i) Explain the reasons why.
 - (ii) Describe the significance and nature of those assets.

And

 - (iii) Disclose information that is helpful in assessing the value of those heritage assets.

- (e) When heritage assets are recognised in the statement of financial position the following disclosure is required:
- (i) The carrying amount of heritage assets at the beginning of the reporting period and the reporting date, including an analysis between classes or groups of heritage assets recognised at cost and those recognised at valuation.
 - And
 - (ii) When assets are recognised at valuation, sufficient information to assist in understanding the valuation being recognised (date of valuation, method used, whether carried out by external valuer and if so their qualification and any significant limitations on the valuation).
- (f) A summary of transactions relating to heritage assets for the reporting period and each of the previous four reporting periods disclosing;
- (i) The cost of acquisitions of heritage assets.
 - (ii) The value of heritage assets acquired by donations.
 - (iii) The carrying amount of heritage assets disposed of in the period and proceeds received.
 - And
 - (iv) Any impairment recognised in the period.
 - And
 - (v) Any depreciation or amortisation recognised in the period.

The must show separately those transactions that are included in the statement of financial position and those that are not.

Where it is impracticable to do so, the disclosures required by (f) need not be given for more than one comparative period. If impracticability applies, then a statement must be made to that effect.

[FRS 102.34.56].

In exceptional cases, when a heritage asset acquired during the reporting period in a non-exchange transaction is not recognised because its fair value cannot be measured reliably, the reason that fair value cannot be measured reliably must be stated. This disclosure can be aggregated for groups or classes of heritage assets provided significant information is not obscured. [FRS 102.34.55A].

A lessee is not required to provide the disclosure requirements of paragraphs 20.80(e) and 20.81 for right-of-use assets that are heritage assets when the disclosure requirements described above have been applied to those assets. [FRS 102.20.84].

The disclosure requirements of Sections 17 and 18 do not apply to heritage assets since heritage assets are excluded from their scope. [FRS 102.17.3(a), FRS 102.18.3(b)].

5.5 Summary of GAAP differences

The following table shows the differences between FRS 102 and IFRS.

	FRS 102	IFRS
Scope	Heritage assets are assets which are held and maintained principally for their contribution to knowledge or culture. Judgement is required to assess the characteristics of an asset and whether it is principally held for knowledge and culture.	No specific requirements for heritage assets. Accounting will follow the nature of the asset (e.g., lease, property, plant and equipment, intangible or investment property).
Recognition and measurement	In accordance with Section 17, Section 18 or Section 20 (which requires depreciated cost or fair value with valuation gains/losses through OCI). An investment property is unlikely to be a heritage asset.	Not applicable.

FRS 102		IFRS
Presentation and disclosures	Heritage assets must be presented in the statement of financial position separately from other assets. Separate disclosures are required for heritage assets with further separation for heritage assets held as a right-of-use asset.	No specific presentation or disclosures for heritage assets.

6 Requirements that apply only to Public Benefit Entities

6.1 Overview

This section relates to paragraphs in Section 34 that are prefixed with 'PBE' and must be applied only by Public Benefit Entities. A public benefit entity is an entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members. *[FRS 102 Appendix I]*.

There are three sub-sections within Section 34 which deal with PBEs and which are headed as follows:

- Incoming Resources from Non-Exchange Transactions (see 6.4 below).
- Public Benefit Entity Combinations (see 6.6 below).
- Public Benefit Concessionary Loans (see 6.7 below).

What you need to know

- A non-exchange transaction is defined as one whereby an entity receives value from another entity without directly giving approximately equal value in exchange or gives value to another entity without directly receiving approximately equal value in exchange. A non-exchange transaction that meets the definition of a government grant falls under the scope of *Section 24 Government Grants*. The requirements in Section 34 apply to resources received in a non-exchange transaction by public benefit entities, or entities within a public benefit entity group, when those resources can be reliably measured. In this context, non-exchange transactions can include, but are not limited to, donations of cash or goods, facilities such as the free use of office accommodation and services usually provided by an individual or entity as part of their trade or profession for a fee.
- If a public entity business combination is in substance a gift, the combination is accounted for under Section 19 of FRS 102, except for the following:
 - The excess of the fair value of the assets received over the fair value of the liabilities assumed is recognised as a gain in income and expenditure. This gain represents the gift of the value of one entity to another and is recognised as income.
 - The excess of the fair value of the liabilities assumed over the fair value of the assets received is recognised as a loss in income and expenditure. This loss represents the net obligations assumed, for which the receiving entity has not received a financial reward and is recognised as an expense.
- Entities making or receiving public benefit entity concessionary loans have a policy choice and must use either:
 - The accounting policy choice made for its financial instruments under paragraphs 11.2 and 12.2. Or
 - The accounting treatment specified in Section 34 which is as follows: such loans must be initially measured at the amount received or paid and recognised in the statement of financial position. Subsequently, the carrying amount of concessionary loans in the financial statements must be adjusted to reflect any accrued interest payable or receivable. To the extent that a loan is irrecoverable, any impairment loss must be recognised as an expense.

The following minor changes were introduced by the Periodic Review March 2004 amendments to FRS 102: *[FRS 102.BC.B34I.7, FRS 102.BC.B34I.8, FRS 102.BC.B34I.9]*.

- A clearer articulation of whether and when incoming resources from non-exchange transactions must be recognised and, if so, measured either at the fair value of the resources received or receivable, or the value to the entity. The determination of the value to the entity was also clarified.
- Guidance on legacies has been clarified to focus on the principle that income from a legacy must be recognised when it is probable that the legacy will be received and its value can be measured reliably. As this principle was unchanged, the amendments are not expected to alter existing practice.
- The deletion of Appendix B of Section 34, which specified aspects of recognition for legacies and services and set out requirements relating to performance conditions and measurement, incorporating these requirements within paragraphs PBE34.67 to PBE34.74. The changes made are not intended to alter practice but rather to make the standard easier to apply.

6.2 Introduction

The requirements of FRS 102 apply to public benefit entities and other entities, not just to companies. However, paragraph numbers prefixed with 'PBE' must only be applied by public benefit entities. These paragraphs must not be applied directly, or by analogy, by entities that are not public benefit entities, other than, when specifically directed, entities within a public benefit entity group. A public benefit entity must apply all paragraphs in FRS 102 prefixed with 'PBE' to the extent that they are relevant, including in applying the remaining sections of FRS 102. For those public benefit entities within the scope of a Statement of Recommended Practice (SORP), the use of these paragraphs is permitted by the applicable SORP. [FRS 102.1.2].

The definition of a public entity group (see 6.9 below) refers only to wholly-owned subsidiaries of a public-benefit entity. Therefore, the requirements of the 'PBE' paragraphs of Section 34 of FRS 102 do not apply to partially-owned subsidiaries of a public benefit entity parent.

Separate guidance has been provided in FRS 102 as the topic is only addressed in the Government Grants section of IFRS for SME's. The FRC observe in the Basis for Conclusions that the receipt of resources from non-exchange transactions is an inflow of resources that is highly significant for many PBEs and is a major source of their funding. [FRS 102.BC.B34I.1].

The FRC gave consideration as to whether to add guidance for PBEs as to when a liability for a funding commitment should be recognised. In the FRC's view, an entity must only recognise a liability if the commitment to provide funding is made unconditionally, and the grantor cannot realistically withdraw from the commitment. In this situation, an entity recognises a liability for the present value of the total funding promised. However, as this view is an application of the principles in Section 2 and Section 21, it was concluded that the requirements for funding commitments should apply to all entities and not just PBEs. [FRS 102.BC.B34G.3, FRS 102.BC.B34G.4].

Where not discussed elsewhere, the requirements of 'PBE' provisions in other Sections of FRS 102 are listed at 6.8 below.

6.3 Comparison between Section 34 for Public Benefit Entities and IFRS

IFRS does not have a separate section or standard dealing with public benefit entities. Therefore, public benefit entities using IFRS would recognise, measure and make disclosures in respect of assets and liabilities according to the applicable IFRS's.

6.4 Incoming resources from non-exchange transactions

6.4.1 Introduction

The receipt of resources from non-exchange transactions is an inflow of resources that is highly significant for many PBEs. This was not addressed in the *IFRS for SMEs* Accounting Standard and therefore guidance on the topic was included in FRS 102. [FRS 102.BC.B34I.1].

A non-exchange transaction is defined as one where an entity receives value from another entity without directly giving approximately equal value in exchange or gives value to another entity without directly receiving approximately equal value in exchange. [FRS 102 Appendix I]. A non-exchange transaction that meets the definition of a government grant falls under the scope of Section 24, and these are covered in Chapter 26 [FRS 102.PBE34.64].

Where public benefit entities, or entities within a public benefit entity group, receive other resources from non-exchange transactions then the public benefit entity requirements in Section 34 are applied. [FRS 102.PBE34.65].

Non-exchange transactions can include, but are not limited to, donations (of cash, goods, and services) and legacies (see 6.4.2 below). [FRS 102.PBE34.66].

6.4.2 Recognition

An entity must recognise receipts of resources from non-exchange transactions as follows: [FRS 102.PBE34.67]

- (a) Transactions that do not impose specified future performance-related conditions on the entity are recognised in income when the resources are received or receivable.
- (b) Transactions that do impose specified future performance-related conditions on the entity are recognised in income only when the performance-related conditions are satisfied.

- (c) When resources are received or receivable before the performance-related conditions are satisfied, the entity recognises a liability.

A 'restriction' is defined as "a requirement that limits or directs the purposes for which a resource may be used that does not meet the definition of a performance related condition". [FRS 102 Appendix I]. A performance condition is defined as "A condition under which entitlement to resources is conditional on the performance of: (a) a specified activity; or (b) a particular level of service or units of output to be delivered." [FRS 102 Appendix I].

The existence of a restriction does not prohibit a resource from being recognised in income when receivable. [FRS 102.PBE34.68]. An example of a restriction is when a donor requires that a donation must be used to fund a specific activity, but the donor does not set any requirements making the donation conditional on achieving specific outputs or service levels from the activity, i.e., use of the donation is not dependent on a performance related condition).

Resources must only be recognised when the value of the incoming resources can be measured reliably. [FRS 102.PBE34.69].

The standard gives the following examples of resources that can usually be measured reliably:

- Donations of cash or goods.
- Facilities such as free use of office accommodation or event space.

Or

- Services usually provided by an individual or an entity as part of their trade or profession for a fee.

It is expected that other contributions made by volunteers cannot be measured reliably and must therefore must not be recognised. [FRS 102.PBE34.69A].

The FRC consider this is a pragmatic solution recognising there are potential issues in determining a value to the entity for volunteer services and their contribution to the organisation and notes that quantifying this type of service may not be practicable. It is noted that there is an argument to suggest that volunteer services could be measured by reference to a metric such as the minimum wage, however this measure does not take into consideration an organisation's requirements for volunteers. This arbitrary value may also not be reflective of their skills, experience or role, and to determine a different method of valuation would be very subjective. [FRS 102.BC.B34I.5]. However, when a service is provided voluntarily and its value can be measured reliably, for example a service for which the entity would otherwise have had to pay (e.g., legal or financial advice), the value to the entity of that service must be recognised in the financial statements. [FRS 102.BC.B34I.6].

In some situations, it may be impracticable to estimate the value of a resource with sufficient reliability when the resource received or receivable (e.g., in the case of high volume, low value second-hand goods donated for resale). In such cases, the income must be recognised in the period when the resource is sold or distributed. [FRS 102.PBE34.70]. When goods are donated for subsequent sale (e.g., donations to charity shops), the FRC noted that it could be argued that the donated goods must be valued only when they are sold. However, this is not consistent with the accruals concept which requires the financial statements to recognise goods when they are received. On pragmatic grounds, FRS 102 requires that when it is impracticable to estimate the value of a resource with sufficient reliability when the resource is received or receivable, the income shall be recognised in the period when the resource is sold or distributed (e.g., in the case of high volume, low value second-hand goods donated for resale). Further, the same accounting may be applied by other wholly-owned entities in a public benefit entity group, to eliminate the need to restate goods donated for subsequent sale on consolidation (e.g., where a charity operates its shops through a subsidiary that is a non-charitable company. [FRS 102.BC.B34I.4, FRS 102.BC.B34I.5].

The recognition of receipts of resources will result in the recognition of income and a corresponding asset or expense by the entity. There may be circumstances when resources are used in the production of an asset, for example erecting a building. In those cases, the associated resources would be recognised as a part of the cost of that asset. When a lease contains a non-exchange transaction (e.g., when lease payments are significantly below market rents), the incoming resources must be accounted for as a receipt of resources that form part of the cost of the right-of-use asset. [FRS 102.PBE34.70B].

An entity must recognise a liability for any resource, previously received and recognised in income, when a subsequent failure to meet restrictions or performance-related conditions attached to it, causes repayment to become probable. [FRS 102.PBE34.71].

6.4.2.A Legacies

Donations in the form of legacies must be recognised when it is probable that the legacy will be received and its value can be measured reliably. Whether the receipt of a legacy is probable and whether its value can be measured reliably may be affected by events such as valuations or disputes. In determining the probability of receipt and reliability of measurement, and in measuring the expecting inflow, an entity may apply estimates and assumptions to a portfolio of legacies if it reasonably expects that the result of doing so would not differ materially from the result of applying the approach to each individual legacy.

[FRS 102.PBE34.70A].

When a legacy meets the definition of a contingent asset, the entity must not recognise it but provide the disclosures required by Section 21 of FRS 102 for contingent assets. Similarly, when a legacy meets the definition of an asset, but the recognition criteria are not met, the entity is encouraged to consider disclosing information relevant to user's understanding of the entity's financial position. [FRS 102.PBE34.70A].

An entity must apply Section 32 *Events after the End of the Reporting Date* to determine whether the receipt of evidence after the reporting date is an adjusting event. [FRS 102.PBE34.70A].

6.4.3 Measurement

FRS 102 requires donated assets to be valued at their fair value as the FRC considered that circumstances in which this was not possible, such as an inability to exploit an asset fully, would rarely occur.

[FRS 102.BC.B34I.2].

Consequently, an entity must measure incoming resources from non-exchange transactions as follows:

[FRS 102.PBE34.73]

- (a) Donated services and facilities that would otherwise have been purchased must be measured at the value to the entity.
- (b) All other incoming resources from non-exchange transactions must be measured at the fair value of the resources received or receivable.

The value to the entity in (a) above will be the price the entity estimates it would pay in the open market for a service or facility of equivalent utility. For example, the amount the entity would have paid if the service or facility had not been donated. This might not be the same as the market value of the service or utility received. For example, if the entity received a premium service but would otherwise only have paid for a standard service, the value to the entity may be the value of a standard service. If an entity would not have purchased the service or facility at all, had it not been donated, the value to the entity is expected to be nil.

[FRS 102.PBE34.73A].

In (b) the fair value of resources received or receivable are usually the price that the entity would have paid on the open market for an identical or equivalent resource. Section 2A *Fair Value Measurement* provides guidance on determining fair value. When there is no evidence of an open market value for an identical or comparable resource, fair value must be estimated using another valuation technique. Relevant evidence for use in another valuation technique may include: [FRS 102.PBE34.73B].

- (a) The cost of the item to the donor.

Or

- (b) In the case of goods that are expected to be sold, the estimated resale value (which may reflect the amount actually realised) after deducting the cost to sell the goods.

As noted in 6.4 above, donated services are recognised as income with an equivalent amount recognised as an expense in income and expenditure, unless the expense can be capitalised as part of the cost of an asset.

[FRS 102.PBE34.70B].

6.4.3.A Impairment of assets held for service potential

Section 17 *Impairment of assets* requires assets within its scope to be carried at the lower of their fair value less costs to sell and their value in use. In a for-profit context, value in use is determined by measuring the present value of the cash flows derived from the asset. However, a PBE will often hold assets for their service potential rather than their ability to generate cash flows. In these circumstances, it is sometimes impossible to determine a value in use by reference to cash flows and will be more appropriate to regard value in use as the present value of future service potential. [FRS 102.BC.B27.1].

6.4.4 Disclosures regarding non-exchange transactions

An entity must disclose the following relating to non-exchange transactions: [FRS 102.PBE34.74]

- (a) The nature and amounts of resources receivable from non-exchange transactions recognised in the financial statements.
- (b) Any unfulfilled conditions or other contingencies attaching to resources from non-exchange transactions that have not been recognised in income.
And
- (c) An indication of other forms of resources from non-exchange transactions from which the entity has benefited, for example unrecognised volunteer services, or donated goods that have been received but which the entity does not expect to recognise until the goods are sold or distributed.

6.5 Property held for the provision of social benefits

Extract from FRS 102

BC.B17.1 The requirements for property held for the provision of social benefits apply to all entities applying FRS 102 and are not restricted to PBEs.

In drafting FRS 102, the FRC considered whether properties held for the provision of social benefits would meet the definition of an investment property. The definition of investment property includes properties held to earn rentals and/or for capital appreciation, but excludes properties held for use in the production or supply of goods and services, or for administrative purposes. However, the FRC observed that although many PBEs that engage in the provision of social housing receive rental income, their primary purpose is to provide social benefits. Provision of social housing is similar to supplying a service and therefore, property held for the primary purpose of providing social benefits is excluded from the scope of investment property and must be accounted for as property, plant and equipment. Similarly, PBEs may hold investment properties, being those that are not held primarily to provide social benefits but return market value rentals and/or are held for their capital appreciation. Those properties must be accounted for as investment properties. [FRS 102.BC.B17.2, FRS 102.BC.B17.3, FRS 102.BC.B17.4].

6.6 Public benefit entity combinations

These requirements in Section 34 apply only to public benefit entities entering into the following entity combinations (i.e., business combinations) which involve a whole entity or parts of an entity combining with another entity: [FRS 102.19.6(b), FRS 102.PBE34.75]

- Combinations at nil or nominal consideration which are in substance a gift.
And
- Combinations which meet the definition and criteria of a merger.

In all other cases, in particular for combinations which are determined to be acquisitions, public benefit entities must apply the requirements of Section 19 *Business Combinations and Goodwill* (see Chapter 22). [FRS 102.PBE19.2A, FRS 102.PBE34.76].

6.6.1 Combinations that are in substance a gift

A combination that is in substance a gift must be accounted for in accordance with Section 19, except for following matters: [FRS 102.PBE34.77]

- (a) Any excess of the fair value of the assets received over the fair value of the liabilities assumed is recognised as a gain in income and expenditure. This gain represents the gift of the value of one entity to another and must be recognised as income. [FRS 102.PBE34.78].
- (b) Any excess of the fair value of the liabilities assumed over the fair value of the assets received is recognised as a loss in income and expenditure. This loss represents the net obligations assumed, for which the receiving entity has not received a financial reward and must be recognised as an expense. [FRS 102.PBE34.79].

6.6.2 Combinations that are an acquisition

Any entity combination which is: [FRS 102.PBE34.81]

- In substance neither a gift nor a merger.
Or
- For which merger accounting is not permitted under the statutory framework under which the public benefit entity reports, must be accounted for as an acquisition in accordance with Section 19.

6.6.3 Combinations that are a merger

Extract from FRS 102

PBE34.80 Unless it is not permitted by the statutory framework under which a public benefit entity reports, an entity combination that is a merger shall apply merger accounting as prescribed below. If merger accounting is not permitted, an entity combination shall be accounted for as an acquisition in accordance with Section 19. [FRS 102.PBE34.80].

The note on legal requirements to FRS 102 states that, for public benefit entities, the use of merger accounting has not been extended beyond its applicability in company law, or other relevant statutory framework. If a public benefit entity that is a company considers that, for the overriding purpose of giving a true and fair view, merger accounting must be applied in circumstances other than those set out in paragraph 10 of Schedule 6 to the Regulations, it may do so providing the relevant disclosures are made in the notes to the financial statements. [FRS 102.A3.30A].

Under merger accounting the following procedures are applied: [FRS 102.PBE34.82, FRS 102.PBE34.83, FRS 102.PBE34.84, FRS 102.PBE34.85]

- (a) The carrying value of the assets and liabilities of the parties to the combination are not adjusted to fair value, although adjustments must be made to achieve uniformity of accounting policies across the combining entities.
- (b) The results and cash flows of all the combining entities must be brought into the financial statements of the newly formed entity from the beginning of the financial period in which the merger occurs. However, an exception is provided from this if either paragraph 9.9 or paragraph 9.9A of FRS 102 applies to a subsidiary (i.e., a subsidiary has either severe long-term restrictions which substantially hinder the parent's rights, has been acquired exclusively with a view to resale and has not previously been consolidated, or the subsidiary is immaterial. See Chapter 8 at 3.4)
- (c) The comparative amounts, marked as 'combined figures', must be restated by including the results for the previous accounting period for all the combining entities and their statements of financial position for the previous reporting date.
And
- (d) All costs associated with the merger must be charged as an expense in the period incurred.

6.6.4 Disclosures for combinations that are a merger

For each entity combination accounted for as a merger in the reporting period the following disclosures are required in the newly formed entity's financial statements: [FRS 102.PBE34.86]

- (a) The names and descriptions of the combining entities or businesses.
- (b) The date of the merger.
- (c) An analysis of the principal components of the current year's total comprehensive income to indicate:
 - (i) The amounts relating to the newly formed merged entity for the period after the date of the merger.
And
 - (ii) The amounts relating to each party to the merger up to the date of the merger.
- (d) An analysis of the previous year's total comprehensive income between each party to the merger.
- (e) The aggregate carrying value of the net assets of each party to the merger at the date of the merger.
And
- (f) The nature and amount of any significant adjustments required to align accounting policies and an explanation of any further adjustments made to net assets as a result of the merger.

6.6.5 Relief from applying Section 34 to combinations before transition

A first-time adopter may elect not to apply the requirements detailed in 6.6 to 6.6.4 above to public benefit entity combinations that were effected before the date of transition to FRS 102. However, if on first-time adoption a public benefit entity restates any entity combination to comply with this section, it must restate all later entity combinations. *[FRS 102.35.10(q)].*

6.7 Public benefit entity concessionary loans

Public benefit entities and other members of a public benefit entity group that make or receive public benefit entity concessionary loans must refer to the relevant paragraphs of Section 34 for the accounting requirements for such loans. *[FRS 102.PBE11.1A, FRS 102.PBE12.1A].*

Public benefit entity concessionary loans are defined as loans made or received between a public benefit entity, or an entity within the public benefit entity group, and another party at below the prevailing market rate of interest that are not repayable on demand and are for the purposes of furthering the objectives of the public benefit entity or public benefit entity parent. *[FRS 102.PBE34.88].*

The prevailing market rate is defined as the rate of interest that would apply to the entity in an open market for a similar financial instrument. *[FRS 102 Appendix I].*

6.7.1 Accounting policy choice

An entity making or receiving public benefit entity concessionary loans must choose to apply to those loans either:

(a) The recognition, measurement and disclosure requirements in Section 11 or Section 12 (see Chapter 13 and 15).

Or

(b) The accounting treatment set out at 6.7.2 below.

A public benefit entity or an entity within a public benefit entity group must apply the same accounting policy to concessionary loans both made and received. *[FRS 102.PBE34.89].*

The effect of choosing the accounting treatment set out in 6.7.2 below is that all public benefit entity concessionary loans are recognised at cost rather than at either amortised cost or fair value under Sections 11 or 12 of FRS 102, depending on the nature of the loan.

6.7.2 Accounting requirements

6.7.2.A Initial measurement

A public benefit entity or an entity within a public benefit entity group making or receiving concessionary loans must initially measure these arrangements at the amount received or paid and recognise these in the statement of financial position. *[FRS 102.PBE34.90].*

6.7.2.B Subsequent measurement

In subsequent years, the carrying amount of concessionary loans in the financial statements must be adjusted to reflect any accrued interest payable or receivable. *[FRS 102.PBE34.91].* There is no requirement that an entity use the effective interest method for a public benefit entity concessionary loan and accrete interest on a loan received or paid at an amount above or below the redemption amount.

To the extent that a loan that has been made is irrecoverable, any impairment loss must be recognised as an expense. *[FRS 102.PBE34.92].* An impairment loss is recognised if the carrying amount of the public benefit entity concessionary loan is lower than its recoverable amount (i.e., the higher of its fair value less costs to sell and value in use).

6.7.2.C Presentation and disclosure

Concessionary loans made and concessionary loans received must be presented by the entity either as separate line items on the face of the statement of financial position or in the notes to the financial statements. *[FRS 102.PBE34.93].*

Concessionary loans must be presented separately between amounts repayable or receivable within one year and amounts repayable or receivable after more than one year. *[FRS 102.PBE34.94].*

The entity must disclose in its significant accounting policies the measurement basis used for concessionary loans and any other accounting policies which are relevant to the understanding of these transactions within the financial statements. *[FRS 102.PBE34.95]*.

The entity must also disclose: *[FRS 102.PBE34.96]*

- (a) The terms and conditions of concessionary loan arrangements, for example the interest rate, any security provided and the terms of the repayment.

And

- (b) The value of concessionary loans which have been committed but not taken up at the year end.

Concessionary loans made or received must be disclosed separately. However multiple loans made or received may be disclosed in aggregate, providing that such aggregation does not obscure significant information. *[FRS 102.PBE34.97]*.

6.8 Other sections in FRS 102 relating to public benefit entities

The following requirements of FRS 102 are also relevant to public benefit entities:

- A public benefit entity that applies the 'PBE' prefixed paragraphs shall make an explicit and unreserved statement that it is a public benefit entity. *[FRS 102.PBE1AC.2B, FRS 102.3.3A]*. This disclosure is not required for a small entity in the Republic of Ireland applying Section 1A. *[FRS 102.3.1AA]*.
- Property held primarily for the provision of social benefits, e.g., social housing held by a public benefit entity, shall not be classified as investment property and shall be accounted for as property, plant and equipment in accordance with Section 17. *[FRS 102.16.3A]*.
- A public benefit entity that is a lessee with lease payments significantly below market rents must, at commencement or lease modification date, use the information readily available to it to determine whether it is in receipt of such incoming resources. If so, the lessee shall recognise those incoming resources as part of the cost of the right-of-use asset. *[FRS 102.1.51(b), FRS 102.20.35]*.
- A public benefit entity that is unable readily to determine either the interest rate implicit in the lease, or the lessee's incremental or obtainable borrowing rate for a lease, must use the rate of interest otherwise obtainable by the public benefit entity on deposits held with financial institutions. *[FRS 102.PBE20.50]*.

Appendix A – Defined terms

Extract from FRS 102 Appendix I Glossary

Definitions

combination that is in substance a gift non-exchange	A combination carried out at nil or nominal consideration that is not a fair value exchange but in substance the gift of one entity to another. A transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.
performance-related condition (in respect of funding commitments, government grants and other non-exchange transactions)	A condition under which entitlement to resources is conditional on the performance of: (a) a specified activity; or (b) a particular level of service or units of output to be delivered.
public benefit entity (PBE)	An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.
public benefit entity concessionary loan	A loan made or received between a public benefit entity or an entity within a public benefit entity group and another party: (a) at below the prevailing market rate of interest; (b) that is not repayable on demand; and (c) that is for the purposes of furthering the objectives of the public benefit entity or public benefit entity parent.
public benefit entity group restriction	A public benefit entity parent and all of its wholly-owned subsidiaries. A requirement that limits or directs the purposes for which a resource may be used that does not meet the definition of a performance-related condition.

Footnote 63 to Appendix I *Glossary* of FRS 102 elaborates that a PBE does not necessarily imply that the purpose of the entity is for the benefit of the public as a whole. For example, many PBEs exist for the direct benefit of a particular group of people, although it is possible that society as a whole also benefits indirectly. In the FRC's view, the most important factor is what the primary purpose of such an entity is, and that it does not exist primarily to provide economic benefit to investors. Organisations such as mutual insurance companies, other mutual co-operative entities and clubs that provide dividends or other economic benefits directly and proportionately to their owners, members or participants are not PBEs.

Some PBEs undertake certain activities that are intended to make a surplus in order to fund their primary activities and that consideration must be given to the primary purpose of an entity's (or group's) activities in assessing whether it meets the definition of a PBE.

A PBE may have received contributions in the form of equity, even though the entity does not have a primary profit motive. However, because of the fundamental nature of public benefit entities, any such contributions are made by the equity holders of the entity primarily to enable the provision of goods and services to beneficiaries rather than with a view to a financial return for themselves. This is different from the position of lenders; loans do not fall into the category of equity. [FRS 102 Appendix I.fn63].

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Chapter 37

Transition to FRS 102

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Overview

Section 35 *Transition to this FRS* ('Section 35') addresses the first-time adoption of FRS 102. The guidance in Section 35 is a simplified version of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

The underlying principle in Section 35 is that a first-time adopter must prepare financial statements applying FRS 102 retrospectively. However, Section 35 sets out a number of optional exemptions and mandatory exceptions that allow or require a first-time adopter to deviate from this principle in preparing an opening statement of financial position at the date of transition (i.e., at the beginning of the earliest period presented). Section 35 also sets out the disclosures required to explain the transition to FRS 102. These include reconciliations from its previous financial reporting framework to FRS 102 of equity at the date of transition and the comparative period end, and of the comparative profit or loss.

What you need to know

- A first-time adopter is an entity that presents its first financial statements that conform to FRS 102 (being the first financial statements in which the entity makes an explicit and unreserved statement of compliance with FRS 102), regardless of whether its previous financial reporting framework was adopted IFRS, FRS 101, FRS 105 or another set of accounting standards.
- Section 35 applies to the first FRS 102 financial statements. An entity that applied FRS 102 in a previous reporting period, but whose most recent annual financial statements did not contain an explicit and unreserved statement of compliance, could choose to apply Section 35 or to retrospectively apply FRS 102 as if it had never stopped applying it.
- The 'date of transition' to FRS 102 is the beginning of the earliest period for which the entity presents full comparative information in accordance with FRS 102 in its first financial statements that comply with FRS 102.
- In preparing its opening statement of financial position (at the date of transition), a first-time adopter must follow the requirements of FRS 102, subject to application of the mandatory exceptions (relating to derecognition of financial assets and financial liabilities, non-controlling interests and accounting estimates) and optional exemptions provided in Section 35. Adjustments arising as a result of the transition to FRS 102 are recognised directly in retained earnings (or, if appropriate, another category of equity).
- When an entity makes estimates in accordance with FRS 102, these must be consistent with estimates made under previous GAAP for the same date (after adjusting for the effects of any differences in accounting policies), unless there is objective evidence that the previous GAAP estimates were in error.
- From the date of transition, FRS 102 must be applied in full, except where provided otherwise in Section 35. Consistent accounting policies are applied throughout the periods presented and transitional provisions in amendments to FRS 102 that apply to ongoing FRS 102 reporters are not relevant (unless replicated in Section 35 itself).
- A first-time adopter must explain the transition to FRS 102, including presenting reconciliations of equity at the date of transition and the end of the comparative period, and of profit or loss of the comparative period with previous GAAP. These reconciliations must, to the extent practicable, distinguish between adjustments arising from changes in accounting policies and those relating to the correction of errors. There is no requirement in Section 35 (unlike IFRS 1) to present an opening statement of financial position and related notes. There are also certain disclosures where an entity has applied FRS 102 in a previous reporting period but not in its most recent annual financial statements and is re-applying FRS 102.

1 Introduction

Entities transitioning to FRS 102 are likely to have applied adopted IFRS or FRS 101 *Reduced Disclosure Framework* (or if previously applying the micro-entities regime, FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*). This chapter therefore focuses on differences between adopted IFRS (given that FRS 101 follows the same recognition and measurement requirements, with limited exceptions) and FRS 102.

There may be many reasons why an entity might choose to change its financial reporting framework to FRS 102. These could include:

- The entity ceasing to have its instruments listed on a UK regulated market (or other public markets) which required reporting in accordance with IFRS.
 - A change in ownership of the entity (where a different accounting framework is followed by the new group of which the entity is a member).
 - A change in the financial framework followed by the group of which the entity is a member.
 - Tax and/or distributable profit implications of different financial reporting frameworks.
 - A desire to reduce GAAP complexity and disclosure (e.g., arising from the implementation of new IFRS).
- And
- Ineligibility to continue applying FRS 105.

1.1 Changes made by the Periodic Review 2024 to FRS 102

In March 2024, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS* (Periodic Review 2024). The key changes affecting Section 35 can be summarised as follows:

- Section 35 provides first-time adopters certain optional exemptions from full retrospective application of FRS 102 and under the amendments, certain new exemptions have been introduced for first-time adopters in connection with lease accounting and revenue recognition. These exemptions are not the same as the transitional provisions offered to existing FRS 102 reporters but offer similar reliefs. There are also changes to other exemptions, such as deemed cost exemptions, to reflect the new lease model for lessees and to remove exemptions that related to the previous lease accounting model.
- Optional exemptions available to first time adopters in respect of lease accounting comprise:
 - The option to assess whether a contract contains a lease based on facts and circumstances at the date of transition, rather than at the commencement date of the lease (see 5.11.1 below).
 - For an entity previously applying IFRS 16 *Leases*, an option to use the lease liability and right-of-use asset balances calculated under IFRS 16 as the FRS 102 lease liability and right-of-use asset balances on the date of transition to FRS 102 and to rely on its previous assessment of impairment (under adopted IFRS) at that date (see 5.11.2 below).
 - A lessee not applying the Section 35 optional exemption to carry forward the lease liability calculated under IFRS 16 measures lease liabilities at the date of transition at the present value of remaining lease payments, discounted using the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate (see 5.11.3 below). The right-of-use assets must be measured at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments (except in the case of a right-of-use asset that meets the definition of investment property, which is generally measured at fair value). However, a lessee is permitted to apply one or more of the following options, which are available on a lease-by-lease basis:
 - (a) An option to apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
 - (b) An option not to recognise a lease liability and right-of-use asset for leases ending within 12 months of the date of transition or for which the underlying asset is of low value.
 And
 - (c) An option to use hindsight in the assessment of lease term.
- With regards to revenue recognition, a first-time adopter is permitted to apply any of the same practical expedients which are available to existing FRS 102 reporters on transition to the amended standard. These practical expedients (which must be applied consistently to all contracts and periods presented) comprise the following (see 5.12 below):

- For 'completed contracts' (meaning a contract for which the entity has transferred all the goods or services identified in accordance with its previous financial reporting framework), an optional relief from restating contracts that either begin or end in the same reporting period or are completed contracts as at the beginning of the earliest period presented.
- For completed contracts with variable consideration, an option to use the transaction price at the date the contract was completed rather than estimating variable consideration in the comparative periods.

And

- An optional relief from full retrospective restatement of contracts modified before the date of initial application or the date of transition.
- Additional disclosure requirements have been introduced requiring first-time adopters to state which optional exemptions have been applied in the transition to FRS 102, and to provide an explanation of material changes to reported financial position that are not presented in the reconciliations of profit or loss and equity, including whether these arise from errors or changes in accounting policy (see 6.2 and 6.3 below).
- First-time adopters will no longer be able to elect to apply the recognition and measurement provisions of IAS 39 *Financial instruments: Recognition and Measurement* unless doing so would make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included (see 4.1.1 below).
- A new optional exemption is introduced to allow a first-time adopter selecting an accounting policy of capitalising development costs to elect to treat the date of transition as the date on which capitalisation commences (see 5.8 below).
- Certain exemptions included in the previous version of FRS 102 have been removed where no longer considered to be required.
- Other wording changes have been made to reflect the fact that entities will typically be transitioning from IFRS, FRS 101 or FRS 105 (meaning that some previous exemptions that were relevant for first-time adopters transitioning from previous UK GAAP are no longer relevant). There are also a number of clarifications to the existing text of Section 35.

1.2 References to IFRS 1

IFRS 1, as referred to throughout this chapter, is the version of IFRS 1 issued as of July 2024 as amended by *Annual Improvements to IFRS Accounting Standards - Hedge Accounting by a First-Time Adopter (Amendments to IFRS 1)*. However, as described below, IFRS 1 continues to be amended as changes are made to other IFRSs.

2 Key differences between Section 35 and IFRS

The transition exceptions and exemptions included in Section 35 are similar to those included in IFRS 1. However, Section 35 omits certain exceptions and exemptions that are included in IFRS 1, adds certain others and modifies the wording in places. Overall Section 35 contains significantly less guidance and examples on the application of the transition exceptions and exemptions than IFRS 1. Many transition exemptions in IFRS 1 that do not appear in Section 35 relate to the implementation of IFRSs that do not have a direct counterpart in FRS 102.

IFRS 1 contains specific transition exemptions relating to IFRS 9 *Financial Instruments* not included in Section 35 (although IFRS 9 is available as an accounting policy choice for the recognition and measurement of financial instruments under FRS 102). Section 35 does, however, include transition provisions for hedge accounting where IAS 39 or IFRS 9 is to be applied to financial instruments under FRS 102. These are similar to the transition provisions for hedge accounting included in IFRS 1 but include a concession over the timing of completion of the designation and documentation of hedging relationships (see 5.16.3 below). There is also a transition exception for derecognition of financial assets and financial liabilities (see 4.1 below).

The main differences between Section 35 and IFRS 1 are listed below:

- Section 35 contains relief where it is impracticable for an entity to restate the opening statement of financial position or make the required disclosures. [FRS 102.35.11].
- The disclosure requirements regarding transition in the annual financial statements are less extensive in Section 35. For example, there are no requirements to:
 - Present an opening statement of financial position and related notes. [FRS 102.35.7]
 - Explain how the transition affects the reported cash flows or to disclose the adjustments made for impairment or reversal of impairment in preparing the opening statement of financial position.
 - Reconcile total comprehensive income determined in accordance with its previous financial reporting framework to FRS 102 (although there is a requirement to reconcile profit or loss). [FRS 102.35.13(c)]
 - Make certain disclosures relating to designation of financial assets or financial liabilities and to the use of deemed cost. [IFRS 1.29-31C]
 Or
 - Explain changes to accounting policies or the use of exemptions between the first FRS 102 interim financial report and the first FRS 102 financial statements and update the reconciliations previously included in the interim financial statements. [IFRS 1.32(c)].
- In addition, Section 35 includes the following transition exemptions not in IFRS 1:
 - Dormant entities (see 5.17 below). [FRS 102.35.10(m)]
 - Public benefit entity combinations effected pre-transition (see 5.3 below). [FRS 102.35.10(q)]
 And
 - Development costs (see 5.8 below).
- As part of the Periodic Review 2024, several transitional provisions were added as a result of revisions to Section 20 *Leases* and Section 23 *Revenue from Contracts with Customers*. The main differences between Section 35 and IFRS 1 are listed below:
 - Section 35 contains a specific transition exemption for a lessee applying IFRS 16 immediately prior to the date of transition to FRS 102. [FRS 102.35.10(x)]
 - When not applying the IFRS 16 election, Section 35 allows a lessee to choose an obtainable borrowing rate as a discount rate in measuring the lease liability at the date of transition. [FRS 102.35.10(x)]
 - The practical expedients in Section 35 for lessees do not include the option available in IFRS 1 to exclude initial direct costs from measurement of the right-of-use asset at the date of transition. [FRS 102.35.10(x)]
 - Section 35 provides optional relief from full retrospective restatement of contracts modified before the beginning of the reporting period. The entity, instead, may reflect the aggregate effect of all of the modifications that occurred before the beginning of the earliest period presented or before the beginning of the reporting period. Under IFRS 1, however, the relief applies only to contracts modified before the date of transition rather than before the beginning of the reporting period. [FRS 102.35.10(y), FRS 102.35.1.65(c)].

Where FRS 102 does not specifically address a transaction, Section 10 *Accounting Policies, Estimates and Errors* requires management to use judgement in developing and applying a relevant and reliable accounting policy. In making that judgement, management must refer to and consider the sources listed in Section 10, and may consider the requirements and guidance in adopted IFRS dealing with similar and related issues. [FRS 102.10.4, FRS 102.10.5, FRS 102.10.6]. Consequently, management may refer to the IFRS 1 requirements and guidance relating to the same exception or exemption. However, care needs to be taken in doing so where the first-time adoption or underlying accounting for the item differs.

3 Scope and preparation of the opening FRS 102 statement of financial position

3.1 Scope of Section 35

Section 35 applies to a first-time adopter of FRS 102 regardless of whether its previous financial reporting framework was adopted IFRS, FRS 101, FRS 105 or another set of generally accepted accounting principles (GAAP) such as its national accounting standards, or another framework such as the local income tax basis (see 3.1.1 below). [FRS 102.35.1].

Most FRS 102 reporters in the UK will be UK companies or LLPs preparing statutory accounts under the Companies Act 2006 ('CA 2006') (or the CA 2006 as applied to LLPs). In such cases, the previous financial reporting framework will be FRS 101, FRS 105, or adopted IFRS.

A first-time adopter must apply the requirements of Section 35 in its first financial statements that conform to FRS 102. [FRS 102.35.3]. These are the first financial statements (excluding interim financial statements) in which the entity makes an explicit and unreserved statement of compliance with FRS 102. [FRS 102.35.4]. These financial statements are referred to as the 'first FRS 102 financial statements' below.

Section 35 also addresses the situation where an entity re-applies FRS 102 after a period of applying a different financial reporting framework (see 3.1.2 below).

3.1.1 Who is a first-time adopter?

Normally, it will be clear whether an entity is a first-time adopter of FRS 102, i.e., an entity that presents its first annual financial statements that conform to FRS 102, regardless of whether its previous financial reporting framework was adopted IFRS or another set of accounting standards. [FRS 102 Appendix I]. However, Section 35 provides a description of circumstances in which an entity is a first-time adopter and therefore is within the standard's scope (see the extract from Section 35 below): [FRS 102.35.4]

Extract from Section 35

- 35.4** An entity's first financial statements that conform to this FRS are the first financial statements⁵⁸ in which the entity makes an explicit and unreserved statement in those financial statements of compliance with this FRS. Financial statements prepared in accordance with this FRS are an entity's first such financial statements if, for example, the entity:
- (a) did not present financial statements for previous periods;
 - (b) [Deleted]
 - (c) presented its most recent previous financial statements in conformity with adopted IFRS;
 - (d) presented its most recent previous financial statements in conformity with FRS 101; or
 - (e) presented its most recent previous financial statements in conformity with FRS 105.

⁵⁸ This excludes interim financial statements.

The first FRS 102 financial statements must be a complete set of financial statements, as defined in paragraph 3.17 of FRS 102 (see Chapter 6 at 2.3). This means that the financial statements must include a full set of primary statements and notes (together with comparatives). [FRS 102.35.4, FRS 102.35.5, FRS 102.35.6].

Small entities applying Section 1A *Small Entities* of FRS 102 are required to present an income statement, statement of financial position and notes (together with comparatives), but are not required to present a cash flow statement. [FRS 102.1A.8, FRS 102.7.1B]. However, a small entity may need to present a statement of comprehensive income when it recognises gains or losses in other comprehensive income and a statement of changes in equity (or, where appropriate, a statement of income and retained earnings) when it has changes in equity other than profit or loss. [FRS 102.1A.9]. See Chapter 5 at 3.3.3.

The first FRS 102 financial statements of a UK company (or LLP) will usually be the statutory financial statements, but this might not always be the case (e.g., first-time adoption in an offering document). In practice, most companies publishing offering documents are likely to be applying IFRS or adopted IFRS rather than FRS 102.

An entity is not a first-time adopter if it presented financial statements in the previous year that contained an explicit and unreserved statement of compliance with FRS 102 even if its auditors qualified the auditor's report on those financial statements.

3.1.2 Repeat application of FRS 102

An entity that has applied FRS 102 in a previous reporting period, but whose most recent previous annual financial statements did not contain an explicit and unreserved statement of compliance with FRS 102, has a choice either to apply Section 35 or else to apply FRS 102 retrospectively in accordance with Section 10, as if the entity had never stopped applying FRS 102. [FRS 102.35.2]. Such an entity must also disclose the reason it stopped applying FRS 102, the reason it is resuming application of FRS 102 and whether it has applied Section 35 or FRS 102 retrospectively (see 6.4 below). [FRS 102.35.12C].

Where the entity chooses to re-apply Section 35, it must apply the transition exceptions and exemptions without regard to the elections made when it applied Section 35 previously. The entity will, therefore, apply the transition exceptions and exemptions of Section 35 based on its new date of transition to FRS 102. However, where an entity chooses to apply FRS 102 retrospectively, it does so as if it had never stopped applying FRS 102. [FRS 102.35.2]. Therefore, the entity must retain the transition exceptions and exemptions applied in its first FRS 102 financial statements.

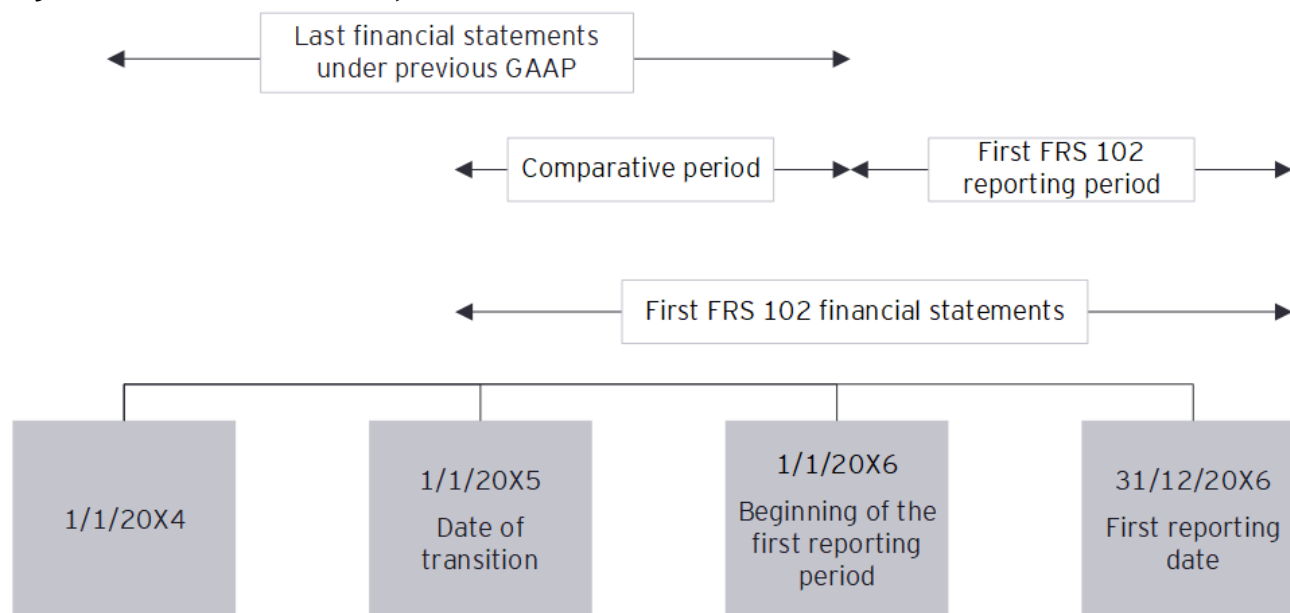
3.2 First-time adoption timeline

An entity's first FRS 102 financial statements must include at least two statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows (unless exempt) and two statements of changes in equity and related notes. [FRS 102.3.17, FRS 102.3.20, FRS 102.7.1B, FRS 102.35.5]. Where permitted by the standard, statements of income and retained earnings may be included in place of the statements of comprehensive income and statements of changes in equity. [FRS 102.3.18, FRS 102.6.4].

As a small entity is not generally required to present a statement of comprehensive income or a statement of changes in equity, a small entity's first FRS 102 financial statements need only include at least two statements of financial position, two income statements and related notes. [FRS 102.1A.8]. However, Section 1A explains that in order for the financial statements to meet the 'true and fair requirement', a small entity may need to present a statement of comprehensive income when it recognises gains or losses in other comprehensive income and a statement of changes in equity (or, where appropriate, a statement of income and retained earnings) when it has changes in equity other than profit or loss. [FRS 102.1A.9].

The date of transition is the beginning of the earliest period for which the entity presents full comparative information in accordance with FRS 102 in its FRS 102 financial statements. [FRS 102.35.6, FRS 102 Appendix I]. Figure 3-1 below shows how for an entity with a December year-end the above terms are related:

Figure 3-1: First-time adoption timeline



The following Illustration shows how an entity determines its date of transition to FRS 102.

Illustration 3-1: Determining the date of transition to FRS 102

- (i) *Entity A's year-end is 31 December and it presents financial statements that include one comparative period. Entity A changes its financial reporting framework to prepare financial statements in conformity with FRS 102 for the first accounting period starting on or after 1 January 20X6.*
Entity A's first financial statements in conformity with FRS 102 are for the period ending on 31 December 20X6. Its date of transition to FRS 102 is 1 January 20X5, which is the beginning of the comparative period included in its first financial statements in conformity with FRS 102.
- (ii) *Entity B's year-end is 30 November and it presents financial statements that voluntarily include full information for two comparative periods. Entity B changes its financial reporting framework to prepare financial statements in conformity with FRS 102 for the accounting period ended 30 November 20X6.*
Entity B's first financial statements in conformity with FRS 102 are for the accounting period ended 30 November 20X6. Its date of transition to FRS 102 is 1 December 20X3, which is the beginning of the earliest period for which full comparative information is included in its first financial statements in conformity with FRS 102.
- (iii) *Entity C's most recent financial statements under its previous financial reporting framework are for the period from 1 July 20X4 to 31 December 20X5. Entity C presents its first financial statements (with one comparative period) in conformity with FRS 102 for the period ending 31 December 20X6.*
Entity C's date of transition is 1 July 20X4.

How we see it

While FRS 102 requires presentation of at least one comparative period, neither FRS 102 (nor the CA 2006, for a UK company) require the comparative period to be a 12-month period. Thus, the entity's date of transition will be the beginning of the earliest comparative period, irrespective of the length of that period.

However, the financial statements must disclose that the comparative period is not a 12-month period, the reason why the comparative period is not 12 months and that the periods presented are not entirely comparable.

[FRS 102.3.10, FRS 102.3.14, FRS 102.3.17, FRS 102.35.5].

3.3 Determining the previous financial reporting framework

Although FRS 102 does not define 'previous financial reporting framework', it is generally taken to mean the basis of accounting that a first-time adopter used immediately before adopting FRS 102. This is the equivalent term to 'previous GAAP' as used in IFRS 1. [IFRS 1 Appendix A].

Most UK companies (and LLPs) are required to prepare and file statutory accounts. [s394, s441, s394 (LLP), s441 (LLP)]. There are exemptions for certain dormant subsidiary companies (and LLPs) not to prepare and file statutory accounts. [s394A, s448A, s394A (LLP), s448A (LLP)]. In addition, certain unlimited companies are not required to file statutory accounts. [s448]. Consequently, it will generally be appropriate to regard the GAAP used in the latest set of statutory accounts of a UK company (or LLP) prior to implementation of FRS 102 as the previous financial reporting framework. While there may be scope for judgement in certain situations over what is the previous financial reporting framework, such situations are likely to be rare.

3.4 Preparation of the opening FRS 102 statement of financial position

The fundamental principle in Section 35 is to require full retrospective application of FRS 102, subject to certain mandatory exceptions and optional exemptions that can be applied at the date of transition.

[FRS 102.35.7].

Extract from Section 35

- 35.7** Except as provided in paragraphs 35.9 to 35.11B, an entity shall, in its opening statement of financial position as of its date of transition to this FRS (ie the beginning of the earliest period presented):
- (a) recognise all assets and liabilities whose recognition is required by this FRS;
 - (b) not recognise items as assets or liabilities if this FRS does not permit such recognition;
 - (c) reclassify items that it recognised under its previous financial reporting framework as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under this FRS; and
 - (d) apply this FRS in measuring all recognised assets and liabilities.
- This section does not require the opening statement of financial position to be presented.

A first-time adopter might identify errors under its previous financial reporting framework when transitioning to FRS 102. Material prior period errors identified under its previous financial reporting framework must be adjusted retrospectively, to the extent practicable. [FRS 102.10.21]. The reconciliations required by Section 35 must also, to the extent practicable, distinguish the correction of those errors from changes in accounting policies (see 6.3 below). [FRS 102.35.14].

Where the accounting policies applied in the opening statement of financial position under FRS 102 differ from those applied under an entity's previous financial reporting framework, the resulting adjustments arise from transactions, other events or conditions before the date of transition. Therefore, an entity must recognise those adjustments directly in retained earnings (or, if appropriate, another category of equity - see Illustration 3-2 below) at the date of transition to FRS 102. [FRS 102.35.8].

Illustration 3-2: Revaluation of property

On transition to FRS 102, Entity A adopts a policy of revaluation for its freehold property. [FRS 102.17.15E, FRS 102.17.15F]. The freehold property, with a net book value of £500,000 under its previous financial reporting framework (where the cost model had been applied), is revalued to £1.1m, being its fair value at the date of transition. A revaluation reserve of £600,000 is recognised at the date of transition.

Under FRS 102, freehold property is revalued through other comprehensive income and consequently deferred tax arises on this timing difference. [FRS 102.29.6]. The adjustment to reflect the revaluation (and related deferred tax) is recognised in equity as at the date of transition. [FRS 102.35.8].

If Entity A is a UK company (or LLP) preparing statutory accounts, a statutory revaluation reserve is required to be established by the alternative accounting rules in the Regulations (and LLP Regulations). [1 Sch 35, 1 Sch 35 (LLP)]. The related deferred taxation charge arising on the revaluation may be offset against the statutory revaluation reserve in accordance with the alternative accounting rules rather than taken to retained earnings. [1 Sch 35(3)]. See 3.4.3 below and Chapter 20 at 3.7.3 and Chapter 31 at 6.

Another example where adjustments (if any) may be reflected in a category of equity other than retained earnings concerns where cash flow hedge accounting is applied under FRS 102. See 5.16 below for further discussion of the hedge accounting transition provisions.

IFRS 1 includes additional requirements and guidance in respect of the transition compared to FRS 102 that can provide further insight into the requirements of Section 35. The application of specific exceptions and exemptions in Section 35 (including any relevant additional guidance in IFRS 1) are addressed at 4 and 5 below, respectively. However, some general issues are discussed below, namely:

- Changes of accounting policy made on transition to FRS 102 (see 3.4.1 below).
 - Impairment testing at the date of transition (see 3.4.2 below).
 - Use of the historical cost accounting rules, alternative accounting rules, and fair value accounting rules (by UK companies, LLPs and certain other entities) (see 3.4.3 below).
 - The impracticability exemption, and subsequent application of transition exemptions (see 3.4.4 below).
- And
- Transition issues where a previous IFRS or FRS 101 reporter applies IFRS 9 to the recognition and measurement of financial instruments under FRS 102 (see 3.4.5 below).

3.4.1 Changes of accounting policy made on transition to FRS 102

The fundamental principle in Section 35 is to require full retrospective application of FRS 102. This means that consistent accounting policies are used in the opening statement of financial position and for all periods presented in an entity's first FRS 102 financial statements. [FRS 102.10.7, FRS 102.35.8].

A first-time adopter is not under a general obligation to ensure that its FRS 102 accounting policies are as similar as possible to its accounting policies under its previous financial reporting framework. Therefore, a first-time adopter could adopt a revaluation model for property, plant and equipment even if it had applied a cost model under its previous financial reporting framework (or *vice versa*).

A first-time adopter would, however, need to take into account the requirements of Section 10 to ensure that its choice of accounting policy results in information that is relevant and reliable. In doing so, in situations where an FRS does not specifically address the issue, management must refer to the hierarchy set out in paragraph 10.5 and may consider the requirements and guidance in adopted IFRS dealing with similar and related issues. [FRS 102.10.4, FRS 102.10.5, FRS 102.10.6].

Following the Periodic Review 2024 amendments, first-time adopters may choose to apply the accounting policy choice available under paragraphs 11.2(b) and 12.2(b) - which are the recognition and measurement provisions of IAS 39 (as adopted in the relevant jurisdiction), the disclosure requirements of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instruments Issues*, and the presentation requirements of paragraphs 11.28A and 12.25W - only if this would make the entity's accounting policies consistent with those adopted in the consolidated financial statements in which the entity is included.

Otherwise, the first-time adopter must choose to apply either: [FRS 102.35.8C]

- The accounting policy choice available under paragraphs 11.2(a) and 12.2(a) - which are the provisions of Section 11 and Section 12 in full.

Or

- The accounting policy choice available under paragraphs 11.2(c) and 12.2(c) - which are the recognition and measurement provisions of IFRS 9 (as adopted in the relevant jurisdiction) and IAS 39 (as amended following the publication of IFRS 9), the disclosure requirements of Section 11 and 12, and the presentation requirements of paragraphs 11.28A and 12.25W,

to account for all of its financial instruments (see 4.1.1 below).

How we see it

In our view, transitional provisions in other sections of FRS 102, other FRC standards (such as FRS 103 *Insurance Contracts*), IAS 39 or IFRS 9 (where applied to the recognition and measurement of financial instruments), and other IFRSs that are required to be applied by certain FRS 102 reporters, are ignored when an entity applies Section 35 to the transition. This is the case unless the transitional provisions are stated to apply to a first-time adopter (as is the case for FRS 103) or are provided for as a specific transition exception or exemption in Section 35.

Section 35 contains a number of transition exemptions relating to Sections 11 and 12. The only transition exemption explicitly referring to the use of IAS 39 or IFRS 9 relates to hedge accounting (see 5.16 below).

TECH 02/17BL *Guidance on Realised and Distributable Profits under the Companies Act 2006* ('TECH 02/17BL'), issued by the ICAEW and ICAS, provides guidance on how and when transition to a new GAAP affects distributable profits. This guidance is discussed in Chapter 1 at 4.5 and Chapter 1 at 5.8.

3.4.2 Impairment testing at the date of transition

FRS 102 permits first-time adopters to make use of deemed cost for certain assets as the initial carrying amount on transition. Section 35 specifically requires that the carrying amounts of exploration and evaluation assets and assets in the development and production phases are tested for impairment when the exemption in paragraph 35.10(j) is taken for oil and gas assets (see 5.6 below). However, while FRS 102 does not specifically call for an impairment test of other assets, a first-time adopter should be mindful that there are no exemptions from full retrospective application of the requirements set out in Section 27 *Impairment of Assets* (or indeed in relation to the impairment of financial assets under Sections 11 and 12, IAS 39, or IFRS 9).

Therefore, an entity must consider whether there is an indicator of impairment (or reversal of previous impairment) of assets at the date of transition that might require an impairment test to be performed. In relation to financial assets, an entity is required to consider whether there is objective evidence that an impairment loss has been incurred (where Sections 11 and 12, or IAS 39 is applied), and to recognise a loss allowance for expected credit losses in accordance with IFRS 9 where that standard is applied.

If an entity uses fair value as deemed cost for an asset whose fair value is above cost, an impairment test may be appropriate for other assets where the deemed cost election has not been taken.

Impairment losses for assets (except goodwill) are reversed under Section 27 if, and only if, the reasons for the impairment loss have ceased to apply. Hence, for assets (other than goodwill), no practical differences between applying Section 27 fully retrospectively or as at the date of transition are expected. [FRS 102.27.28, FRS 102.27.29]. Performing the test at the date of transition results in recognition of any required impairment as of that date, remeasuring any impairment determined under the entity's previous financial reporting framework to comply with the approach in Section 27.

The estimates used to determine whether a first-time adopter recognises an impairment provision at the date of transition to FRS 102 need to be consistent with estimates made for the same date under its previous financial reporting framework (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error. If a first-time adopter needs to make estimates for that date that were not necessary under its previous financial reporting framework, such estimates and assumptions must not reflect conditions that arose after the date of transition to FRS 102.

If a first-time adopter's opening FRS 102 statement of financial position reflects impairment losses for an asset held at deemed cost (whether the losses were recognised under its previous financial reporting framework or upon transition to FRS 102), any later reversal of those impairment losses (not permitted for goodwill) must be recognised in profit or loss provided that Section 27 does not require such reversal to be treated as a revaluation. [FRS 102.27.30].

How we see it

Where an entity makes use of deemed cost exemptions at transition, deemed cost is used as a surrogate for cost at the date the deemed cost is established. Therefore, if the carrying amount at the date the deemed cost is established reflects previous impairment, these impairment losses cannot be later reversed and any later impairment losses are reflected in profit or loss.

Certain transition exemptions permit use of a deemed cost equal to the carrying amount of the asset as determined under the entity's previous financial reporting framework – an example includes investments in subsidiaries, associates or jointly controlled entities in individual or separate financial statements.

[FRS 102.35.10(f)].

How we see it

Where this is the case, we consider that application of Section 27 could lead to a further impairment on transition, but not to a reversal of an impairment determined correctly under the entity's previous financial reporting framework (as reflecting a reversal of impairment is not consistent with the deemed cost being equal to the previous financial reporting framework carrying amount). See 5.5 below.

Section 35 does not require specific disclosures regarding any impairment losses recognised or reversed on transition to FRS 102; however, where material, disclosure of such adjustments is likely to be relevant to an explanation of the transition. [FRS 102.35.12]. Indeed, a first-time adopter is required to present reconciliations of the statement of equity at the date of transition and at the end of the latest comparative period presented, and to explain material changes to its reported financial position, where not presented in the reconciliation. [FRS 102.35.12B, FRS 102.35.13,]. See 6.2 below.

3.4.3 Use of the historical cost accounting rules, alternative accounting rules and fair value accounting rules

A UK company's (or LLP's) statutory accounts prepared in accordance with FRS 102 are Companies Act accounts (non-IAS accounts, for an LLP). Therefore, the company (or LLP), in preparing its FRS 102 opening statement of financial position, must consider whether it makes use of the historical cost accounting rules, alternative accounting rules or fair value accounting rules set out in Part 2 of Schedule 1 to the Regulations (or the equivalent requirements in Schedules 2 and 3 to the Regulations or Schedule 1 to the LLP Regulations).

This is relevant both to whether any adjustments made at the date of transition are reported in retained earnings or another category of equity, and to subsequent accounting and disclosure requirements. For example, where the revaluation model is applied to property, plant and equipment, a statutory revaluation reserve must be established under the alternative accounting rules. See Chapter 20 at 3.7.3.

3.4.3.A Deemed cost

A number of the transition exemptions permit an entity to establish a deemed cost that may differ from the historical cost carrying amount under its previous financial reporting framework. The implications of deemed cost are discussed at 5.5 below. For a UK company's (or LLP's) statutory accounts, the deemed cost, in many cases, will need to comply with either the alternative accounting rules or the fair value accounting rules, as applicable. Illustration 3-2 at 3.4 above illustrates that where a revaluation policy is adopted by a UK company (or LLP), a statutory revaluation reserve is established where required under the alternative accounting rules. However, even if, for example, a UK company (or LLP) records an item of property, plant and equipment at a deemed cost equal to its fair value at the date of transition or treats a revaluation under its previous financial reporting framework as a deemed cost at the date of the revaluation (see 5.5 below), application of the alternative accounting rules may require the company (or LLP) to establish (or maintain an existing) statutory revaluation reserve. [1 Sch 35, 1 Sch 35 (LLP)].

3.4.3.B Financial instruments held at fair value

Where financial instruments are measured at fair value under the fair value accounting rules, certain fair value movements are required to be recognised in other comprehensive income and accumulated in the statutory fair value reserve. [1 Sch 40, 1 Sch 40 (LLP)]. The most common examples relate to fair value movements arising on: cash flow hedges (see Chapter 14 at 4.8), exchange differences in respect of monetary items forming part of a net investment in a foreign operation (and hedges of a net investment in a foreign operation) (see Chapter 14 at 4.9), and, where IAS 39 is applied to the recognition and measurement of financial instruments, available-for-sale financial assets. [IAS 39.45(d)].

How we see it

As discussed in Chapter 13 at 4.4.2.C, our view is that the fair value accounting rules also apply to investments in debt instruments accounted at fair value through other comprehensive income in accordance with IFRS 9. This is because the accounting is similar to that for an available-for-sale financial asset. Therefore, fair value movements arising on such debt instruments are also, where appropriate, reflected in the statutory fair value reserve.

A statutory fair value reserve may sometimes be required for a cash flow hedge on transition, even where hedge accounting is not being used going forward. This will, however, depend on whether IAS 39, or IFRS 9, or Sections 11 and 12 are being used as the transition provisions differ. See 5.16 below for a discussion of the transition provisions for hedge accounting.

By contrast, in our view, accounting for an investment in equity instruments at fair value through other comprehensive income in accordance with IFRS 9 makes use of the alternative accounting rules. Therefore, fair value movements (other than dividends from that investment, which are required to be recognised in profit or loss) must be reflected in the statutory revaluation reserve.

Where a financial liability is designated at fair value through profit or loss in accordance with IFRS 9, fair value changes attributable to changes in the credit risk of the liability are accounted in other comprehensive income (unless that treatment would create or enlarge an accounting mismatch). [IFRS 9.4.2.2, IFRS 9.5.7.1(c), IFRS 9.5.7.7-9]. Recording such fair value gains and losses attributable to changes in credit risk in other comprehensive income in accordance with IFRS 9 will usually be a departure from the requirement of paragraph 40 of Schedule 1 to the Regulations (which requires fair value gains and losses to be included in the profit and loss account, except where the financial instrument is a hedging instrument or an available for sale security) for the overriding purpose of giving a true and fair view. [FRS 102.A3.12C]. This is discussed further at Chapter 13 at 4.4.1.

Whether or not adjustments are taken to retained earnings or another category of equity, particular care needs to be taken in evaluating whether such adjustments are realised or not for the purposes of determining the distributable profits of a UK company. TECH 02/17BL provides guidance. See also Chapter 1 at 4.5 and Chapter 1 at 5.8.

3.4.3.C Investment property – transitional adjustments

Under FRS 102, investment property is remeasured at fair value through profit or loss (except for investment property rented to another group entity, where a policy choice is made to transfer the investment property to property, plant and equipment (as owner) or to right-of-use assets (as lessee) and apply the cost model). [FRS 102.16.7, FRS 102.16.4A]. In a UK company's (or LLP's) statutory accounts, this accounting makes use of the fair value accounting rules.

It is possible that a first-time adopter previously accounted for investment property using the cost model as a policy choice under adopted IFRS (or FRS 101). Where the fair value model is applied to the investment property under FRS 102, the adjustment of the carrying amount to fair value at the date of transition is included in retained earnings (or transferred to a separate non-distributable reserve) as the revaluation applies the fair value accounting rules.

It is also possible that a first-time adopter previously accounted for investment property rented to another group entity at fair value through profit or loss under adopted IFRS (or FRS 101) but, on transition to FRS 102, makes a policy choice to transfer the investment property to property, plant and equipment (or to right-of-use asset, if a lessee) and to apply the cost model. If this is the case, the investment property will need to be restated to original cost or deemed cost on transition (see 3.4.3.A above and 5.5 below). [FRS 102.A3.40B, FRS 102.A3.40C]. Where a deemed cost is used on transition for such investment properties to be accounted using the cost model, a statutory revaluation reserve may arise where the deemed cost exceeds the depreciated historical cost of such properties (see 5.5 below).

On transition, deferred tax is provided on any revaluation in accordance with Section 29 *Income Tax*, as this is generally a timing difference recognised on or prior to transition. Deferred tax relating to investment property that is measured at fair value must be measured using the tax rates and allowances that apply to sale of the asset, except for investment property that has a limited useful life and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the property over time. [FRS 102.29.6, FRS 102.29.16].

3.4.4 Impracticability exemption, and subsequent application of transition exemptions

If it is impracticable for an entity to restate the opening statement of financial position at the date of transition for one or more of the adjustments required by paragraph 35.7(a) to (d) (see 3.4 above), an entity must:

- Apply paragraphs 35.7 to 35.10 (i.e., retrospective application of FRS 102, subject to the transition exceptions and exemptions) for such adjustments in the earliest period for which it is practicable to do so.
- And
- Identify which amounts in the financial statements have not been restated.

If it is impracticable for an entity to provide any disclosures required by FRS 102 for any comparative period(s) presented, the omission of the disclosure(s) must be disclosed. [FRS 102.35.11]. Applying a requirement is impracticable when an entity cannot apply it, after making every reasonable effort to do so. [FRS 102 Appendix I].

If it is not practical on first-time adoption to apply a particular requirement of paragraph 18 of IFRS 6 *Exploration for and Evaluation of Mineral Resources* to previous comparative amounts, an entity must disclose that fact. [FRS 102.34.11C].

Section 35 states that, where applicable to the transactions, events or arrangements affected by applying the exemptions, an entity may continue to use the exemptions that are applied at the date of transition to FRS 102 when preparing subsequent financial statements, until such time when the assets and liabilities associated with those transactions, events or arrangements are derecognised. [FRS 102.35.11A]. This simply confirms that, in preparing FRS 102 financial statements after first-time adoption, the exemptions and exceptions taken at the date of transition continue to be applied as opposed to Section 35 only applying to the first FRS 102 financial statements. Once the associated assets and liabilities are derecognised, those transition exemptions cease, in any event, to have any accounting effect.

However, when there is subsequently a significant change in the circumstances or conditions associated with transactions, events or arrangements that existed at the date of transition, to which an exemption has been applied, an entity must reassess the appropriateness of applying that exemption in preparing subsequent financial statements in order to maintain a true and fair view in accordance with Section 3 *Financial Statement Presentation*. [FRS 102.35.11B]. It is not clear what circumstances are envisaged by this requirement, but it appears to permit the possibility of an entity later ceasing to use transition exemptions taken.

How we see it

Transition exemptions are pragmatic concessions available in the first FRS 102 financial statements that involve a departure from fully retrospectively applying FRS 102. In our view, if an entity did not take a particular transition exemption in its first FRS 102 financial statements, the entity is unable to apply that transition exemption as a 'voluntary change in accounting policy' in later financial statements as this would not meet the requirement that the financial statements provide reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

3.4.5 Transition issues where a previous IFRS or FRS 101 reporter applies IFRS 9 to the recognition and measurement of financial instruments under FRS 102

A first-time adopter of FRS 102 that previously reported under IFRS or FRS 101 would have applied IFRS 9, including the transitional provisions set out in Chapter 7 of IFRS 9 on first applying that standard (or the transitional provisions set out in IFRS 1 on first-time adoption of IFRS/FRS 101). The transitional provisions for an ongoing IFRS/FRS 101 reporter, for example, meant that the classification and measurement of financial assets (including the ability to make designations of financial assets at fair value through profit or loss or of investments in equity instruments at fair value through profit or loss) was determined, based on the facts and circumstances at the date of initial application of IFRS 9. The following sections cover issues on recognition and measurement of financial instruments when choosing to apply IFRS 9 or IAS 39 when transitioning to FRS 102.

Additionally, an entity that transitioned from IAS 39 to IFRS 9 may have elected to continue to apply the hedge accounting requirement in IAS 39 to all its hedging relationships, when it first applied IFRS 9. [IFRS 9.7.2.21]. Therefore, in the following section, we also consider transition issues that apply when a first-time adopter applied IAS 39's requirements to its hedge accounting.

3.4.5.A Previous IFRS or FRS 101 reporter already applying IFRS 9 continues to apply IFRS 9

A previous IFRS or FRS 101 reporter already applying IFRS 9 is likely to continue applying IFRS 9 to the recognition and measurement of financial instruments when it transitions to FRS 102 in a subsequent accounting period. It would have applied the transition provisions in IFRS 9 when it first applied that standard (see 3.4.5 above). For example, it might have made determinations on initial recognition of financial instruments, such as whether to designate a financial asset or liability meeting certain criteria as at fair value through profit or loss, or an investment in an equity instrument as at fair value through other comprehensive income. [IFRS 9.4.1.4, IFRS 9.4.1.5, IFRS 9.4.2.2]. These IFRS 9 transition provisions would not apply on transition to FRS 102 (see 3.4.1 above). Section 35 only addresses derecognition of financial assets and financial liabilities (see 4.1 below) and hedge accounting (see 5.16 below). [FRS 102.35.9(a), FRS 102.35.10(t)].

How we see it

We doubt that the FRC intended that an entity already applying IFRS 9 under adopted IFRS or FRS 101 would change their accounting treatment (even if that relied on determinations made or included adjustments to equity under transitional provisions when first applying IFRS 9) when choosing to apply IFRS 9 on transition to FRS 102. Therefore, we would not expect any changes on application of FRS 102.

3.4.5.B Previous IFRS or FRS 101 reporter previously applying IAS 39 to hedge accounting continues to apply IAS 39 to hedge accounting

Ongoing IFRS/FRS 101 reporters were permitted to choose an accounting policy to continue to apply the hedge accounting provisions of IAS 39 (together with IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*) on initial application of IFRS 9. [IFRS 9.7.2.21]. This concession is located in the section on transition for hedge accounting in IFRS 9 but is more in the nature of an accounting policy choice available within the standard for ongoing IFRS/FRS 101 reporters and hence is not permitted on first-time adoption of IFRS.

First-time adopters of FRS 102 have an accounting policy choice of applying IFRS 9 (as adopted in the relevant jurisdiction) and IAS 39 (as amended following the publication of IFRS 9) to the recognition and measurement of financial instruments. Accordingly, although this chapter refers to applying IFRS 9 to the recognition and measurement of financial instruments, this should be read as applying “the recognition and measurement provisions of IFRS 9 *Financial Instruments* (as adopted by the relevant jurisdiction) and IAS 39 (as amended following the publication of IFRS 9)” to be in line with FRS 102. [FRS 102.35.8C, FRS 102.11.2(c), FRS 102.12.2(c)].

How we see it

Therefore, we believe that an entity already applying IFRS 9 and applying IAS 39 to its hedges can continue to adopt this accounting policy on transition to FRS 102.

If the entity changes its policy to apply IFRS 9’s hedge accounting requirements on transition to FRS 102, certain issues arising are discussed at 3.4.5.C below.

3.4.5.C Previous IFRS or FRS 101 reporter previously applying IAS 39 to account for hedge accounting but changes to IFRS 9

If a first-time adopter had applied IAS 39 to account for hedge accounting under its previous financial framework but changes to IFRS 9 on transition to FRS 102, it must apply IFRS 9 retrospectively, subject to the transition provisions on hedge accounting (see 5.16.3 below).

For many entities, the existing hedging relationships under IAS 39 may continue under IFRS 9 (after consideration of rebalancing), with no accounting adjustments to the hedge accounting required to the opening statement of financial position under FRS 102. See the most recent version of EY’s publication, International GAAP® for further discussion of IFRS 9’s requirements on hedge accounting.

However, entities will need to consider the following implementation issues in relation to hedge accounting on transition to FRS 102:

- It will be necessary to ensure that all the qualifying criteria for hedge accounting under IFRS 9 are met at the date of transition (except that the entity may complete the designation and documentation of the hedging relationship after the date of transition but before the date of authorisation of the financial statements) in order for hedge accounting for existing hedging relationships to continue from the date of transition. [IFRS 9.6.4.1, FRS 102.35.10(t)(iv)]. Otherwise, hedge accounting will need to be discontinued prospectively from the date of transition. [IFRS 9.6.5.6, IFRS 9.6.5.7, IFRS 9.6.5.10, IFRS 9.6.5.12].
- If new hedging relationships are identified under IFRS 9 (that were not identified under IAS 39), the opening statement of financial position would not reflect the hedging relationship. However, hedge accounting could be established prospectively from the date all qualifying criteria for hedge accounting under IFRS 9 are met (subject to the concession over the timing of designation and documentation allowed for in the transition provision), which might be prospectively from the date of transition or a later date. [FRS 102.35.10(t)(iv)]. See 5.16.3 below.
- Under IAS 39, a hedging relationship that failed the effectiveness tests would have been required to be discontinued. [IAS 39.88, IAS 39.91(b), IAS 39.101(b)]. Under IFRS 9, the retrospective effectiveness test has been withdrawn, although the qualifying criteria for hedge accounting include ongoing effectiveness requirements such as the existence of an economic relationship between the hedged item and the hedging instrument. [IFRS 9.6.4.1(c)]. In these circumstances, the opening statement of financial position of the entity would continue to reflect the discontinuance of the past hedging relationship but, if all the qualifying criteria (subject to the concession over the timing of designation and documentation allowed for in the transition provision) are met at the date of transition, the entity could re-establish hedge accounting prospectively from the date of transition. [FRS 102.35.10(t)(iv)]. See 5.16.3 below.
- An entity changing from IAS 39 to IFRS 9 on adoption of FRS 102 may also need to adjust the hedge ratio of the hedging relationship (‘rebalancing’) in its hedge documentation. It would appear that the effects of any rebalancing would be reflected in profit or loss following the date of transition. This is the same position as would be the case if an ongoing IFRS reporter had moved from IAS 39 to IFRS 9. [IFRS 9.7.2.25(b)]. IFRS 9’s requirements for rebalancing of hedges are discussed in the most recent version of EY’s publication, International GAAP®.
- The hedge accounting under IAS 39 differs, or may differ, compared to under IFRS 9 where the intrinsic value of an option (or the spot element of a forward contract) was designated as a hedging instrument. IFRS 9 also permits an entity to exclude the foreign currency basis spread when designating a financial instrument as a hedging instrument (but this was not permitted under IAS 39).

Under IAS 39, where the time value of an option or the forward element of a foreign currency contract was excluded from the hedging relationship, fair value movements on those elements were recognised in profit or loss. Under IFRS 9, where the time value of an option is excluded from the hedging relationship, the fair value movements on the time value of the option are first recognised in other comprehensive income (and a separate component of equity), with the subsequent treatment depending on the nature of the hedged transaction. A similar treatment may be elected on a hedge-by-hedge basis for the fair value movements attributable to the forward element of foreign currency contracts (and foreign currency basis spread). [IAS 39.74, IFRS 9.6.5.15, IFRS 9.6.5.16].

For first-time adopters, the accounting for 'costs of hedging' at the date of transition requires careful consideration. IFRS 9's accounting for 'costs of hedging' is discussed in the most recent version of EY's publication, International GAAP®.

4 Mandatory exceptions to retrospective application

Section 35 prohibits retrospective application of its requirements in some areas, many of which correspond to similar mandatory exceptions in IFRS 1. The mandatory exceptions in FRS 102 cover areas where full retrospective application could be costly, onerous, or may involve use of hindsight.

The mandatory exceptions in Section 35 cover the following areas: [FRS 102.35.9]

- Derecognition of financial assets and financial liabilities (see 4.1 below)
- Accounting estimates (see 4.2 below)
- And
- Non-controlling interests (see 4.3 below)

Each of the exceptions is explained further below. However, the following exemptions in Section 35 contain certain mandatory requirements:

- Hedge accounting where IFRS 9 or IAS 39 are applied to the recognition and measurement of financial instruments (see 5.16.3 below).
- An entity becoming a first-time adopter in its consolidated financial statements later than its subsidiary, associate or joint venture (see 5.15.2 below).
- A parent adopting FRS 102 in its separate financial statements earlier or later than in its consolidated financial statements (see 5.15.4 below).
- And
- A lessee applying the other transitional arrangement when not applying the IFRS 16 election (see 5.11.3 below).

4.1 Derecognition of financial assets and financial liabilities

Extract from Section 35

- 35.9** On first-time adoption of this FRS, an entity shall not retrospectively change the accounting that it followed under its previous financial reporting framework for any of the following transactions:
- (a) Derecognition of financial assets and financial liabilities

Financial assets and liabilities derecognised under an entity's previous financial reporting framework before the date of transition shall not be recognised upon adoption of this FRS. Conversely, for financial assets and liabilities that would have been derecognised under this FRS in a transaction that took place before the date of transition, but that were not derecognised under an entity's previous financial reporting framework, an entity may choose:

 - (i) to derecognise them on adoption of this FRS; or
 - (ii) to continue to recognise them until disposed of or settled.

Derecognition is defined as the removal of all or part of a recognised asset or liability from an entity's statement of financial position. [FRS 102 Appendix I].

4.1.1 Implementation issues

There is no further implementation guidance on this transition exception. The main first-time adoption implementation issues are:

- What comprises derecognition of financial assets and financial liabilities under the entity's previous financial reporting framework.
- And
- Whether there are financial assets and financial liabilities that would have been derecognised under FRS 102 in a pre-transition transaction, but were not derecognised under the entity's previous financial reporting framework.

An FRS 102 reporter has an accounting policy choice of applying the following to the recognition and measurement of financial instruments: [FRS 102.11.2, FRS 102.12.2]

- Section 11 and Section 12 of FRS 102.
- IAS 39 (as adopted in the relevant jurisdiction) as the standard applies prior to the application of IFRS 9 (referred to as 'IAS 39' below).

Or

- IFRS 9 (as adopted in the relevant jurisdiction) and IAS 39 (as amended following the publication of IFRS 9) (together referred to as 'IFRS 9' below).

FRS 102 defines which version of IAS 39 must be applied. See Chapter 13 at 3. However, following the Periodic Review 2024 amendments, a first-time adopter may choose to apply IAS 39 only if this would make the entity's accounting policy choice consistent with the accounting policy adopted in the consolidated financial statements in which the entity is included. [FRS 102.35.8C, FRS 102.11.2, FRS 102.12.2]. See 4.1.2 below for possible implementation issues.

In practice, previous IFRS or FRS 101 reporters will be applying IFRS 9, given that IAS 39 has already been superseded by IFRS 9. This commentary highlights some issues that might be relevant for a first-time adopter previously applying IFRS 9 to consider, depending on the policy choice for the recognition and measurement of financial instruments selected.

Comparatives need to be restated in accordance with the accounting policy choice applied to the recognition and measurement of financial instruments under FRS 102.

Financial assets and financial liabilities that remain recognised on transition will need to be measured in accordance with the accounting policy choice that the entity applies to the recognition and measurement of financial instruments under FRS 102. Consequently, if the accounting policy adopted differs to that applied under the previous financial framework (generally, FRS 105, IFRS or FRS 101), adjustments may be required on transition to FRS 102.

4.1.2 First-time adopters that previously applied IFRS 9 and choose to apply IAS 39 or IFRS 9 to the recognition and measurement of financial instruments on adoption of FRS 102

FRS 102 reporters are permitted to apply IAS 39 (in certain circumstances, explained at 4.1.1 above) or IFRS 9 to the recognition and measurement of financial instruments under FRS 102. The derecognition requirements for financial assets and financial liabilities in IAS 39 and IFRS 9 are the same. However, if financial assets or financial liabilities had been derecognised prior to the date of transition to FRS 102 (e.g., on transition to IFRS in the past, [IFRS 1.B2, IFRS 1.B3]) which would not ordinarily qualify for derecognition under the policy choice adopted under FRS 102, any such financial assets or financial liabilities still in existence at the date of transition remain derecognised on transition to FRS 102 because of the derecognition exception in paragraph 35.9(a). The discussion at 4.1.3 below may still be relevant to a previous IFRS or FRS 101 reporter.

Where an exchange or modification of a financial asset or liability is not accounted as an extinguishment (and is therefore not derecognised), the measurement of the financial asset or financial liability could differ under IFRS 9 compared to IAS 39 (depending on the approach taken under IAS 39).

Under IFRS 9, the modified contractual cash flows of a financial asset or financial liability (that is not accounted as an extinguishment following an exchange or modification), will be discounted at the original effective interest rate, with an adjustment to the carrying amount of the financial liability and profit or loss. [IFRS 9.3.3.2, IFRS 9.5.4.3, IFRS 9.BC4.252, IFRS 9.BC4.253]. However, IAS 39 (which only addresses modifications of financial liabilities) does not provide conclusive guidance as to whether an adjustment is made to the carrying amount of the financial liability or financial asset for such changes in contractual cash flows (or whether the effective interest rate must be changed). Consequently, there could be measurement adjustments required if an IFRS 9 reporter changes to IAS 39 on transition to FRS 102 (if permitted to do so).

4.1.3 Financial assets and financial liabilities previously derecognised

Financial assets and financial liabilities derecognised under the entity's previous financial reporting framework before the date of transition (and consequently not recognised on transition to FRS 102) would be re-recognised if they qualify for recognition as a result of a later transaction or event (i.e., subsequent to the date of transition) using the accounting policy choice that the entity applies to the recognition and measurement of financial instruments under FRS 102, i.e., IAS 39 (where permitted to be used), or IFRS 9, or Sections 11 and 12.

Some arrangements for the transfer of assets, particularly securitisations, may last for some time, with the result that transfers might be made both before and on or after the date of transition under the same arrangement. Where assets were transferred prior to the date of transition and derecognised under the previous financial reporting framework (IFRS or FRS 101), the assets are not re-recognised (unless the transferee is required to be consolidated under FRS 102 – see discussion below).

FRS 102's requirements on consolidation of special purpose entities ('SPEs'), [FRS 102.9.10, FRS 102.9.11, FRS 102.9.12], differ from those in IFRS 10 *Consolidated Financial Statements*. [FRS 102.BC.B9.2, FRS 102.BC.B9.3, FRS 102.BC.B9.4]. Since there are no specific transitional or first-time adoption provisions, FRS 102's requirements must be applied fully retrospectively by first-time adopters. Therefore, financial assets and financial liabilities derecognised on transfer to an SPE that was not consolidated under the entity's previous financial reporting framework (but would be required to be consolidated under FRS 102) will be re-recognised on transition to FRS 102 by way of consolidation of the SPE. This is unless the SPE itself had subsequently achieved derecognition of the items concerned under the entity's previous financial reporting framework before the date of transition, other than by transfer to another entity consolidated by the FRS 102 first-time adopter.

4.1.4 Financial assets and financial liabilities previously not derecognised

There may be cases where financial assets and financial liabilities were retained in the balance sheet under the entity's previous financial reporting framework but would have been derecognised under FRS 102. On transition to FRS 102, a first-time adopter is permitted to derecognise financial assets and financial liabilities in accordance with the derecognition requirements of the accounting policy choice applied to the recognition and measurement of financial instruments under FRS 102.

Where the entity continues to recognise them on transition, it must retrospectively apply the accounting standard that it applies to the recognition and measurement of financial instruments under FRS 102. These might lead to measurement adjustments of the financial assets and financial liabilities as the recognition and measurement requirements of IAS 39, IFRS 9 and Sections 11 and 12 differ in certain respects. In particular, care should also be taken where an IFRS or FRS 101 reporter had undertaken an exchange or modification of a financial asset or financial liability with the original counterparty prior to the date of transition (but this was not accounted as an extinguishment and therefore not derecognised). [IAS 39.40, IFRS 9.3.3.2, IFRS 9.5.4.3, IFRS 9.BC4.252, IFRS 9.BC4.253].

See 4.1.5.B below and Chapter 13 at 6.2 and Chapter 13 at 7.4 where Sections 11 and 12 are applied to the recognition and measurement of financial instruments under FRS 102.

4.1.5 Specific implementation issues where a previous IFRS or FRS 101 reporter (previously applying IFRS 9) applies Sections 11 and 12 under FRS 102.

4.1.5.A Financial assets – what is derecognition?

Generally, it will be clear whether a financial asset has been derecognised under IFRS 9 and therefore must not be re-recognised on transition to FRS 102. However, Section 35 does not specifically address whether derecognition of a part of a financial asset or continued recognition of an asset to the extent of its continuing involvement are regarded as derecognition for the purposes of paragraph 35.9(a).

IFRS 9 requires an entity to determine whether the derecognition requirements are to be applied to a part of a financial asset (or a part of a group of financial assets) or a financial asset (or a group of similar financial assets) in its entirety. [IFRS 9.3.2.2]. Situations where parts of a financial asset are capable of derecognition under IFRS 9 include: specifically identified cash flows (e.g., the interest cash flows of a debt instrument, commonly referred to as an interest rate strip), a fully proportionate share of the cash flows (e.g., 90% share of all cash flows of a debt instrument), and a fully proportionate share of specifically identified cash flows (e.g., 90% of the interest cash flows from a financial asset). [IFRS 9.3.2.2(a)].

Section 11, unlike IFRS 9, does not refer to derecognition of parts of a financial asset (although it does so in respect of parts of a financial liability). [FRS 102.11.33, FRS 102.11.36, FRS 102.12.14].

How we see it

Nevertheless, in our view, specifically identified cash flows or a fully proportionate share of all or of specifically identified cash flows would meet the definition of a financial asset. Therefore, derecognition of a part of a financial asset in accordance with IFRS 9 would be regarded as derecognition of a financial asset for the purposes of the transition exception in paragraph 35.9(a). Consequently, the part of the original financial asset derecognised would not be reinstated on transition to FRS 102.

IFRS 9 states that if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset but has retained control, it must continue to recognise the financial asset to the extent of its continuing involvement. IFRS 9 sets out how the continuing involvement in the asset (or part of the asset) and the associated liability must be measured. [IFRS 9.3.2.6(c)(ii), IFRS 9.3.2.16].

How we see it

It would seem unlikely that an entity with assets (or parts of assets) recognised to the extent of the continuing involvement would choose to apply Sections 11 and 12, since these sections do not set out rules for accounting for such arrangements (see Chapter 13 at 7.2.3.B). However, if Sections 11 and 12 are applied to the recognition and measurement of financial instruments where an entity transitions to FRS 102, in our view, the accounting for the continuing involvement would need to be retrospectively restated (and hence the financial instruments not recognised).

4.1.5.B Financial liabilities

IFRS 9 addresses derecognition of financial liabilities, including when an exchange of debt between an existing borrower and lender, or modification of the terms of existing debt gives rise to derecognition. Hence, it will be clear whether a financial liability has been derecognised under IFRS 9 prior to the date of transition and therefore must not be re-recognised on transition to FRS 102.

IAS 39 (where permitted), IFRS 9 and Sections 11 and 12 require an entity to derecognise a financial liability (or part of a financial liability) only when it is extinguished (i.e., when the obligation specified in the contract is discharged, is cancelled or expires). [IAS 39.11.36, IFRS 102.12.14, IAS 39.39, IFRS 9.3.3.1]. Sections 11 and 12 contain the same basic requirements on accounting for exchanges of a financial liability between an existing borrower and lender and the modification of terms of an existing financial liability as IAS 39 and IFRS 9, but not the related application guidance. [IAS 39.AG57, IFRS 9.B3.3.1]. In particular, the application guidance in IAS 39 and IFRS 9 covers the evaluation of whether an exchange or modification of debt has substantially different terms, and the accounting for an exchange or modification. As discussed in Chapter 13 at 7.4.2, an entity applying Sections 11 and 12 as an accounting policy choice under FRS 102 could look to Section 10 and develop an appropriate policy, such as by considering what is contained in IFRS. [FRS 102.10.4, FRS 102.10.5, FRS 102.10.6].

An entity previously applying IFRS 9 that exchanged or modified debt with the same lender in circumstances where the terms of the exchanged or 'modified' debt are not 'substantially different' would not have accounted for the extinguishment of the original financial liability. [IFRS 9.3.3.2]. On initial application of FRS 102, there is no exemption from measuring the exchanged or 'modified' debt that continues to be recognised in accordance with the requirements of Sections 11 and 12. The measurement adjustments, if any, required on transition for exchanged or 'modified' debt will depend on the accounting previously adopted under IFRS 9, as discussed further below, and on the accounting adopted under Sections 11 and 12.

The application guidance in IFRS 9 addresses the treatment of costs or fees associated with the exchange or modification of a financial liability that is not accounted as an extinguishment - requiring that the costs or fees are adjusted against the carrying amount of the liability, and amortised over the remaining term of the modified liability. [IFRS 9.B.3.3.6A]. Under IFRS 9, the modified contractual cash flows of a financial liability (that is not accounted as an extinguishment following an exchange or modification), will be discounted at the original effective interest rate, with an adjustment to the carrying amount of the financial liability and profit or loss. [IFRS 9.3.3.2, IFRS 9.5.4.3, IFRS 9.BC4.252, IFRS 9.BC4.253]. See the most recent version of EY's publication, International GAAP® for further discussion of IFRS 9's requirements on exchange or modification of debt by the original lender.

FRS 102 does not provide any specific guidance on the subsequent accounting where it is determined that an exchange or modification of a financial liability is not an extinguishment of the original financial liability. This matter is addressed in Chapter 13 at 7.5.

4.2 Accounting estimates

4.2.1 Exception to retrospective application

On first-time adoption of FRS 102, an entity must not retrospectively change the accounting that it followed under its previous financial reporting framework for accounting estimates. [FRS 102.35.9(c)]. However, FRS 102 offers no further guidance in respect of this exception. Since paragraph 35.9(c) does not refer to accounting estimates 'at the date of transition', as other exceptions do, it seems that the exception relates to accounting estimates made under the entity's previous financial reporting framework in both the opening statement of financial position at the date of transition and in the comparative period(s) presented. As this is consistent with the corresponding exception in IFRS 1, entities may want to consider the guidance in that standard.

IFRS 1 requires an entity to use estimates under IFRSs that are consistent with the estimates made for the same date under its previous GAAP – after adjusting for any difference in accounting policies – unless there is objective evidence that those estimates were in error. [IFRS 1.14]. Under IFRS 1, an entity cannot apply hindsight and make 'better' estimates when it prepares its first IFRS financial statements. Therefore, an entity is not allowed to consider subsequent events that provide evidence of conditions that existed at the date of transition (or at the end of the comparative period), but that came to light after the date that the entity's financial statements under its previous financial reporting framework were finalised. If an estimate made under its previous financial reporting framework requires adjustment because of new information after the relevant date, an entity treats this information in the same way as a non-adjusting event after the reporting period. In addition, the exception also ensures that a first-time adopter need not conduct a search for, and change the accounting for, events that might have otherwise qualified as adjusting events, e.g., the resolution of a court case relating to an obligation as at the date of transition or end of the comparative period.

Similarly, where FRS 102 requires a first-time adopter to make estimates that were not required under its previous financial reporting framework, the general approach is to base those estimates on conditions that existed at the date of transition (or, where applicable, the end of the comparative period).

The following example²⁴⁷ shows the application of paragraph 35.9(c).

Illustration 4-1: Accounting estimates

On 31 December 20X4, Entity A had a debtor balance of £500. On 31 December 20X4, Entity A was concerned about the credit risk of the debtor and was in discussion with the debtor as to how the debt might be settled. As a consequence, Entity A had made a provision of £250, i.e., for 50% of the balance as at that date. During 20X5, the debtor collapsed and was liquidated.

When Entity A prepares its opening balance sheet as at 1 January 20X5 (the date of transition), it is clear that it will not be able to collect the outstanding debt. However, Entity A does not revise its estimate under its previous financial reporting framework because FRS 102 prohibits retrospective adjustments to accounting estimates on the date of transition.

4.2.2 Post-balance sheet events and correction of errors

Material prior period errors identified at transition and in the comparatives must be retrospectively corrected. [FRS 102.10.21].

4.3 Non-controlling interest

The definition and accounting requirements for non-controlling interest in FRS 102 are discussed in Chapter 8 at 3.7. There are some differences in accounting to IFRS 10.

In measuring non-controlling interest, FRS 102's requirements (in Section 9 *Consolidated and Separate Financial Statements*) to allocate profit or loss and total comprehensive income between non-controlling interest and owners of the parent (see Chapter 6 at 3.5 and Chapter 8 at 3.7): [FRS 102.9.14, FRS 102.9.22]

- For accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control (see Chapter 8 at 3.6.2 and Chapter 8 at 3.6.4) [FRS 102.9.19A, FRS 102.9.19.C, FRS 102.9.19D, FRS 102.9.20A]

And

²⁴⁷ FRC FRS 102 Factsheet 7 Transition to FRS 102 (November 2024).

- For accounting for a loss of control over a subsidiary (see Chapter 8 at 3.6.3) [*FRS 102.9.18A, FRS 102.9.18B, FRS 102.9.19*]

must be applied prospectively from the date of transition to FRS 102 (or from such earlier date as FRS 102 is applied to restate business combinations – see paragraph 35.10(a)). [*FRS 102.35.9(e), FRS 102.35.10(a)*].

The application of the exception is straightforward. It simply states that the accounting in FRS 102 for these matters is applied prospectively from the date of transition (or where pre-transition business combinations are restated in accordance with Section 19 *Business Combinations and Goodwill*, from the earlier date from which business combinations are restated – see 5.2.1 below). [*FRS 102.35.9(e)*]. Of course, changes to assets and liabilities of a subsidiary with a non-controlling interest made at the date of transition will have a consequential effect on non-controlling interest at that date.

Retrospective changes for previous allocations of profit or loss and total comprehensive income (made prior to the date of transition, or that earlier date from which Section 19 is applied) are prohibited. Consequently, where a provision has been made under the entity's previous financial reporting framework against a non-controlling interest debit balance prior to the date of transition (or that earlier date from which Section 19 is applied), this is not reversed on transition to FRS 102. In addition, if that subsidiary subsequently earns profits post transition, any past losses absorbed by the parent are not reversed but the profits are attributed to the parent and non-controlling interest based on existing ownership interests. [*FRS 102.9.14, FRS 102.9.22*]. This situation could apply to a first-time adopter previously reporting under IFRS, which may be reporting non-controlling interest after taking advantage of the transition exemptions in IFRS 1 (when it first adopted IFRS) or on first application of IFRS 10 – which are similar to those in paragraph 35.9(e). [*IFRS 10.C6, IFRS 1.B7*].

The accounting in FRS 102 for a change in ownership of a subsidiary without loss of control is similar to the requirements of IFRS 10. [*IFRS 10.23, IFRS 10.B96*]. However, care needs to be taken where there are transactions involving changes in non-controlling interest subsequent to the date of transition that do not result in loss of control of a subsidiary. Where the non-controlling interest had been provided against (i.e., losses allocated to the parent) as at the date of transition (or as at the earlier date from which business combinations are restated), the parent does not reallocate any of those losses on re-measuring the non-controlling interest for the change in relative ownership. This means that the non-controlling interest is re-measured at the date of the transaction based upon the 'change in their relative interest' and not by reference to a percentage change of net assets. While FRS 102 is not explicit on the accounting required, this approach would be consistent with the approach taken under IFRS.

The accounting for a change in ownership of a subsidiary with loss of control in FRS 102 (see Chapter 8 at 3.6.3) differs to IFRS in a number of respects, notably no reclassification of exchange differences previously recognised in other comprehensive income or remeasurement of any retained interest to fair value (at the date of loss of control). [*IFRS 10.25, IFRS 10.B97-99A, FRS 102.9.18A, FRS 102.9.18B, FRS 102.9.19*]. Transactions in the comparative period (or post the date for which business combinations are restated in accordance with Section 19) may, therefore, need to be restated.

The accounting for non-controlling interest under IFRS and FRS 102 could also differ on a business combination (see Chapter 22 at 3.8). [*IFRS 3.32, IFRS 10.B44, IFRS 10.B45*]. However, this transition exception does not address such GAAP differences. There is an optional transition exemption that addresses business combinations, discussed at 5.2 below.

5 Optional exemptions to retrospective application

5.1 Introduction

Section 35 sets out optional exemptions from the general requirement of full retrospective application of the requirements of FRS 102. [FRS 102.35.10]. While many of these correspond to exemptions in IFRS 1, other exemptions are specific to FRS 102.

The optional exemptions in Section 35 cover the following areas:

- Business combinations, including group reconstructions (see 5.2 below)
- Public benefit entity combinations (see 5.3 below)
- Share-based payment transactions (see 5.4 below)
- Fair value or previous revaluation as deemed cost (see 5.5 below)
- Deemed cost for oil and gas assets (see 5.6 below)
- Individual and separate financial statements (see 5.7 below)
- Development costs (see 5.8 below).
- Borrowing costs (see 5.9 below)
- Decommissioning liabilities included in the cost of property, plant and equipment and right-of-use assets (see 5.10 below)
- Leases (see 5.11 below)
- Revenue from contracts with customers (see 5.12 below)
- Compound financial instruments (see 5.13 below)
- Designation of previously recognised financial instruments (see 5.14 below)
- Assets and liabilities of subsidiaries, associates and joint ventures (see 5.15 below)
- Hedge accounting (see 5.16 below)
- Dormant entities (see 5.17 below)

In addition, FRS 103 includes transition exemptions in relation to insurance contracts (see 5.18 below).

The Periodic Review 2024 removed the exemption in paragraph 35.10(i) to not apply the requirements of paragraphs 34.12I to 34.16A to service concession arrangements (see Chapter 36) that were entered into before the date of transition to FRS 102, and in effect, continue applying the same accounting policies as applied at the date of transition. Therefore, an operator that transitions to FRS 102 after the effective date of Periodic Review 2024 is required to retrospectively apply these requirements as the exemption is no longer available. Paragraph 35.11A of FRS 102 allows an entity to continue to use the exemptions applied at the date of transition to FRS 102 when preparing subsequent financial statements, until such time when the assets and liabilities associated with those transactions, events or arrangements are derecognised. However, when there is subsequently a significant change in the circumstances or conditions associated with transactions, events or arrangements that existed at the date of transition, an entity is required to reassess the appropriateness of applying the exemption in meeting the true and fair view requirement in subsequent financial statements. [FRS 102.35.10(i), FRS 102.35.11A, FRS 102.35.11B].

Despite being located within the optional transition exemptions, the transition provisions for hedge accounting in paragraph 35.10(t)(iv) are mandatory where IFRS 9 or IAS 39 is applied to the recognition and measurement of financial instruments. [FRS 102.35.10(t)(iv)]. In addition, where an entity adopts FRS 102 in its consolidated financial statements later than its subsidiary, associate or joint venture (or a parent adopts FRS 102 in its separate financial statements earlier or later than for its consolidated financial statements), the transition provisions in paragraph 35.10(r) are mandatory. [FRS 102.35.10(r)]. And where a lessee is not eligible to or chooses not to apply the IFRS 16 election, the entity is required to use the transition provision in paragraph 35.10(x) in measuring the lease liability and right-of-use asset. [FRS 102.35.10(x), FRS 102.B20.17].

How we see it

Other than as detailed above, the exemptions are optional, so a first-time adopter can pick and choose the exemption(s) that it wants to apply. There is no hierarchy of exemptions; therefore, when an item is covered by more than one exemption, a first-time adopter has a free choice in determining the order in which it applies the exemptions.

Each of the exemptions is explained further below.

5.2 Business combinations, including group reconstructions

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) Business combinations, including group reconstructions

A first-time adopter may elect not to apply Section 19 *Business combinations and Goodwill* to business combinations that were effected before the date of transition to this FRS. However, if a first-time adopter restates any business combination to comply with Section 19, it shall restate all later business combinations. If a first-time adopter does not apply Section 19 retrospectively, the first-time adopter shall recognise and measure all its assets and liabilities acquired or assumed in a past business combination at the date of transition to this FRS in accordance with paragraphs 35.7 to 35.9 or, if applicable, with paragraphs 35.10(b) to (y) except for:

- (i) intangible assets other than goodwill - intangible assets subsumed within goodwill shall not be separately recognised; and
- (ii) goodwill - no adjustment is made to the carrying value of goodwill; if goodwill has previously been determined to have an indefinite useful life, it shall be re-assessed to determine its remaining useful life and shall subsequently be measured in accordance with paragraph 19.23.

The business combinations exemption permits a first-time adopter not to restate, in accordance with Section 19, business combinations that occurred prior to its date of transition. Whether or not a first-time adopter elects to restate pre-transition business combinations, it may still need to restate the carrying amounts of the acquired assets and assumed liabilities (see 5.2.3.B and 5.2.3.C below).

The requirements to allocate profit or loss and total comprehensive income between non-controlling interest and owners of the parent; for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and for accounting for a loss of control over a subsidiary must be applied prospectively from the date of transition (or from such earlier date as FRS 102 is applied to restate business combinations). [FRS 102.35.9(e)]. See 4.3 above.

Paragraphs PBE34.75 to 34.86 of FRS 102 contain specific requirements on accounting for public benefit entity combinations, which are discussed at 5.3 below.

Unlike IFRS 1, Section 35 provides no guidance beyond the wording of the transition exemption itself. While there may be other approaches, we consider that Appendix C of IFRS 1 can be helpful in interpreting the transition exemption and will refer to that guidance where appropriate. There are some GAAP differences between IFRS 1 and FRS 102 regarding the business combinations exemption; therefore, some aspects of the guidance in Appendix C are not relevant. This commentary is organised as follows:

- Option to restate business combinations retrospectively (see 5.2.1 below).
 - Scope of the transition exemption (see 5.2.2 below).
 - Application of the transition exemption not to restate business combinations - general (see 5.2.3 below).
 - Restatement of goodwill when not restating business combinations (see 5.2.4 below).
 - Changes in scope of consolidation when not restating business combinations (see 5.2.5 below).
- And
- Example of application of the transition exemption not to restate business combinations (see 5.2.6 below).

The accounting where a first-time adopter opts to restate business combinations occurring before the date of transition retrospectively is addressed at 5.2.1 below, and the accounting where a first-time adopter opts not to restate business combinations occurring before the date of transition retrospectively is addressed at 5.2.2 to 5.2.6 below.

5.2.1 Option to restate business combinations retrospectively

A first-time adopter must account for business combinations occurring after its date of transition under Section 19. The requirements of Section 19 are discussed in Chapter 22. Therefore, any business combination during the comparative period(s) needs to be restated in accordance with FRS 102.

An entity is permitted to elect to apply Section 19 to business combinations occurring before the date of transition, but must then restate any subsequent business combinations under Section 19. In other words, a first-time adopter can choose any date in the past from which it wants to account for all business combinations under Section 19, without restating business combinations that occurred before that date.

How we see it

Although there is no restriction that prevents retrospective application by a first-time adopter of Section 19 to all past business combinations, in our view, a first-time adopter does not restate business combinations under Section 19 that occurred before the date of transition when this would require undue use of hindsight.

If any pre-transition business combinations are restated, the first-time adopter must also apply FRS 102's requirements on the measurement of non-controlling interests from the date of the earliest business combination that is restated (see 4.3 above).

5.2.1.A Considerations on restatement of business combinations

If the exemption from restating pre-transition business combinations is not applied, the requirements of Section 19 (see Chapter 22) would need to be applied retrospectively. This might be an onerous exercise that might require undue use of hindsight. For example, restatement would require:

- Reassessment as to whether the previous financial reporting framework classification of the business combination (as an acquisition by the legal acquirer, reverse acquisition by the legal acquiree, or merger accounting) was appropriate.
- A fair value exercise to be performed, at the date of the business combination, if the purchase method is required. Any adjustments to the carrying amounts of assets and liabilities may also impact deferred tax and non-controlling interest.
- An adjustment to non-controlling interest arising on a business combination, if this had been initially recognised at fair value under IFRS, as permitted as an accounting policy choice on a transaction-by-transaction basis. [IFRS 3.19, IFRS 3.B44, IFRS 3.B45]. This treatment is not permitted under Section 19, which would require the non-controlling interest to be initially recognised at the non-controlling interest's share of the net amount of the identifiable assets, liabilities and contingent liabilities recognised and measured in accordance with Section 19 at the acquisition date (see Chapter 22 at 3.8). [FRS 102.9.13(b), FRS 102.19.14A].
- Remeasurement of consideration at the date of the business combination, to the amounts required under Section 19. In particular, contingent consideration and pre-existing interests are included at fair value at the date of the business combination under IFRS, but this is not the case under Section 19. [IFRS 3.32, IFRS 3.37, IFRS 3.39].

And

- The amounts recognised in the business combination to be restated under Section 19 and, subsequently, to be accounted for under FRS 102.

The application of the purchase method in Section 19 differs in certain respects from acquisition accounting under IFRS 3 *Business Combinations*. See Chapter 22 at 3 for details of application of the purchase method under Section 19. See Chapter 22 at 6 for the summary of GAAP differences.

In particular, retrospective application of Section 19 may result in changes to the recognition of intangible assets compared to IFRS 3. The extent of any differences to IFRS may depend on what policy the entity applies to the recognition of intangible assets under FRS 102. [FRS 102.18.8]. In addition, FRS 102 requires that the expected future economic benefits attributable to the intangible asset are probable and the fair value of the intangible asset is measured reliably whereas under IFRS, the probability recognition and reliable measurement criteria are always considered to be satisfied. [IAS 38.33]. See Chapter 22 at 2.8 and 3.7.3.A.

Section 19 has a general requirement that the acquiree's identifiable assets and liabilities (and contingent liabilities assumed in a business combination) – provided their fair value can be measured reliably – are measured at their acquisition-date fair values (with certain recognition and measurement exceptions). [FRS 102.19.14]. These requirements may differ from those in the entity's previous financial reporting framework. IFRS 3 requires that the identifiable assets and liabilities (and if their fair values can be measured reliably, contingent liabilities) are measured at their acquisition-date fair values in accordance with IFRS 13 *Fair Value Measurement*, but also contains specific exceptions to the recognition and measurement principles. [IFRS 3.10, IFRS 3.18, IFRS 13.5]. If a business combination is restated under Section 19, the adjustments to the fair values of the identifiable assets and liabilities (and contingent

liabilities) at the date of the business combination (including any changes to deferred tax and non-controlling interest) are reflected as an adjustment to goodwill. Therefore, applying Section 19 to the business combination would mean restatement of goodwill arising on the acquisition, adjusted for any subsequent amortisation and impairment.

Where the exemption not to restate business combinations is taken, any adjustments to the assets and liabilities acquired or assumed (including related deferred tax, which is required on the differences between the values recognised for assets (other than goodwill) and liabilities acquired in a business combination and the amounts at which those assets and liabilities will be assessed for tax – see Chapter 31 at 6.6) are reflected in retained earnings (or if appropriate, another category of equity). [FRS 102.35.9]. See 5.2.3.C below. Where the business combination involves a purchase of trade and assets reflected in the individual financial statements of a UK company, recognising additional deferred tax liabilities on fair value adjustments, but not adjusting goodwill, would have an adverse effect on the company's distributable reserves.

Illustration 5-1 at 5.2.6 below illustrates the impact of applying the transition exemption and retrospectively restating the business combination in accordance with Section 19 for a previous IFRS reporter.

5.2.2 Scope of the transition exemption not to restate business combinations

A transaction must be a business combination or a group reconstruction (as defined in FRS 102 – see Chapter 22 at 3.2 and 5.1 respectively) to qualify for the transition exemption; otherwise, it will need to be retrospectively restated subject to the mandatory exceptions and optional exemptions included in Section 35. IFRS does not have a separate accounting concept of a group reconstruction.

How we see it

In practice, some group reconstructions may have qualified as business combinations under common control (as defined in IFRS 3) and either have been accounted as pooling of interests or acquisition accounted (depending on the policy applied by the entity to such transactions under IFRS). Other transactions might not have qualified as business combinations at all under IFRS. So long as the transaction would have met the definition of a group reconstruction under FRS 102, in our view, it will still qualify for the transition exemption.

IFRS 3 has a different and wider definition of a business compared to FRS 102. [IFRS 3.3, IFRS 3 Appendix A, IFRS 3.B7]. See Chapter 22 at 2.3. Some business combinations under IFRS might not be considered business combinations under FRS 102. In such cases, the transition exemption would not apply and retrospective adjustment would appear to be required (if the transaction does not fall within the definition of a group reconstruction).

Unlike IFRS 1, Section 35 does not extend the exemption from applying the principles in Section 19 to acquisitions of associates and interests in joint ventures before the date of transition. [IFRS 1.C5]. These are not business combinations, as defined, and would therefore appear to require retrospective adjustment under FRS 102.

How we see it

An entity may have consolidated a subsidiary in a business combination prior to the date of transition that is a subsidiary required to be excluded from consolidation under FRS 102. Section 35 does not address this particular circumstance. However, in our view, the subsidiary must be excluded from consolidation in accordance with the general requirements of Section 35 to apply the recognition and measurement requirements of FRS 102. Instead, we would expect that the investment in the subsidiary would be accounted in accordance with paragraphs 9.9 to 9.9C of the standard. See 5.2.5.A below and Chapter 8 at 3.4.

5.2.3 Application of the transition exemption when not restating business combinations – general

There are GAAP differences between IFRS 1 Appendix C (which addresses the business combination exemption available under IFRS 1) and Section 35, for example, in respect of the treatment of intangible assets previously subsumed within goodwill (which must not be reinstated as intangible assets under Section 35). Nevertheless, the guidance in IFRS 1 Appendix C can be helpful in interpreting the transition exemption. The commentary below, therefore, draws on IFRS 1 in suggesting approaches that preparers may want to consider.

5.2.3.A Classification of business combination

If a first-time adopter does not restate a business combination, then it would keep the same classification of the business combination (as an acquisition by the legal acquirer, reverse acquisition by the legal acquiree, merger accounting or pooling of interests) as in its financial statements under its previous financial reporting framework. However, if a transaction is restated in accordance with Section 19, the classification of the business combination may change.

5.2.3.B Recognition and derecognition of assets and liabilities

A first-time adopter that applies the transition exemption must recognise all assets and liabilities at the date of transition that were acquired or assumed in a past business combination, other than:

- Financial assets and financial liabilities that fall to be derecognised under the derecognition transition exception in paragraph 35.9(a) (see 4.1 above).
- Assets (including goodwill) and liabilities that were not recognised in the acquirer's consolidated statement of financial position in accordance with its previous financial reporting framework that also would not qualify for recognition as an asset or liability under FRS 102 in the separate (or individual) statement of financial position of the acquiree.

And

- Intangible assets previously subsumed within goodwill.

The entity must exclude items it recognised under its previous financial reporting framework that do not qualify for recognition as an asset or liability under FRS 102 (subject to the derecognition transition exception for financial assets and financial liabilities).

FRS 102 requires an entity to recognise intangible assets separately from goodwill where all of the following conditions are met:

- (a) The recognition criteria in paragraph 18.4 are met.
- (b) The intangible asset arises from contractual or legal rights.

And

- (c) The intangible asset is separable.

However, an entity can choose a policy to recognise additional intangible assets that meet condition (a) and only one of (b) or (c) above. Such a policy must be applied to all intangible assets of the same class and consistently applied to all business combinations. [FRS 102.18.4, FRS 102.18.8]. This policy option broadly replicates the recognition criteria for intangible assets that apply when accounting for a business combination under IFRS. [IAS 38.21, IAS 38.33, IFRS 3.B31]. See Chapter 21 at 3.2.2.A and Chapter 22 at 3.7.3.A.

A previous IFRS or FRS 101 reporter could consider, on transition to FRS 102, to apply an accounting policy of only recognising intangible assets meeting all three conditions (a) to (c) separately from goodwill, but might have recognised intangible assets in a past business combination under IFRS that met (a) and only one of (b) or (c).

How we see it

In our view, a first-time adopter that previously applied IFRS or FRS 101 and which chooses a policy under FRS 102 to recognise separately from goodwill intangible assets meeting all three conditions (a) to (c) in a business combination would be required to derecognise intangible assets where these do not meet this policy. This is because consistent accounting policies must be followed, unless there is an explicit transitional provision to the contrary.

Any resulting change is recognised by adjusting retained earnings (or another category of equity) and not the carrying amount of goodwill. [FRS 102.35.8, FRS 102.35.10(a)].

5.2.3.C Measurement of assets and liabilities

In essence, the approach to recognising and measuring assets and liabilities is to apply FRS 102 retrospectively (subject to the exceptions and exemptions taken at the date of transition), but without revisiting the fair value exercise. This means that where assets and liabilities acquired or assumed in a past business combination were not recognised under the entity's previous financial reporting framework, these should normally be reflected at the amounts that would be recognised in the separate or individual financial statements of the acquiree and no adjustments are made to goodwill. The previous financial reporting framework carrying amounts as at the date of the acquisition are treated as a deemed cost for the purposes of cost-based depreciation and amortisation. This does not preclude the deemed cost exemptions available on transition from being subsequently applied to assets acquired in the business combination that are still held at the date of transition (see 5.5 below).

FRS 102 requires that, where the transition exemption is used, no adjustments are made to the carrying amount of goodwill at the date of transition. [FRS 102.35.10(a)]. However, 5.2.4 below sets out situations where it may be necessary to adjust the carrying amount of goodwill, notwithstanding this prohibition.

Implementation issues arising on measuring assets acquired and liabilities assumed in business combinations include:

(a) Subsequent measurement of assets and liabilities under FRS 102 not based on cost

Where FRS 102 requires subsequent measurement of some assets and liabilities on a basis that is not based on original cost, such as fair value (e.g., certain financial instruments) or on specific measurement bases (e.g., share-based payment or employee benefits), a first-time adopter must measure these assets and liabilities on that basis in its opening FRS 102 statement of financial position, even if they were acquired or assumed in a past business combination. Any resulting change is recognised by adjusting retained earnings (or another category of equity).

(b) Previous financial reporting framework carrying amount as deemed cost

The carrying amounts in accordance with the entity's previous financial reporting framework of assets acquired and liabilities assumed in the business combination, immediately after the business combination, are their deemed cost in accordance with FRS 102 at that date. If FRS 102 requires a cost-based measurement of those assets and liabilities at a later date, that deemed cost is the basis for cost-based depreciation or amortisation from the date of the business combination (i.e., the carrying amounts under the previous financial reporting framework at the date of the business combination are 'grandfathered' as at that date).

A first-time adopter would not use the provisionally determined fair values of assets acquired and liabilities assumed (that were later finalised under its previous financial reporting framework) in applying the business combinations exemption. In any case, goodwill is adjusted retrospectively at the date of transition for the changes to provisional fair values under FRS 101/adopted IFRS. While neither Section 35 nor IFRS 1 explicitly addresses this issue, this is consistent with how the related transition exemption in Appendix C of IFRS 1 has been applied in practice.

By contrast, under its previous financial reporting framework, the entity may have amortised intangible assets or depreciated property, plant and equipment from the date of the business combination. If this amortisation or depreciation is not in compliance with FRS 102 (or indeed the asset was not amortised or depreciated under the entity's previous financial reporting framework, but this is required under FRS 102 – see the discussion on intangible assets at 5.2.4.F below), this is not 'grandfathered' under the business combination exemption. If the amortisation or depreciation methods and rates are not acceptable and the difference has a material impact on the financial statements, a first-time adopter must adjust the accumulated amortisation or depreciation on transition (see 5.5.2 below).

(c) Measurement of items not recognised under the entity's previous financial reporting framework

If an asset acquired or liability assumed in a past business combination was not recognised under the entity's previous financial reporting framework, this does not mean that such items have a deemed cost of zero in the opening FRS 102 statement of financial position. Instead, the acquirer normally recognises and measures those items in its opening statement of financial position on the basis that FRS 102 would require in the statement of financial position of the acquiree. Conversely, if an asset or liability was subsumed in goodwill in accordance with the entity's previous financial reporting framework but would have been recognised separately under Section 19, that asset or liability remains in goodwill unless FRS 102 would require its recognition in the financial statements of the acquiree. However, intangible assets previously subsumed within goodwill under the entity's previous financial reporting framework are not separately recognised. [FRS 102.35.10(a)]. Financial assets and financial liabilities that are derecognised in accordance with the derecognition transition exception (see 4.1 above) are not recognised. [FRS 102.35.9(a)].

(d) Measurement of non-controlling interests and deferred tax

The measurement of non-controlling interests (see also 4.3 above) and deferred tax follows from the measurement of other assets and liabilities. Consequently, deferred tax and non-controlling interests are recalculated after all assets acquired and liabilities assumed have been adjusted under Section 35.

The recognition and measurement of deferred tax is addressed in Section 29, which must be applied retrospectively as no transition exemptions or exceptions apply. In particular, first-time adopters will need to consider what deferred tax would have been recognised at the date of the business combination, as adjusted by subsequent movements in timing differences recognised under Section 29.

Any resulting change in the carrying amount of deferred taxes and non-controlling interest is recognised by adjusting retained earnings or another category of equity.

Some IFRS reporters may have included non-controlling interest at fair value when accounting for the business combination under IFRS 3. [IFRS 3.19, IFRS 3.B44, IFRS 3.B45]. This may often exceed the non-controlling interest based on the proportionate share of the subsidiary's identifiable assets, liabilities (and contingent liabilities) which would be the measurement basis used under FRS 102 at the date of the business combination. [FRS 102.9.13(d), FRS 102.19.14A]. Consequently, some of the goodwill recognised under IFRS would relate to the non-controlling interest.

How we see it

Given that goodwill is not restated where the transition exemption in paragraph 35.10(a) is taken, we believe that it is appropriate that non-controlling interest - which represents the equity in a subsidiary not attributable, directly or indirectly, to its parent - continues to include this attributed goodwill.

5.2.4 Restatement of goodwill when not restating business combinations

Notwithstanding the prohibition in paragraph 35.10(a) from making adjustments to goodwill where past business combinations are not restated, there may be certain situations where an adjustment to goodwill is appropriate. These could include:

- Where there is an indicator that the goodwill may be impaired at the date of transition (see 5.2.4.A below).
- The interaction with FRS 102's requirements to restate goodwill for adjustments to contingent consideration (see 5.2.4.B below).
- A potential conflict with FRS 102's requirements to retranslate goodwill and fair value adjustments relating to a foreign operation. (see 5.2.4.C below).

And

- Changes in the scope of consolidation (see 5.2.5 below).

The transition requirements for negative goodwill (see 5.2.4.D below) and goodwill previously deducted from equity (see 5.2.4.E below) are not explicitly addressed by Section 35, although IFRS 1 Appendix C addresses the latter.

5.2.4.A Impairment of goodwill

Section 35 does not require an impairment review of goodwill to be performed as at the date of transition. However, there are no exemptions in Section 35 from applying Section 27, which requires that an entity must assess at each reporting date whether there is any indication of impairment. FRS 102 prohibits the reversal of impairment losses relating to goodwill. [FRS 102.35.7, FRS 102.27.24, FRS 102.27.28].

For example, an entity may uplift the carrying amount of property, plant and equipment to fair value at the date of transition (by adopting a revaluation policy under FRS 102 or using the deemed cost exemption to state an item of property, plant or equipment at fair value as at the date of transition [FRS 102.35.10(c)] - see 5.5 below). As a consequence, the total carrying amount of the acquired net assets including goodwill might exceed the recoverable amount of the relevant cash-generating unit(s) (or groups of cash-generating unit(s)) to which the goodwill is allocated. Consequently, an impairment of goodwill (and potentially other assets in the cash generating unit(s)) would be recognised in accordance with Section 27. See Chapter 29 at 5.

Section 35 states that no adjustments must be made to the carrying amount of goodwill at the date of transition (or earlier date from which the first-time adopter restates business combinations under Section 19). [FRS 102.35.10(a)].

How we see it

In our view, it would be inappropriate to recognise an impairment loss on the first day of the comparative period of the FRS 102 financial statements when that impairment already existed at the date of transition itself. Therefore, if there is an indicator of impairment at transition, the goodwill must be reviewed for impairment at the date of transition.

Any impairment losses identified at the date of transition would be reflected in retained earnings in accordance with paragraph 35.8, unless the impairment is allocated to revalued assets (such as property, plant and equipment) where the impairment is accounted as a revaluation decrease in accordance with other sections of FRS 102 and reduces a revaluation surplus on that asset included in the revaluation reserve (see Chapter 20 at 3.7 and Chapter 29 at 6). [FRS 102.27.6].

5.2.4.B Transition accounting for contingent consideration

Contingent consideration must be remeasured under the general principles in FRS 102 as there are no exemptions under Section 35. FRS 102 requires that the acquirer includes the estimated amount of contingent consideration (reflecting the time value of money, if material) in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably. Subsequent changes to the estimate are also reflected as adjustments to the cost of the business combination (with the unwinding of any discount reflected as a finance cost in profit or loss in the period it arises). [FRS 102.19.12, FRS 102.19.13A, FRS 102.19.13B]. See Chapter 22 at 3.6.2.

The requirements of IFRS for accounting for contingent consideration differ significantly from those in FRS 102. In particular, IFRS 3 requires that contingent consideration classified as equity must not be remeasured and its subsequent settlement must be accounted for within equity. Other contingent consideration is measured at fair value at each reporting date and changes in fair value are recognised in profit or loss. [IFRS 3.39, IFRS 3.40, IFRS 3.58]. Therefore, a previous IFRS or FRS 101 reporter will need to remeasure contingent consideration classified as a liability (or asset) on transition to FRS 102 to reflect the amounts that are probable (and can be measured reliably) rather than the fair value. The situation with contingent consideration classified as equity is more complicated since FRS 102's requirements on contingent consideration arising from a business combination do not distinguish between contingent consideration classified as equity or as a liability.

How we see it

As explained further in Chapter 22 at 3.6.2.C, in our view, contingent consideration classified as equity is remeasured for changes in the number of equity instruments to be issued (and valued using the fair value at the date of exchange, i.e., the date of acquisition), with adjustments reflected in the cost of combination (and hence goodwill). The estimated amount of contingent consideration classified as equity is not remeasured for subsequent changes in the entity's share price.

Consequently, while paragraph 35.10(a) specifies that no adjustments must be made to goodwill (where the transition exemption is used), Section 19 requires goodwill to be adjusted for changes in the amount of estimated contingent consideration. However, the amount of goodwill recognised by a previous IFRS or FRS 101 reporter would not reflect adjustments to the fair value of contingent consideration made subsequent to the acquisition (unless these qualified as measurement period adjustments). [IFRS 3.39, IFRS 3.40, IFRS 3.45, IFRS 3.58]. The question therefore arises as to whether a first-time adopter is permitted to adjust goodwill as at the date of transition to reflect the estimated contingent consideration, measured in accordance with Section 19 at that date.

How we see it

Although a conflict between paragraph 35.10(a) and Section 19 arises, in our view, goodwill is not adjusted as at the date of transition, and therefore any resulting change to the estimated contingent consideration is recognised by adjusting retained earnings (or another category of equity) at that date. This view recognises that paragraph 35.10(a) takes precedence.

This situation differs in certain respects from the situation discussed at 5.2.4.C below with denominating goodwill in a foreign currency as the accounting just changes the 'same' goodwill from being viewed as denominated in the functional currency to a foreign currency (rather than remeasuring the goodwill to a different amount, based on estimated contingent consideration).

The interaction between the requirements on contingent consideration and those on financial instruments is rather complicated. Sections 11 and 12 of FRS 102, where applied to the recognition and measurement of financial instruments, scope out the accounting by the acquirer for contracts for contingent consideration in a business combination – and instead refer to Section 19. [FRS 102.12.3(g)]. Consequently, goodwill must be adjusted prospectively for re-measurements of contingent consideration that are made subsequent to the date of transition.

An entity that chooses to apply IAS 39 (where permitted) or IFRS 9 to the recognition and measurement of financial instruments, applies the scope of the relevant standard to its financial instruments.

[FRS 102.11.2, FRS 102.12.2]. IAS 39 and IFRS 9 specifically address contingent consideration classified as a financial liability that is recognised in a business combination to which IFRS 3 applies. [IAS 39.9(aa), IFRS 9.4.2.1]. However, the requirements on accounting for contingent consideration are found primarily in IFRS 3 and so do not apply to entities reporting under FRS 102. [IFRS 3.39, IFRS 3.40, IFRS 3.58, IFRS 9.4.2.1(e)].

How we see it

In our view, an entity applying IAS 39 (where permitted) or IFRS 9 to the recognition and measurement of financial instruments would also normally apply the requirement in paragraph 19.12 that contingent consideration is recognised where the adjustments to consideration are probable and can be measured reliably, with subsequent adjustments to goodwill.

5.2.4.C Goodwill on a pre-transition business combination that is a foreign operation (where not restated under Section 19)

Section 35 is not explicit on how to treat goodwill relating to an acquisition of a foreign operation in a business combination that is not restated under Section 19.

While paragraph 35.10(a) specifies that no adjustments must be made to goodwill, Section 30 *Foreign Currency Translation* requires goodwill arising on the acquisition of a foreign operation to be translated. [FRS 102.30.23]. Where a conflict between paragraph 35.10(a) and Section 30 arises, management will need to use judgement to determine an appropriate policy, and this could consequently be an area where diversity in practice might arise. A previous IFRS or FRS 101 reporter will in any event be translating foreign currency goodwill; however, there might be elements of goodwill which were regarded as functional currency goodwill (and not retranslated on an ongoing basis) on transition to IFRS or FRS 101. [IAS 21.23, IAS 21.47, IFRS 1.C2, IFRS 1.C3].

How we see it

In our view, paragraph 35.10(a) does not preclude management in regarding the goodwill as foreign currency goodwill and retranslating the goodwill at the date of transition (and thereafter at each reporting period). An alternative view which could meet the requirements of paragraph 35.10(a) to preserve the carrying amount of goodwill (expressed in the functional currency of the reporting entity) and to comply with Section 30, would be taking the functional currency carrying amount of the goodwill at the date of transition, translating it into the underlying currency of the acquired operations at the exchange rate at the date of transition and thereafter regarding the goodwill as foreign currency goodwill to be retranslated at each reporting period. Another alternative view is that the requirement relates to preserving the carrying amount of the goodwill (i.e., in the reporting entity's functional currency); this view takes a literal reading of the transition exemption in paragraph 35.10(a) and considers that this takes precedence over Section 30's requirements.

5.2.4.D Negative goodwill

FRS 102's accounting requirements for negative goodwill which requires this to be recognised on balance sheet (see Chapter 22 at 3.9.3), differ significantly from those in IFRS 3 where the negative goodwill is recognised immediately in profit or loss. [FRS 102.19.24, IFRS 3.34].

The transition exemption in paragraph 35.10(a) addresses 'goodwill', requiring that no adjustment must be made to the carrying value of goodwill. Goodwill is defined as: "Future economic benefits arising from assets that are not capable of being individually identified and separately recognised" rather than simply as a residual (see Chapter 22 at 3.9). Therefore, goodwill is not the same as the "Excess over cost of acquirer's interest in the net fair value of acquiree's identifiable assets, liabilities and contingent liabilities" (negative goodwill). Moreover, negative goodwill is not strictly an asset or liability (as defined) and so arguably does not fall within the requirement to restate the opening financial position. [FRS 102.35.7].

How we see it

In our view, an entity that applies the transition exemption in paragraph 35.10(a) not to restate business combinations does not reinstate negative goodwill that was recognised immediately in profit or loss under IFRS. Moreover, for the reasons explained in Chapter 22 at 3.9.3, it may often be the case that negative goodwill would have been fully amortised by the date of transition had FRS 102 been applied. However, an entity would need to consider carefully whether any accumulated credit in retained earnings represented by negative goodwill is a realised profit in accordance with the guidance in TECH 02/17BL, as this might not always be the case.

5.2.4.E Goodwill previously deducted from equity

There may be historic circumstances where, under the entity's previous financial framework, some goodwill has been eliminated against reserves.

How we see it

In our view, where the exemption not to restate pre-transition business combinations in accordance with Section 19 is taken, the requirement that no adjustment is made to the carrying value of goodwill means that there is no change to the amount of goodwill recognised as an asset (i.e., the goodwill remains eliminated against equity). Effectively under FRS 102, such goodwill does not exist for accounting purposes. FRS 102 does not permit or require reclassification of goodwill previously deducted from equity to profit or loss when the related operation is disposed of or closed.

5.2.4.F Goodwill and intangible asset amortisation

FRS 102 requires that goodwill and intangible assets be amortised on a systematic basis over a finite useful life using an amortisation method that reflects the expected pattern of consumption of economic benefits. A straight-line basis is used if the entity cannot determine that pattern reliably. If an entity is unable to make a reliable estimate of the useful life of goodwill or an intangible asset, the useful life must not exceed ten years. [FRS 102.18.19, FRS 102.18.20, FRS 102.18.21, FRS 102.19.23]. See Chapter 21 at 3.3.3 and Chapter 22 at 3.9.2 for a fuller discussion.

Under IFRS, the acquirer measures goodwill at the amount recognised at the acquisition date less any accumulated impairment losses. [IFRS 3.B63]. Consequently, goodwill is not amortised.

A first-time adopter may also need to consider the following implementation issues:

- (a) Adjustments to goodwill lives where no restatement of business combinations under Section 19
Where an entity is not restating the business combination in accordance with Section 19, paragraph 35.10(a) requires that no adjustment is made to the carrying amount of goodwill. Following the Periodic Review 2024 amendments, the paragraph now clarifies that if the goodwill has previously been determined to have an indefinite useful life, the goodwill must be re-assessed to determine its remaining useful life and is subsequently measured in accordance with paragraph 19.23. [FRS 102.19.23, FRS 102.35.10(a)].
Therefore, an IFRS or FRS 101 reporter is required to reassess the remaining useful life of the goodwill, as at the date of transition and to amortise the goodwill prospectively.
- (b) Restatement of business combinations in accordance with Section 19
Where a first-time adopter restates a business combination in accordance with Section 19 and has previously ascribed a finite useful life to goodwill, any adjustment to that useful life is accounted for prospectively over the remaining revised useful life determined under FRS 102 as a change in estimate (see 4.2 above).

How we see it

Where, however, an indefinite useful life was used under the entity's previous financial reporting framework (as required under IFRS), amortisation must be adjusted for retrospectively from the date of the business combination. This is because this is a change in accounting policy (not a change in estimate) and the requirement in paragraph 35.10(a) that no adjustment must be made to the carrying amount of goodwill does not apply. On transition to FRS 102, however, goodwill and intangible assets must be amortised over a finite useful life. Therefore, in our view, a move from an indefinite useful life to a finite useful life for goodwill is required to be retrospectively effected – such that the goodwill at transition represents the carrying amounts after adjusting for amortisation on the basis of the finite useful life determined under FRS 102.

(c) Intangible assets

There are no special transition requirements for intangible assets (other than goodwill) and therefore FRS 102's requirements are applied retrospectively. [FRS 102.35.7].

Where an entity amortised an intangible asset over a longer finite useful life than ten years under its previous financial reporting framework, it can continue to use that useful life, where it continues to be a reliable estimate of the useful life. In particular, it would be difficult to argue that the useful life of the intangible asset must simply default to a ten year life. Any changes to the useful life would need to be justified by reference to a change in circumstances (unless the previous life was objectively in error) and be recognised prospectively as a change in estimate (see 4.2 above).

How we see it

However, if an entity ascribed an indefinite useful life to an intangible asset under its previous financial reporting framework, in our view, the intangible asset must be amortised retrospectively over its new finite useful life since this is a change in accounting policy (FRS 102 does not permit use of an indefinite useful life).

The above conclusions apply to all intangible assets, whether acquired separately or in a business combination (and do not depend on whether the business combination is restated in accordance with Section 19 or not).

5.2.5 Changes in scope of consolidation

The scope of consolidation under the entity's previous financial reporting framework may differ from the scope of consolidation under FRS 102. Therefore, a first-time adopter might not have consolidated a subsidiary acquired in a past business combination under its previous financial reporting framework or a subsidiary consolidated under its previous financial reporting framework qualifies to be excluded from consolidation under FRS 102.

Adjustments to the carrying amounts of assets and liabilities of subsidiaries may affect non-controlling interest and deferred tax.

5.2.5.A Changes in scope of consolidation compared to the previous financial reporting framework

Section 9 of FRS 102 states that "A subsidiary is an entity that is controlled by the parent." [FRS 102.9.4]. The definition of 'a subsidiary' in Section 9 is generally consistent with (although not identical to) the definition of 'a subsidiary undertaking' included in section 1162 of the CA 2006. However, Section 9 contains additional guidance on 'control' - in relation to currently exercisable options or convertible instruments; where control is exercised through an agent; and Special Purpose Entities - as well as an extended definition of subsidiaries held exclusively for resale (which are excluded from consolidation). [FRS 102.9.4-12, s1162, s1162 (LLP)].

IFRS 10 has a similar definition that: "A subsidiary is an entity that is controlled by another entity". [IFRS 10 Appendix A]. However, IFRS 10 and FRS 102 differ in the wording of the definition of 'control' (and associated guidance) and exclusions from the scope of consolidation. [FRS 102.9.4-6A]. In many cases, both standards lead to the same determination of whether an entity is or is not a subsidiary. However, a first-time adopter must consider Section 9's requirements on control and the exclusions from the scope of consolidation (discussed in Chapter 8 at 3.3 and 3.4) in order to determine whether any changes are required compared to its previous financial reporting framework. [FRS 102.9.4-12].

5.2.5.B Previously unconsolidated subsidiaries

If, under its previous financial reporting framework, an FRS 102 first-time adopter did not consolidate a subsidiary that it is required to consolidate under FRS 102, it must retrospectively apply FRS 102 to the carrying amounts of the assets and liabilities of that subsidiary, subject to the transition exceptions and transition exemptions set out in Section 35. [FRS 102.35.7].

FRS 102 does not explain how a first-time adopter is to consolidate a subsidiary for the first time (whether because the reporting entity did not consider the entity to be a subsidiary under its previous financial reporting framework or did not prepare consolidated financial statements). However, as set out below, the entity needs to apply the requirements of paragraph 35.10(r) (which addresses the accounting for a subsidiary on transition, where a parent becomes a first-time adopter of FRS 102 later than its subsidiary -

see 5.15.2 below) and may want to consider paragraphs IG27 to IG30 of IFRS 1 (which provide further implementation guidance discussed below) to the extent that these do not conflict with FRS 102.

If an entity becomes a first-time adopter later than its subsidiary, the entity, in its consolidated financial statements, measures the assets and liabilities of the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for consolidation adjustments and for the effects of the business combination in which the entity acquired the subsidiary. [FRS 102.35.10(r)]. Where the subsidiary has not previously adopted FRS 102, the reference above to the "same carrying amounts" is to the amounts FRS 102 would require in the statement of financial position of the subsidiary. [IFRS 1.IG27(a)].

The amounts of goodwill, assets and liabilities recognised in respect of the subsidiary will depend on whether it was acquired in a business combination or not, and if it was so acquired, whether the business combination is restated in accordance with Section 19 or not. [FRS 102.35.10(a)].

- (a) Subsidiary acquired in a business combination: entity uses the transition exemption in paragraph 35.10(a) not to *restate* past business combinations

Where the business combination is not restated in accordance with Section 19, paragraph 35.10(a) is applied to accounting for the business combination (see 5.2 generally). Section 35 does not explain how to implement paragraph 35.10(a) where the subsidiary has not been previously consolidated (i.e., no goodwill has been reflected in the consolidated financial statements).

How we see it

The CA 2006 requires the determination of goodwill, as at the date of the acquisition, where a subsidiary undertaking is acquired and accounted for using the acquisition method. Even if consolidated financial statements were not prepared by the entity under its previous financial reporting framework, the amount of the goodwill, assets and liabilities that would have been recognised had the subsidiary been consolidated may be known or determinable (for example, if the amounts were already available for the purposes of group reporting). In our view, this goodwill amount is recognised on transition.

However, it might not always be possible to reliably determine the goodwill. In such circumstances, on the basis that no goodwill was reflected in the entity's financial statements under its previous financial reporting framework, a view could be taken that the transition adjustments to derecognise the cost of investment and recognise the assets and liabilities of the subsidiary may be reflected in retained earnings (or other category of equity), following the general requirements in Section 35.

In some cases, the impracticability exemption in paragraph 35.11 may be relevant to the accounting for the business combination (see 3.4.4 above).

This differs from the requirement in Appendix C4(j) in IFRS 1 to establish a deemed cost of goodwill, being the difference between the carrying amount of the investment and the assets and liabilities of the subsidiary that would be required in the subsidiary's own IFRS financial statements. [IFRS 1.C4(j)]. While pragmatic, this will result in a deemed cost of goodwill which will rarely represent the true goodwill under a previous financial reporting framework, will give a different answer for goodwill depending on the measurement basis used for the investment in the subsidiary in the parent's separate financial statements, and appears to conflict with paragraph 35.10(a)'s requirement that no adjustment is made to the carrying value of goodwill at the date of transition.

Other assets acquired and liabilities assumed since the business combination and still held at the acquirer's date of transition are reported at:

- The carrying amounts that FRS 102 would require in the subsidiary's own statement of financial position.
- Or
- Where the subsidiary has already adopted FRS 102 before its parent, the amounts included in the subsidiary's statement of financial position in its FRS 102 financial statements, after adjusting for consolidation procedures. [FRS 102.35.10(r), IFRS 1.IG27(a), IFRS 1.IG30(a)].

- (b) Subsidiary acquired in a business combination restated under Section 19

Where the previously unconsolidated subsidiary was acquired in a business combination restated under Section 19, the goodwill and fair values of the identifiable net assets recognised at the date of the business combination would be retrospectively restated. The first-time adopter would need to restate either all pre-transition business combinations or all later business combinations (and apply the requirements of FRS 102 in respect of non-controlling interests from the same date). [FRS 102.35.9(e), FRS 102.35.10(a)].

Other assets acquired and liabilities assumed since the business combination and still held at the acquirer's date of transition are reported at:

- The carrying amounts that FRS 102 would require in the subsidiary's own statement of financial position.
- Or
- Where the subsidiary has already adopted FRS 102 before its parent, the amounts included in the subsidiary's statement of financial position in its FRS 102 financial statements after adjusting for consolidation procedures. [FRS 102.35.10(r), IFRS 1.IG27(a), IFRS 1.IG30(a)].

(c) **Subsidiary not acquired in a business combination**

The first-time adopter would adjust the carrying amounts of the subsidiary's assets and liabilities to the amounts that FRS 102 would require in the subsidiary's own statement of financial position (or where the subsidiary has already adopted FRS 102 before its parent, the amounts included in its statement of financial position in its FRS 102 financial statements), after adjusting for consolidation procedures.

[FRS 102.35.10(r), IFRS 1.IG27(a)].

Where the subsidiary was not acquired in a business combination, no goodwill is recognised.

[IFRS 1.IG27(c)]. Instead, any difference between the carrying amounts and the net identifiable assets determined above is treated as an adjustment to retained earnings (or other component of equity, where appropriate) at the date of transition.

5.2.5.C Previously consolidated entities that are not subsidiaries

A first-time adopter may have consolidated an investment under its previous financial reporting framework that does not meet the definition of a subsidiary under FRS 102. In such a case, the entity must first determine the appropriate classification under FRS 102 (for example, as an associate, jointly controlled entity or financial asset) and then apply Section 35's requirements.

The requirements of FRS 102 must be applied retrospectively subject to any transition exceptions and exemptions available and, where applicable, the use of the impracticability exemption available in paragraph 35.11 (see 3.4.4 above). [FRS 102.35.7, FRS 102.35.11].

5.2.6 Business combination - transition example

The following example illustrates a number of the considerations relevant to the treatment of business combinations on transition.

Illustration 5-1: Business combination example

On 31 December 20X4, Entity A purchased Entity B for £1.2m cash consideration (incurring acquisition costs of £10,000) and further contingent cash consideration. The date of transition is 1 January 20X5 and Entity A prepares its first FRS 102 financial statements for the accounting period beginning 1 January 20X6. Entity A prepared its last annual financial statements in accordance with IFRS at 31 December 20X5.

The assets and liabilities acquired at 31 December 20X4 were as follows:

	<i>Book value (and tax base) in B's financial statements</i>	<i>Fair value (IFRS)</i>	<i>Fair value (if not restating under Section 19)</i>	<i>Fair value if restating (Section 19)</i>
	£000	£000	£000	£000
Intangible asset (brand - 5 year life)	-	200	200	200
Intangible asset (customer contract - 5 year life)	-	300	-	-
Investment property	100	300	300	300
Owner-occupied property (20 year life - nil residual value)	100	500	500	500
Inventory	50	70	70	70
Deferred tax (at 25%)	(40)	(320)	(245)	(245)
Net assets acquired	-	1,050	825	825

Consideration - cash	-	1,200	1,200	1,200
Contingent cash consideration		400	350	350
Transaction costs		10	10	10
Goodwill	-	550	550	735
Adjustment to retained earnings (DR/CR))			175	(10)

The entity accounted for the transaction under IFRS applying the acquisition method. The fair values for the identifiable assets and liabilities and the goodwill recognised are shown in the second column in the table above. Goodwill, which is not amortised under IFRS, has not been impaired. The fair value of the contingent consideration liability recognised was £400,000 at the date of the business combination and £600,000 as at 31 December 20X5. Transaction costs of £10,000 were expensed under IFRS.

The transaction meets the definition of a business combination under FRS 102. An income tax rate of 25% applies in all periods and indexation is ignored. The discount rate used to unwind the contingent consideration is 4%. It is assumed there are no tax effects of fair value movements on, or of settlement of contingent consideration (so that no deferred tax arose under IFRS and there is no timing difference under FRS 102).

Under FRS 102, Entity A accounts for the owner-occupied property using the cost model (same as IFRS). The investment property is accounted at fair value through profit or loss (under IFRS, the entity had elected the cost model, but any depreciation was immaterial in the first year of ownership). The fair value of the investment property was £350,000 as at 31 December 20X5. The present value of the amount of contingent consideration that is estimated as probable to be paid (and can be reliably measured) was £350,000 as at the date of the business combination (and date of transition) and £540,000 as at 31 December 20X5.

This example considers the accounting when the business combination is not restated under Section 19 (using the exemption in paragraph 35.10(a)) and when the business combination is restated under Section 19.

Business combination is not restated under Section 19

At the date of transition, Entity A:

- Does not restate the IFRS carrying amount of the owner-occupied property of £500,000. The values ascribed under IFRS are treated as deemed cost at the date of the business combination (which in this case is also the date of transition).
- Derecognises the customer contract intangible asset of £300,000 as at the date of transition as Entity A applies a policy of not recognising additional classes of intangible assets that do not meet all three recognition criteria. [FRS 102.18.8].
- Reduces the deferred tax liability by £75,000 relating to the fair value adjustment to derecognise the customer contract intangible asset. [FRS 102.29.11].
- Remeasures the contingent consideration to £350,000, i.e., a reduction of £50,000 in the liability recognised under IFRS. [FRS 102.19.12].

Entity A does not change the carrying amount of goodwill of £550,000 recognised under IFRS at the date of transition, and adjusts retained earnings by £175,000 debit for the reduction in the intangible asset and deferred tax liability and remeasurement of contingent liability above. Goodwill is assessed as having a remaining life of 15 years. [FRS 102.35.10(a)].

In the comparative period, Entity A makes the following adjustments compared to IFRS:

- An increase of £50,000 in the carrying amount of the investment property (to its fair value at 31 December 20X5) recognising the fair value gain in profit or loss. This property was carried using the cost model under IFRS (with immaterial depreciation in the comparative period). [FRS 102.16.7].
- The contingent consideration liability is remeasured to £540,000 as at 31 December 20X5. There is a consequential increase of £176,000 to the carrying amount of goodwill as at 31 December 20X5, leaving £14,000 (i.e., $0.04 \times £350,000$) unwind of discount in profit or loss. This adjustment to goodwill is made prospectively (rather than restating goodwill at transition). [FRS 102.19.12]. Under IFRS, a fair value movement of £200,000 had been recognised in profit or loss, measuring the contingent consideration liability at £600,000. This is reversed. [IFRS 3.58].
- Goodwill amortisation of £36,667 (i.e., $£550,000/15$), based on the goodwill amount as at transition, is recognised as an expense. [FRS 102.19.23]. Goodwill is not amortised under IFRS. [IFRS 3.B63].
- The reversal of amortisation on the customer contract of £60,000 (i.e., $£300,000/5$) which is recognised as an intangible asset under IFRS but not FRS 102.
- A reduction of £15,000 to deferred tax income (relating to the reversal of deferred tax under IFRS on the customer contract intangible asset amortisation) and an increase in deferred tax expense of £12,500 (relating to the fair value gain on the investment property which was not recognised under IFRS as the cost model was used). [FRS 102.29.6].

Business combination restated under Section 19

Entity A restates the business combination in accordance with Section 19 (as shown in the final column in the table above). Goodwill of £735,000 arising is amortised over 15 years from the date of the business combination. Therefore, the carrying amount of goodwill is increased by £185,000 and the net assets acquired/contingent consideration liability reduced by £175,000 (compared to IFRS) at the date of transition. The difference of £10,000 relates to capitalised transaction costs that are expensed under IFRS (and is reflected in retained earnings).

In the comparative period, Entity A makes the following adjustments compared to IFRS:

- An increase of £50,000 in the carrying amount of the investment property (to its fair value at 31 December 20X5) recognising the fair value gain in profit or loss. This property was carried using the cost model under IFRS (with immaterial depreciation in the comparative period). [FRS 102.16.7].
- The contingent consideration liability is remeasured to £540,000 as at 31 December 20X5. There is a consequential increase of £176,000 to the carrying amount of goodwill as at 31 December 20X5, leaving £14,000 (i.e., $0.04 \times £350,000$) unwind of discount in profit or loss. This adjustment to goodwill is made prospectively (rather than restating goodwill at transition). [FRS 102.19.12]. Under IFRS, a fair value movement of £200,000 had been recognised in profit or loss, measuring the contingent consideration liability at £600,000. This is reversed. [IFRS 3.58].
- Goodwill amortisation of £49,000 (i.e., $£735,000/15$), based on the goodwill amount as at transition, is recognised as an expense. [FRS 102.19.23]. Goodwill is not amortised under IFRS. [IFRS 3.B63].
- The reversal of amortisation on the customer contract of £60,000 (i.e., $£300,000/5$) which is recognised as an intangible asset under IFRS but not FRS 102.
- A reduction of £15,000 to deferred tax income (relating to the reversal of deferred tax under IFRS on the customer contract intangible asset amortisation), and an increase in deferred tax expense of £12,500 (relating to the fair value gain on the investment property which is not recognised under IFRS as the cost model is used). [FRS 102.29.6].

5.3 Public-benefit entity combinations

A public benefit entity is: "An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members." [FRS 102 Appendix I].

FRS 102 specifies the accounting for different types of public benefit entity combinations (see Chapter 36 at 6). Entities that are subject to a SORP may find that the relevant SORP contains further guidance specific to transactions in their sector. For example, the *Charities SORP (FRS 102)*, issued by the Charity Commission in England and Wales and the Office of the Scottish Charity Regulator in October 2019, contains guidance on various types of public benefit entity combinations involving charities.²⁴⁸ The *Charities SORP (FRS 102)* will be updated to reflect the Periodic Review 2024 and *Exposure Draft SORP 2026* was issued in March 2025.²⁴⁹

A first-time adopter could elect not to apply paragraphs PBE 34.75 to PBE 34.86 relating to public benefit entity combinations to combinations that were effected before the date of transition to FRS 102. However, if on first-time adoption, a public benefit entity restates any entity combination to comply with this section, it must restate all later entity combinations. [FRS 102.35.10(q)].

Section 35 does not add further guidance. However, entities may want to interpret paragraph 35.10(q) in the same way as the exemption not to restate pre-transition business combinations (including group reconstructions) in paragraph 35.10(a). See 5.2 above.

248 [Charities SORP \(FRS 102\)](#): Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102) (effective 1 January 2019), Charity Commission and Office of the Scottish Charity Regulator, October 2019.

249 Exposure Draft SORP 2026: Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and Republic of Ireland (FRS 102), Charity Commission and Office of the Scottish Charity Regulator at <https://www.charitysorp.org/documents/d/quest/exposure-draft-sorp-2026-1->.

5.4 Share-based payment transactions

A first-time adopter is not required to apply Section 26 *Share-based Payment* to equity instruments (including the equity component of share-based payment transactions previously treated as compound instruments) that were granted before the date of transition to FRS 102, or to liabilities arising from share-based payment transactions that were settled before the date of transition to FRS 102. [FRS 102.35.10(b)].

However, a first-time adopter previously applying IFRS 2 *Share-based Payment* or FRS 101 is required to, in relation to equity instruments (including the equity component of share-based payment transactions previously treated as compound instruments) that were granted before the date of transition to FRS 102, apply either IFRS 2 or Section 26 at the date of transition. [FRS 102.35.10(b)].

How we see it

Most first-time adopters will now be previous IFRS or FRS 101 reporters. In our view, the intention of the transition exemption is simply that an entity previously applying IFRS 2 may complete the accounting for a pre-transition grant using the original grant date fair value and it is not intended that the application of Section 26 of FRS 102 to such grants should necessarily result in a remeasurement. However, there is nothing in paragraph 10(b) of Section 35 to prohibit such a remeasurement (for example, as a result of applying the group allocation arrangements of paragraph 16 of Section 26).

The classification of a share-based payment transaction as equity-settled or cash-settled will often be the same under FRS 102 and IFRS 2 (although the requirements on classification are not identical). If a classification difference does result from adoption of FRS 102, it appears that an entity could continue with the IFRS 2 classification for existing awards, even if new grants would be classified differently under FRS 102.

The transition exemptions impact the ongoing accounting for the share-based awards to which the exemption was applied. See Chapter 28 at 17.

5.5 Fair value or previous revaluation as deemed cost

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(c) Fair value as deemed cost

A first-time adopter may elect to measure an:

(i) item of property, plant and equipment (including an investment property transferred to property, plant and equipment in accordance with paragraphs 16.4A(b)); or

(ii) [Deleted]

(iii) intangible asset which meets the recognition criteria and the criteria for revaluation in Section 18 *Intangible Assets other than Goodwill*

on the date of transition to this FRS at its fair value and use that fair value as its deemed cost at that date.

Fair value (see Appendix A) at the date of transition must reflect the conditions that existed at the date of transition. FRS 102 requires that, in the absence of specific guidance in the relevant section of the standard dealing with an item, the guidance in Section 2A of FRS 102 is used in determining fair value. [FRS 102.2A.1-24].

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(d) Revaluation as deemed cost

A first-time adopter may elect to use a revaluation determined under its previous financial reporting framework of an:

(i) item of property, plant and equipment (including an investment property transferred to property, plant and equipment in accordance with sub-paragraph 16.4A(b)); or

(ii) [Deleted]

(iii) intangible asset which meets the recognition criteria and the criteria for revaluation in Section 18

at, or before, the date of transition to this FRS as its deemed cost at the revaluation date.

Establishing the historical cost amounts for an asset may be onerous where the requirements differ from the previous financial reporting framework. A previous IFRS or FRS 101 reporter could have used a deemed cost exemption (similar to those in paragraphs 35.10(c) and (d), discussed above) on first-time adoption of IFRS. [IFRS 1.D5, IFRS 1.D6, IFRS 1.D7]. Use of the deemed cost exemption in paragraph 35.10(d) would allow a first-time adopter that revalued the property, plant and equipment under its previous financial reporting framework to retain the revalued amount as a deemed cost at the date of the revaluation when moving to the cost model on adoption of FRS 102. It would also allow first-time adopters to reflect a one-off revaluation to fair value at the date of transition.

Section 35 includes further deemed cost exemptions for:

- Oil and gas properties (see 5.6 below).

And

- Cost of investments in subsidiaries, associates and joint ventures in separate or individual financial statements (see 5.7 below).

5.5.1 Scope of the deemed cost exemption

The exemptions in paragraphs 35.10(c) and (d) are available on an item-by-item basis (so need not be applied consistently to a class of assets).

In practice, these exemptions are likely to be most useful for items of property, plant and equipment, where there are few restrictions to their application. The deemed cost exemption can only be applied to intangible assets that meet the recognition criteria and criteria for revaluation in Section 18, including the existence of an active market. Therefore, the exemption is of limited practical relevance to intangible assets.

5.5.2 Establishing deemed cost at a date other than transition

If the deemed cost of an asset is determined before the date of transition, then an FRS 102-compliant accounting policy needs to be applied to that deemed cost in the intervening period to determine what the carrying amount of the asset is in the opening FRS 102 statement of financial position. This means that a first-time adopter that uses a revaluation determined under its previous financial reporting framework prior to the date of transition will need to start depreciating the item from the date for which the entity established the revaluation (i.e., deemed cost) not from the date of transition to FRS 102.

This requirement is unlikely to give rise to a GAAP difference where an entity previously adopted IFRS provided the depreciation methods, lives and residual values previously applied remain acceptable under FRS 102. This could be an issue with intangible assets in situations where an indefinite life may have been determined under IFRS. [IAS 38.88].

How we see it

In our view, the intangible asset must be amortised retrospectively over its new finite useful life since this is a change in accounting policy (FRS 102 does not permit use of an indefinite useful life). See the discussion at 5.2.4.F above.

Where it is difficult to apply FRS 102's requirements on depreciation retrospectively, an entity can always use a deemed cost equal to fair value at the date of transition if the asset qualifies for deemed cost measurement under paragraph 35.10(c). *[FRS 102.35.10(c)].*

5.5.3 Impairment

As deemed cost is a surrogate for cost from the date of the measurement, any later impairment must be recognised in profit or loss. Moreover, any previous impairment recognised prior to the date that the deemed cost is established cannot be reversed. Section 27 does not permit reversal of impairment of an asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised in prior years (i.e., depreciated cost based on the deemed cost at the date of measurement). Goodwill impairment cannot be reversed. *[FRS 102.27.28, FRS 102.27.29, FRS 102.27.30, FRS 102.27.31].*

5.5.4 Deferred tax

Where a deemed cost is established based on a valuation determined under an entity's previous financial reporting framework, or fair value at transition, the past revaluation on or prior to transition generally represents a timing difference for which deferred tax will need to be recognised in accordance with the requirements of Section 29. Under the alternative accounting rules, any deferred tax relating to amounts credited or debited to the revaluation reserve (relating to the same asset) may also be recognised in the revaluation reserve as an alternative to retained earnings. *[1 Sch 35(3)(b), 1 Sch 35(3)(b)(LLP)].*

If, after transition, the deferred tax is remeasured (e.g., because of a change in tax rate) and the asset concerned was revalued outside profit or loss under its previous financial reporting framework, an entity needs to determine whether the resulting deferred tax income or expense is recognised in, or outside, profit or loss.

FRS 102 requires an entity to present tax expense (income) in the same component of total comprehensive income (i.e., continuing or discontinued operations, and profit or loss or other comprehensive income) or equity as the transaction or other event that resulted in the tax expense (income). *[FRS 102.29.22].*

The essence of the argument for where such tax effects are to be recognised is whether the reference in paragraph 29.22 to 'other comprehensive income' means items recognised in other comprehensive income under FRS 102 or whether it can extend to the treatment under its previous financial reporting framework.

How we see it

In our view, there are arguments for either approach, i.e., to present the deferred tax remeasurement on an asset that is measured at deemed cost under FRS 102 – but that was revalued outside profit or loss under its previous financial reporting framework – in profit or loss or in other comprehensive income, so long as it is applied consistently.

5.5.5 Revaluation reserve

UK companies (and LLPs) preparing statutory accounts are required by the Regulations (and LLP Regulations) to establish or maintain a statutory revaluation reserve under the alternative accounting rules on transition (see 3.4.3.A above) where property, plant and equipment (including investment property rented intragroup, where the cost model is elected – see discussion below) or intangible assets are included at a deemed cost measurement at the date of transition (which exceeds the depreciated historical cost of the item). *[1 Sch 35, 1 Sch 35 (LLP), FRS 102.35.10(d), FRS 102.A3.40B, FRS 102.A3.40C].*

While a subsequent impairment of an asset carried at deemed cost must be reflected in profit or loss, this does not preclude a transfer between revaluation reserve and retained earnings in respect of the impairment loss (where it is less than the amount of revaluation reserve related to that asset). Similarly, any excess depreciation (based on revalued amount compared to the historical cost amount) can also be transferred from the revaluation reserve to retained earnings. *[1 Sch 35(3)(a), 1 Sch 35(3)(a)(LLP)].*

FRS 102 requires investment property normally to be carried at fair value through profit or loss. This makes use of the fair value accounting rules under the Regulations (and LLP Regulations). However, FRS 102 allows an entity to make a policy choice either to account for investment property rented to another group entity at fair value through profit or loss or, by transferring them, in the case of an investment property held by the entity as: (i) the owner, to property, plant and equipment and applying the cost model in accordance with Section 17; or (ii) the lessee, to right-of-use assets and applying the cost model in accordance with Section 20. *[FRS 102.16.1, FRS 102.16.1A, FRS 102.16.4A-4B, FRS 102.16.7].* Adjustments on transition (including the treatment of the revaluation reserve) to investment properties are addressed in 3.4.3.C above.

The illustrative example²⁵⁰ below shows how a first-time adopter applies paragraph 35.10(d) upon transition to FRS 102.

Illustration 5-2: Application of paragraph 35.10(d)

Entity C, a previous IFRS reporter, owns two properties, A and B. Neither Property A nor Property B is an investment property. Entity C has an existing accounting policy to revalue its properties and to fully depreciate them over a useful life of 50 years. Property A was acquired on 31 December 20U1 at a cost of £1,000 and has been revalued on a regular basis; the last time was on 31 December 20X1 (30 years later) when its value was recorded in the financial statements at £100,000 and its remaining useful life was 20 years. There has been no significant change in the value of Property A since that revaluation.

Property B was acquired on 31 December 20X1, at a cost of £50,000. Property B has never been revalued as it was purchased in the same year that the most recent valuation was carried out, and at that time, its cost was the best available evidence of its valuation. There has been no impairment in its value.

On transition to FRS 102 (1 January 20X5), Entity C decides not to continue its policy of revaluation. (It is assumed that Entity C concludes that its estimates of the residual value and useful life of its properties remain appropriate under FRS 102.)

Paragraph 35.10(d) provides an optional exemption from restating the value of the property based on its original cost. Therefore, Entity C has the following two choices in relation to Property A:

- It could elect to use the most recent revaluation from 20X1 (being £100,000) as its deemed cost at that date and no further adjustment is required.
- Or
- It could restate the cost of the property to its original cost of £1,000, adjusting accumulated depreciation accordingly.

If the revalued amount of £100,000 were used as its deemed cost, in order to comply with company law, the difference from the relevant historical cost amount would need to be shown in a revaluation reserve and the excess depreciation, above that calculated on a historical cost basis, would continue to be offset against it. Also, as Property A is not carried at historical cost any other company law disclosures relating to revalued property will be required.

If the property is restated to the original cost of £1,000, the following adjustment would be required:

Dr	Revaluation reserve	£84,660	
Dr	Accumulated depreciation*	£14,340	
	Cr	Property, plant and equipment	£99,000

* This represents three years' depreciation (from 31 December 20X1 to 1 January 20X5) on the revalued amount, being £15,000 in total (£100,000 x 3/20 years remaining), less 33 years' depreciation (from 31 December 20U1 to 1 January 20X1) on the historical cost, being £660 in total (£1,000 x 33/50 years), which is not adjusted for.

No adjustment is required on transition for Property B. The exemption to permit revaluation as deemed cost is available at the level of individual items of property, plant and equipment. Entity C could choose to revalue Property B at the date of transition and use that new valuation as deemed cost. Similarly, as an alternative to using the 20X1 valuation for Property A, Entity C could revalue it at the date of transition (irrespective of whether Property B is revalued at the date of transition).

5.6 Deemed cost for oil and gas assets

A first-time adopter that under its previous financial reporting framework accounted for exploration and development costs for oil and gas properties in the development or production phases, in cost centres that included all properties in a large geographical area is permitted to elect to measure oil and gas assets (which, for the purpose of this transition exemption, comprise only those assets used in the exploration, evaluation, development or production of oil and gas) at the date of transition to FRS 102 on the following basis:

- (i) Exploration and evaluation assets at the amount determined under the entity's previous financial reporting framework.
- (ii) Assets in the development or production phases at the amount determined for the cost centre under the entity's previous financial reporting framework. The entity must allocate this amount to the cost centre's underlying assets *pro rata* using reserve volumes or reserve values as of that date.

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The entity must test exploration and evaluation assets and assets in the development and production phases for impairment at the date of transition to FRS 102 in accordance with Section 34 *Specialised Activities* or Section 27 respectively and, if necessary, reduce the amount determined in accordance with (i) or (ii) above. [FRS 102.35.10(j)].

Oil and gas entities might have accounted for exploration and development costs for properties in development or production under their previous financial reporting framework in cost centres that include all properties in a large geographical area, e.g., under the 'full cost accounting method'. However, this method of accounting generally uses a unit of account that is much larger than is acceptable under FRS 102 (or indeed IFRS, which has a similar transition exemption). In practice, as most first-time adopters will have previously applied IFRS or FRS 101, this transition exemption is unlikely to be of relevance to many entities.

Applying FRS 102 fully retrospectively would pose significant problems for such entities because – as the IASB noted in paragraph BC47A of IFRS 1 – it would require amortisation “to be calculated (on a unit of production basis) for each year, using a reserves base that has changed over time because of changes in factors such as geological understanding and prices for oil and gas. In many cases, particularly for older assets, this information may not be available.” Even when such information is available, the effort and cost to determine the opening balances at the date of transition would usually be very high.

To avoid the use of deemed cost resulting in an oil and gas asset being measured at more than its recoverable amount, oil and gas assets are required to be tested for impairment at the date of transition. The deemed cost amounts are reduced to take account of any impairment charge in accordance with Section 34 (for exploration and evaluation assets) (see Chapter 36 at 3) and Section 27 (for assets in the development and production phases) (see Chapter 29). The requirements of Section 34 are based on those in IFRS 6 (with certain adaptations). [FRS 102.34.11]. Section 34 would, therefore, require an entity to determine an accounting policy for allocating exploration and evaluation assets to cash-generating units for impairment purposes. A cash-generating unit or group of cash-generating units (used for exploration and evaluation assets) must be no larger than an operating segment (as defined in the Glossary to FRS 102). [FRS 102.34.11B, IFRS 6.21].

5.7 Individual and separate financial statements

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(f) Individual and separate financial statements

When an entity prepares individual or separate financial statements, paragraphs 9.26, 14.4 and 15.9 require the entity to account for its investments in subsidiaries, associates, and jointly controlled entities either at cost less impairment or at fair value.

If a first-time adopter measures such an investment at cost, it shall measure that investment at one of the following amounts in its individual or separate opening statement of financial position, as appropriate, prepared in accordance with this FRS:

- (i) cost determined in accordance with Section 9 *Consolidated and Separate Financial Statements*, Section 14 *Investments in Associates* or Section 15 *Investments in Joint Ventures* at the date of transition; or
- (ii) deemed cost, which shall be the carrying amount at the date of transition as determined under the entity's previous financial reporting framework.

An entity must apply the same accounting policy (i.e., cost, fair value with changes in fair value recognised in comprehensive income (or profit or loss) in accordance with paragraphs 17.15E and 17.15F, or fair value with changes in fair value recognised in profit or loss) to all investments in a single class (for example, investments in subsidiaries that are held as part of an investment portfolio, those that are not so held, associates or jointly controlled entities), but can elect different policies for different classes. [FRS 102.9.26, FRS 102.9.26A, FRS 102.14.4, FRS 102.15.9]. See Chapter 8 at 4.1 and 4.2.

Where the cost model is applied, the transition exemption would permit the choice of cost or deemed cost to be applied on an investment-by-investment basis. See 5.7.1 below for specific considerations where cost or deemed cost is used for investments.

The transition exemption allows a first-time adopter to 'grandfather' the carrying amount determined under its previous financial reporting framework at the date of transition as a deemed cost at that date. Unlike the comparable exemption in IFRS 1, [IFRS 1.D14], however, Section 35 does not permit use of deemed cost equal to the fair value at the date of transition (unless that happens to be the previous carrying amount). Investments in subsidiaries, associates and jointly controlled entities in the individual or separate financial statements included at cost or a deemed cost are subject to the impairment requirements of Section 27 (see Chapter 29).

5.7.1 Use of cost or deemed cost for investments – implementation issues

Where a UK company acquires an investment accounted for at cost in a share-for-share exchange, FRS 102 permits the initial cost of the investment to be reported either at its fair value at the date of the transaction or at an amount excluding any reliefs that would have been required to be reflected in share premium but for the existence of merger relief or group reconstruction relief. Hence, it is not necessary to establish a 'deemed cost' on transition where the previous carrying amount was net of such reliefs. [FRS 102.A3.24, FRS 102.A3.24A]. See Chapter 8 at 4.2.1.

Previous IFRS or FRS 101 reporters that measured investments in subsidiaries, associates and joint ventures at fair value or using the equity method in separate financial statements (but now wish to adopt the cost model on transition to FRS 102) might also wish to use the transition exemption. The equity method is not permitted in individual or separate financial statements under FRS 102. [FRS 102.9.26, FRS 102.9.26A, FRS 102.14.4, FRS 102.15.9]. Previous IFRS or FRS 101 reporters that used the cost model under IAS 27 *Separate Financial Statements* might also wish to use the transition exemption where the carrying amount of the investment under IFRS does not represent cost under FRS 102. Examples of such situations include: where a deemed cost was used on transition to IFRS/FRS 101; where the cost of the investment has been reduced by the amount of pre-acquisition dividends in the past; or where IAS 27 specifies the cost of investment in certain group reorganisations. [IAS 27.10, IAS 27.13, IAS 27.14]. Previous IFRS or FRS 101 reporters might also wish to use the transition exemption where the cost of investment reflects past fair value hedge accounting, which is not being continued under FRS 102 and Sections 11 and 12 are applied.

Where a UK company (or LLP) preparing statutory accounts uses a deemed cost at the date of transition that reflects a revaluation under its previous financial reporting framework, this would generally mean that the investment is carried at a revalued amount that makes use of the alternative accounting rules. See 3.4.3 and 3.4.3.A above.

5.8 Development costs

Section 18 provides a choice of policy as to whether to capitalise development costs (meeting the conditions for capitalisation in paragraph 18.8H) or to expense all development costs, to be applied consistently (see Chapter 21 at 2.3). [FRS 102.18.8K].

A first-time adopter choosing to adopt an accounting policy of capitalising development costs is permitted to elect to treat the date of transition to FRS 102 as the date on which capitalisation commences. [FRS 102.35.10(w)].

Additionally, a first-time adopter choosing to adopt an accounting policy of expensing development costs, which had adopted a policy of capitalising development costs under a previous financial reporting framework must not include such capitalised development costs as part of the cost of an asset on transition to FRS 102. [FRS 102.35.8B].

Prior to the amendments made to FRS 102 in the Periodic Review 2024, first time adopters were required to apply Section 18 retrospectively.

Where business combinations are restated in accordance with Section 19, intangible assets (including development costs) must be recognised at their fair values where the recognition criteria in Section 19 (depending on the policy applied – see Chapter 22 at 3.7.3.A) are met, even if a policy of expensing development costs is followed under Section 18.

5.9 Borrowing costs

FRS 102 offers a policy choice of expensing borrowing costs as incurred or of capitalising borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Where a capitalisation policy is adopted, this must be applied consistently to a class of qualifying assets (see Chapter 27 at 3.3). [FRS 102.25.2].

An entity choosing to adopt an accounting policy of capitalising borrowing costs as part of the cost of a qualifying asset is permitted to elect to treat the date of transition to FRS 102 as the date on which capitalisation commences. [FRS 102.35.10(o)]. However, if the entity chooses to adopt an accounting policy of expensing borrowing costs under FRS 102, but had adopted a policy of capitalising borrowing costs under a previous financial reporting framework (which is mandatory for a previous IFRS or FRS 101 reporter), it must not include such capitalised borrowing costs as part of the cost of an asset on transition to FRS 102. [FRS 102.35.8A].

First-time adopters applying a capitalisation policy for borrowing costs under Section 25 *Borrowing Costs* can use the transition exemption which offers relief by allowing an entity to commence capitalising borrowing costs arising on qualifying assets from the date of transition. That way these entities can avoid difficult restatement issues, such as determining which assets would have qualified for capitalisation of borrowing costs in past periods, which costs met the definition of borrowing costs and determining the amount of borrowing costs that qualified for capitalisation in past periods.

However, a previous IFRS or FRS 101 reporter would already be capitalising borrowing costs in accordance with IAS 23 *Borrowing Costs*. There are some differences between IAS 23 and Section 25, for example, under IFRS, capitalisation of borrowing costs is mandatory for most qualifying assets and there are differences in how the capitalisation rate is calculated on general borrowings and expenditure on qualifying assets is determined. See Chapter 27 at 2. Also, a previous IFRS or FRS 101 reporter could have used the transition exemption under IFRS 1 and therefore might not have fully retrospectively applied IAS 23. The IFRS 1 transition exemption allowed a first-time adopter to elect to apply IAS 23 from the date of transition (or from an earlier date as permitted by paragraph 28 of IAS 23). [IFRS 1.D23]. Consequently, there could be cases where the amounts capitalised under IAS 23 are not aligned with the amounts required to be capitalised under Section 25 of FRS 102.

How we see it

Unlike the comparable IFRS 1 transition exemption, in our view, the FRS 102 transition exemption does not permit grandfathering of the borrowing cost component included in the carrying amounts of a qualifying asset at the date of transition under a previous financial framework.

Therefore, if the amounts capitalised by a previous IFRS or FRS 101 reporter are materially different from a fully retrospective application of Section 25, an adjustment would be needed on transition to FRS 102. In some cases, the impracticability exemption in paragraph 35.11 could be relevant to the accounting for the capitalised borrowing costs (see 3.4.4 above).

A first-time adopter of IFRS that establishes a deemed cost for an asset (see 5.5 above) cannot capitalise borrowing costs incurred before the measurement date of the deemed cost. [IFRS 1.IG23]. While FRS 102 does not include an explicit statement to this effect, it would generally be appropriate to follow the same treatment under FRS 102 where a deemed cost exemption is used. This would avoid an entity that has recognised an asset at a deemed cost equal to its fair value at a particular date increasing its carrying value to recognise interest capitalised before that date. However, the entity could make use of the transition exemption to commence capitalising borrowing costs from the date of transition in accordance with Section 25.

The illustrative example²⁵¹ below shows a first-time adopter that previously adopted a policy of expensing borrowing costs but chooses to adopt a policy of capitalising borrowing costs upon transition to FRS 102, electing to treat the date of transition to FRS 102 as the date on which capitalisation commences in accordance with paragraph 35.10(o). [FRS 102.35.10(o)].

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Illustration 5-3: First-time adopter applying paragraph 35.10(o)

Entity D decided to construct a new building for its own use. Work on the construction commenced during 20X4. Entity D capitalised tangible fixed assets on the basis of cost, in accordance with its previous financial reporting framework, but had not previously constructed any significant assets. As at 31 December 20X4, Entity D had capitalised construction costs of £25,000 and estimated that it still had approximately 9 months of construction work ahead. Entity D had adopted an accounting policy of not capitalising borrowing costs, but if it had, the amount capitalised would have been £300. During 20X5, Entity D completed construction of the building. The total cost to be capitalised in accordance with FRS 102 (excluding borrowing costs) is £90,000. Qualifying borrowing costs calculated in accordance with FRS 102 relating to the project as a whole are £2,500, including the £300 from 20X4.

On transition to FRS 102, Entity D reviews its accounting policies and decides that it will now choose to capitalise borrowing costs in accordance with Section 25. In accordance with paragraph 35.10(o), it chooses to capitalise costs prospectively from 1 January 20X5. As a result, no adjustment is made to the carrying value of the asset at the date of transition (1 January 20X5); the £300 previously written off is not capitalised, but £2,200 of borrowing costs are capitalised during the year ended 31 December 20X5.

5.10 Decommissioning liabilities included in the cost of property, plant and equipment and right-of-use assets

Paragraph 17.10(c) of FRS 102 states that the cost of an item of property, plant and equipment includes the “initial estimate of the costs, recognised and measured in accordance with Section 21 *Provisions and Contingencies*, of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”

A first-time adopter is permitted to elect to measure this component of the cost of an item of property, plant and equipment at the date of transition to FRS 102, rather than on the date(s) when the obligation initially arose. [FRS 102.35.10(i), FRS 102.17.10(c)].

Paragraph 20.47(d) of FRS 102 similarly states that the cost of a right-of-use asset includes an estimate of the costs to be incurred by the lessee, recognised and measured in accordance with Section 21, in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease – unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

A first-time adopter is permitted to elect to measure this component of the cost of a right-of-use asset at the date of transition to FRS 102, rather than on the date(s) when the obligation initially arose.

[FRS 102.35.10(iA), FRS 102.20.47(d)]

IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* contains more detailed requirements than Section 21. An entity might want to consider IFRIC 1 in accounting for changes in existing decommissioning, restoration and similar liabilities and the guidance on the related first-time adoption exemption in IFRS 1. [IFRS 1.D21].

The transition exemptions in IFRS 1 provide a pragmatic approach to determining the decommissioning component of the carrying amount of an item of property, plant and equipment or right-of-use asset. Depreciation and impairment losses on the asset can cause differences between the carrying amount of the liability and the amounts included in the carrying amount of the asset. The transition exemption provides an exemption from determining the changes to the carrying amount of the asset that occurred before the date of transition.

Most previous IFRS and FRS 101 reporters would already be following an accounting treatment for decommissioning provisions (and adjustments to the related assets) consistent with FRS 102 and are unlikely to apply the transition exemptions.

See Chapter 24 at 3.11.1 for discussion of decommissioning provisions.

5.11 Leases

Section 35 provides a number of exemptions for a first-time adopter from full retrospective application of Section 20. These apply to first-time adopters that are lessees except for the transition exemption over assessment of whether a contract existing at the date of transition to FRS 102 contains a lease (see 5.11.1 below) which applies to both lessors and lessees.

Lessors, therefore, classify a lease as operating or financing on the basis of circumstances existing at the inception of the lease. Lease classification is only reassessed if there is a lease modification. Changes in estimates (for example, changes in estimates of the useful economic life or the residual value of the underlying asset) or changes in circumstances (e.g., default of the lessee) do not give rise to a new classification of a lease.

The requirements of Section 20 are largely aligned with IFRS. Unlike IFRS, it does not require land and buildings components to be separated (although we would expect entities applying Section 20 to identify and account for land and building components separately – see Chapter 23 at 7.1.2). Paragraph 20.106 of FRS 102 does address how lease payments are recognised where lease payments in an operating lease are structured to increase in line with expected general inflation which differs to IFRS. This would need to be retrospectively adjusted by an IFRS reporter. See Chapter 23 at 11.3 for further details as to the changes for lessors and Chapter 23 at 2 for differences with IFRS.

Most first-time adopters of FRS 102 will be previous IFRS or FRS 101 reporters and are already following an accounting treatment for leases largely consistent with Section 20 of FRS 102. Nevertheless, there are some implementation issues for lessees to consider that are discussed later in this section.

First-time adopters of FRS 102 that are lessees have a choice of:

(a) If the entity previously applied IFRS 16, applying ‘the IFRS 16 election’ (see 5.11.2 below).

Or

(b) Applying the transition arrangements for entities not applying the IFRS 16 election (see 5.11.3 below).

A lessee applying IFRS 16 for the first time was permitted to make an accounting policy choice between fully retrospective application or modified retrospective application (with two measurement options). In the interests of simplicity, FRS 102 requires a lessee (both on transition to the new requirements for ongoing reporters, and for first-time adopters) to apply the modified retrospective approach and set the right-of-use asset equal to the liability (adjusted for any previously recognised prepayment or accrual of lease payments), unless it chooses the IFRS 16 election available to first-time adopters (or the IFRS 16 option available to ongoing reporters – see Chapter 23 at 11.2.1). [FRS 102.B20.17].

The transition balance sheet, therefore, reflects the right-of-use assets and lease liabilities under both approaches (a) and (b) above, and Section 20 is applied in the current and comparative periods. This differs to the transition for ongoing FRS 102 reporters where comparative periods are not restated and retained earnings (or other component of equity) are adjusted at the beginning of the period of initial application (see Chapter 23 at 11.2). [FRS 102.1.47].

Regardless of the approach taken, a first-time adopter that is a lessee must measure a right-of-use asset that meets the definition of investment property, and which will not be transferred to right-of-use assets using the election in paragraph 16.4A(b)(ii), at fair value on the date of transition to FRS 102. See 5.11.4 below.

5.11.1 Assessment of whether a contract contains a lease

A first-time adopter is allowed to assess whether a contract existing at the date of transition to FRS 102 contains a lease by applying paragraphs 15 to 18 of Section 20 of FRS 102 (see Chapter 23 at 4.1) on the basis of facts and circumstances existing at the date of transition to FRS 102, rather than at the commencement date of the lease. [FRS 102.35.10(x)]. While paragraph 35.10(x) refers to the ‘commencement date’ of the lease, paragraph 20.15 requires the entity to assess whether a contract contains a lease at the inception date of the contract (and this date is referred to in the discussion below). [FRS 102.20.15]. This would not have any effect on application.

Since the transition exemption refers to ‘a contract’, there is no requirement to apply the same lease assessment date to all contracts as at the date of transition. Therefore, it would be possible to classify some leases based on the facts and circumstances at the date of transition, and others at the inception of the contract.

This transition exemption allows an entity to avoid the practical difficulties of going back many years by permitting this assessment to be made at the date of transition to FRS 102. In effect, it determines which leases will be accounted under the new requirements in Section 20, and which under other sections of FRS 102. It is not permitted to apply the old leasing model to contracts which are not assessed as leases using this exemption.

Previous IFRS or FRS 101 reporters could have used a similar transition exemption on first-time adoption of IFRS or FRS 101, [IFRS 1.D9], but if that assessment had been made based on facts and circumstances at the date of transition to IFRS (rather than the earlier inception date of the contract), it would be appropriate for a first-time adopter of FRS 102 to consider whether there were changes in the facts and circumstances between the date of transition to IFRS or FRS 101 and the date of transition to FRS 102 that would mean different contracts contained leases (as defined in FRS 102).

The transitional provisions of IFRS 16 allowed ongoing IFRS reporters to apply IFRS 16 to contracts previously identified as leases applying IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease* (and not to apply IFRS 16 to contracts not identified as leases under those standards), provided this practical expedient was applied to all of its contracts. [IFRS 16.C3]. Previous IFRS or FRS 101 reporters are likely to make use of the IFRS 16 election (see 5.11.2 below) on transition to FRS 102. It is important to note, however, that the IFRS 16 election is a 'measurement' transitional provision rather than one that permits 'grandfathering' of lease assessments. A first-time adopter under FRS 102 would need to reassess whether its contracts contain a lease (as defined under FRS 102) on the basis of facts and circumstances existing either at the date of transition or at the inception date of the contract. This is regardless of whether it applies the IFRS 16 election or the other transitional provision in paragraph 35.10(x) and irrespective of whether it previously had applied paragraph D9 of IFRS 1 or paragraph C3 of IFRS 16. [FRS 102.35.10(x), FRS 102.35.7].

Illustration 5-4 below demonstrates how a first-time adopter determines whether a contractual arrangement contains a lease.

Illustration 5-4: Determining whether an arrangement contains a lease

Entity A's first FRS 102 financial statements are for a period that ends on 31 December 20X6 and include comparative information for 20X5 only. Its date of transition to FRS 102 is 1 January 20X5.

On 1 January 20X3, Entity A entered into a take-or-pay arrangement to supply gas. On 1 January 20X4, there was a change in the contractual terms of the arrangement.

On 1 January 20X5, Entity A could determine whether the arrangement contains a lease under Section 20 on the basis of facts and circumstances existing on that date. Alternatively, Entity A could apply the criteria in Section 20 on the basis of facts and circumstances existing on 1 January 20X3 but will need to reassess the arrangement on 1 January 20X4 in respect of the changes made on that date. [FRS 102.20.15].

5.11.2 IFRS 16 election

A lessee applying IFRS 16 immediately prior to the date of transition to FRS 102 is permitted to use the lease liability and right-of-use asset calculated under IFRS 16 as the lease liability and right-of-use asset on the date of transition to FRS 102 and to rely on its previous assessment of whether right-of-use assets are impaired at the date of transition to FRS 102, rather than applying Section 27 at that date. A lessee making this election is required to disclose that fact and must apply it to all of its leases. [FRS 102.35.10(x)].

This is an optional transition exemption which is intended to promote efficiency within groups. [FRS 102.B20.7].

Additionally, a first-time adopter that is a lessee must measure a right-of-use asset that meets the definition of investment property, and which will not be transferred to right-of-use assets using the election in FRS 102.16.4A(b)(ii), at fair value on the date of transition to FRS 102. See 5.11.4 below.

5.11.2.A Implementation issues

Previous IFRS and FRS 101 reporters are likely to make use of the IFRS 16 election. It could be onerous to use the transitional arrangements in 5.11.3 below since all leases would need to be remeasured using either the incremental borrowing rate or obtainable borrowing rate at the date of transition to FRS 102.

The IFRS 16 election establishes the opening balances of leases in existence at the date of transition and Section 20 applies to lease accounting thereafter. For example, if there was a post-transition lease modification or a change in index or rate affecting a pre-transition lease, the requirements of Section 20 rather than IFRS 16 would be applied.

While Section 20 is not identical to IFRS 16, many of the differences are optional simplifications which can be avoided if an entity wishes to adopt policies close to its previous accounting under IFRS or FRS 101. However, on applying Section 20, an entity could make use of simplifications for subsequent lease accounting, if applicable. [FRS 102.B20.6].

Where the IFRS 16 election is used, the finance cost used in accounting for the lease going forwards would be based on the rate of interest implicit in the lease or incremental borrowing rate that was already being used for the lease accounting under IFRS 16. If this was not the case, the lease accounting would not unwind by the end of the lease. This does not preclude a lessee using a different choice of discount rate (such as the obtainable borrowing rate) for leases entered into post transition as the choice of discount rate applies on a lease-by-lease basis. [FRS 102.20.49].

Illustration 5-5 below demonstrates how a first-time adopter previously applying IFRS 16 applies paragraph 35.10(x).

Illustration 5-5: Transition example for leases - first-time adopter previously applying IFRS 16

Entity B's first FRS 102 financial statements are for a period that ends on 31 December 20X6. Its date of transition to FRS 102 is 1 January 20X5. Its previous financial reporting framework is IFRS.

On 1 January 20X4, Entity B enters into a 3-year lease of equipment, with the following annual payments payable at the end of each year: £10,000 in year one, £12,000 in year two and £14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). The initial measurement of the right-of-use asset and lease liability is £33,000 (present value of lease payments using an incremental borrowing rate of approximately 4.235%).

On 31 December 20X4, its right-of-use asset and lease liability amounts to £22,000 and £24,398, respectively. Applying IAS 36 *Impairment of Assets*, Entity B concludes that its right-of-use asset is not impaired.

On 1 January 20X5, Entity B elects to apply the IFRS 16 election available under paragraph 35.10(x) of FRS 102. Hence, the opening balances at the date of transition are the carrying amounts of the right-of-use asset and lease liability calculated under IFRS 16. Since Entity B has made this election, it must apply this to all of its leases. Entity B also elects to rely on its previous assessment of whether the right-of-use asset is impaired.

[FRS 102.35.10(x)].

Entity B subsequently measures its right-of-use asset in accordance with paragraph 20.55 to 20.61 and its lease liability in accordance with paragraphs 20.62 to 20.64 of FRS 102.

5.11.3 Transition arrangements for lessees not applying the IFRS 16 election

Where an entity is not eligible to or chooses not to apply the IFRS 16 election, the entity uses the transition exemption to measure the lease liability at the date of transition to FRS 102 at the present value of remaining lease payments, discounted using the lessee's incremental borrowing rate or the lessee's obtainable borrowing rate for each lease at the date of transition to FRS 102. The right-of-use asset must then be measured at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments. [FRS 102.35.10(x)].

Additionally, a first-time adopter that is a lessee must measure a right-of-use asset that meets the definition of investment property, and which will not be transferred to right-of-use assets using the election in paragraph 16.4A(b)(ii), at fair value on the date of transition to FRS 102. See 5.11.4 below.

[FRS 102.35.10(x)].

A lessee is allowed to use one or more of the following practical expedients at the date of transition to FRS 102 (applied on a lease-by-lease basis):

- (i) Apply a single discount rate to a portfolio of leases with reasonably similar characteristics (e.g., a similar remaining lease term for a similar class of underlying asset in a similar economic environment).
- (ii) Choose not to recognise a lease liability and right-of-use asset for leases for which the lease term ends within 12 months of the date of transition to FRS 102, or leases for which the underlying asset is of low value (as described in paragraph 20.5). Instead, the entity must account for (and disclose information about) these leases as if they were short-term leases accounted for in accordance with paragraph 20.6.
- (iii) Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. [FRS 102.35.10(x)].

The above transition exemptions are similar but not identical to those available under IFRS. Under Section 35, like Section 20, an entity is permitted to choose either the incremental borrowing rate or obtainable borrowing rate to discount the lease payments on a lease-by-lease basis. The use of the obtainable borrowing rate is not permitted under IFRS.

5.11.3.A Implementation issues

As noted at 5.11.2 above, previous IFRS and FRS 101 reporters are likely to make use of the IFRS 16 election.

A first-time adopter must consider certain implementation issues as follows:

- As mentioned in Chapter 23 at 11.2.2, Section 1 *Scope* of FRS 102 (which applies to ongoing FRS 102 reporters) does not specify whether the lessee's incremental borrowing rate or obtainable borrowing rate at the date of transition for ongoing reporters should be determined based on the original lease term or the remaining lease term.

Section 35 also does not provide explicit guidance for first-time adopters.

How we see it

We believe that a lessee has an accounting policy choice to use either the original lease term or remaining lease term to determine the incremental borrowing rate or obtainable borrowing rate at the date of transition. The policy chosen needs to be consistently applied and disclosed in the financial statements.

- Although a lessee is allowed to use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease, neither Section 35 nor Section 1 provide detailed guidance on the use of hindsight.

How we see it

As explained in Chapter 23 at 11.2.2 for ongoing reporters, we believe that hindsight can be applied only to matters of judgement and estimates and therefore would not apply to matters of fact such as changes to an index or rate. We believe the same view applies to first-time adopters.

- Paragraph 35.10(x) does not specify how to account for onerous leases at the date of transition for a first-time adopter lessee not applying the IFRS 16 election. In most cases, a right-of-use asset and lease liability will now be recognised applying the transitional exemption although there will be situations where this is not the case. It is possible for leases still to give rise to onerous provisions in certain cases (e.g., where the low value exemption or short-term lease exemption is applied to the lease, or where a lease has become onerous before the commencement date of the lease). See Chapter 24 at 3.3.1.A for further discussion of when onerous provisions are recognised. As explained in 3.4.2 above, while FRS 102 does not specifically call for an impairment test of assets other than exploration and evaluation assets at the date of transition to FRS 102, a first-time adopter should be mindful that there are no exemptions from full retrospective application of the requirements set out in Section 27. Therefore, an entity must consider whether there is an indicator of impairment for right-of-use assets at the date of transition that might require an impairment test to be performed.

5.11.4 Investment property

Regardless of the approach taken on transition (see 5.11 above), if the right-of-use asset meets the definition of investment property (see Chapter 19 at 3.1), the entity must measure the right-of-use asset at fair value on the date of transition. This is unless the entity rents investment property to another group entity and the first-time adopter chooses to account for such properties using the cost model rather than at fair value, as permitted by paragraph 16.4A(b)(ii). [FRS 102.16.4A(b)(ii), FRS 102.35.10(x)].

First-time adopters applying IFRS or FRS 101 might have used the cost model as IAS 40 *Investment Property* allows a choice of the cost or fair value model.

Since investment properties are carried at fair value through profit or loss using the fair value accounting rules that apply to UK companies and LLPs, any adjustment to the carrying amount of the investment property (and any related deferred tax) could be reflected in retained earnings on transition. Revaluation gains over historical cost would not usually be realised. The FRC notes that entities measuring investment property at fair value may transfer fair value movements that are not distributable profits to a non-distributable reserve (but are not required to do so) which may assist in identifying profits available for distribution. [FRS 102.A3.28].

Illustration 5-6: Transition example for leases - right-of-use asset that meets the definition of investment property

On 1 January 20X3, Entity A (original lessee/ intermediate lessor), an IFRS reporter, enters into a ten-year lease for 5,000 square metres of office space (the head lease) with Entity B (the head lessor). At commencement of the head lease, Entity A subleases the 5,000 square metres of office space for four years to Entity C (the sublessee).

Having considered the requirements of IFRS 16, Entity A classifies the sublease as operating lease. In accordance with IAS 40, the right-of-use asset meets the definition of investment property. Entity A's accounting policy for its investment property under IFRS is to apply the cost model. This example ignores tax effects (including deferred tax).

As of 31 December 20X4, the right-of-use asset and lease liability related to this lease amounted to £5,888 and £6,210, respectively.

Entity A adopts FRS 102. The date of transition is 1 January 20X5 and Entity A prepares its first FRS 102 financial statements for the accounting period beginning 1 January 20X6.

Entity A has chosen to apply the IFRS 16 election in accordance with FRS 102 paragraph 35.10(x). Therefore, it has used its lease liability calculated under IFRS 16 of £6,210 as the lease liability on date of transition to FRS 102.

The right-of-use asset meets the definition of investment property under Section 16 *Investment Property*. Entity A measures the right-of-use asset at its fair value (excluding lease payments) on the date of transition of £6,000. Entity A recognises a credit to retained earnings of £112 (£6,000 - £5,888) on the date of transition.

5.11.5 Implementation issues

Certain implementation issues that a first-time adopter must consider are discussed below.

- As explained in Chapter 23 at 6.2.1, some lease arrangements may contain a government grant or non-exchange transaction for a public benefit entity, for example when lease payments are significantly below market rents. The lessee is required to account for such incoming resources in accordance with the requirements of Section 24 *Government Grants* (when a lease component contains a government grant) or, for a public benefit entity, paragraphs PBE 34.63-PBE 34.74 (when a lease component contains a non-exchange transaction) by recognising the non-exchange component as a contribution to the cost of the right-of-use asset. The resulting impact is that carrying value of the right-of-use asset will be higher than the contractual lease payments would imply. [FRS 102.20.47(e), FRS 102.B20.16]. In the discussion that follows, reference to incoming resources from a government grant or non-exchange transaction for a public benefit entity, is referred to as a 'non-exchange component'. A related situation arises when an entity receives a monetary government grant, say in the form of cash, in respect of entering into a separate lease contract.

IFRS 16 does not provide specific guidance on accounting for leases containing a non-exchange component. In particular, it does not specifically require an entity to account for the incoming resources as a contribution to the right-of-use asset (together with a separate credit) as FRS 102 now does. Further, there are some differences between the recognition and measurement requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and Section 24 when accounting for a government grant, whether that arises from a non-exchange component in a lease contract with the government as lessor or a separate government grant in respect of a lease. The following discussion covers some of the issues that arise when grants have been accounted for under IFRS in a manner that is different from the requirements of FRS 102:

- Grants previously recognised under IFRS at nominal amount

Section 24 requires grants to be measured at the fair value of the asset received or receivable, unlike IAS 20 which permits non-monetary government grants to be recorded, alternatively, at a nominal amount. [FRS 102.24.5, IAS 20.23].

Where an entity chooses to apply the transition exemption in paragraph 35.10(x) (either applying or not applying the IFRS 16 election) on first time adoption of FRS 102 and has leases that contain non-monetary non-exchange component (e.g., leases at below-market rates) that had previously been recognised at nominal amount under IFRS, paragraph 35.10(x) is silent as to whether the entity would adjust the right-of-use asset to reflect the non-exchange component in the lease. [FRS 102.35.10(x)].

A view that could be taken is that paragraph 35.10(x) does not require the entity to adjust the right-of-use asset calculated under IFRS 16 (where the IFRS 16 election is applied) or the other

transitional exemption to reflect the non-exchange component. [FRS 102.35.10(x)]. However, as there is no exemption in Section 35 relating to the recognition of the non-exchange component under Sections 24, an alternative view is that in order to comply with the requirements of that section, the lessee must, at the date of transition, adjust the right-of-use asset.

How we see it

In our view, lessees have an accounting policy choice of whether or not to adjust the right-of-use asset (determined using the IFRS 16 election or other transitional exemption in paragraph 35.10(x)) in the manner required under Section 20 and Section 24. The policy adopted is applied consistently to all leases containing a non-exchange component.

The discussion above applies similarly to a public benefit entity in receipt of incoming resources from a non-exchange transaction applying Section 20 and Section 34.

- Grants recognised under IFRS which have been deducted from the right-of-use asset
IAS 20 permits government grants to be deducted from the related asset rather than being shown as deferred income. FRS 102 does not permit the deduction of the grant from the related asset. [IAS 20.24, FRS 102.24.5B, FRS 102.24.5G].

Where a first-time adopter that is a lessee previously received a monetary grant in respect of lease contract which is deducted from the right-of-use asset as permitted by paragraph 24 of IAS 20, the right-of-use asset would be presented at an amount lower than would have been calculated under IFRS 16.

Where a first-time adopter applies the IFRS 16 election in paragraph 35.10(x), Section 35 is silent as to whether the first-time adopter would exclude the effect of this netting and present separately the government grant.

How we see it

We believe such an entity must gross up the right-of-use asset for the amount of the grant that was presented net. This is because the IFRS 16 election in paragraph 35.10(x) requires the lessee to use "...the lease liability and right-of-use asset calculated under IFRS 16 ..." The deduction of a government grant from a right-of-use asset in accordance with paragraph 24 of IAS 20 is a presentation matter, and in our view is not a calculation that arose under IFRS 16. Furthermore, paragraph 96 of Section 2 does not permit the offsetting of assets and liabilities unless required or permitted by FRS 102 nor is this permitted by Sections 20 and 24.

The accounting for any non-exchange component would, therefore, follow the requirements of Section 24 (applying the accruals model or performance model under the lessee's existing accounting policy).

Illustration 5-7 below provides an example of how a lessee accounts for a monetary grant deducted from a right of use asset under IFRS.

Illustration 5-7: Monetary grant previously deducted from a right-of-use asset under IFRS

On 1 January 20X3, Entity A, an IFRS reporter, entered into a five-year lease of a property with a lessor. The annual lease payments are £1,000 (paid in advance). Entity A concluded that it cannot readily determine the interest rate implicit in the lease and calculated a right-of-use asset of £4,500*, as at 1 January 20X3, under IFRS 16 using its incremental borrowing rate of 5.56%. The government provided a cash grant of £2,500 to Entity A in relation to the leased property. Entity A's accounting policy under IAS 20 is to deduct the grant in arriving at the carrying amount of the right-of-use asset so that the carrying amount of the right-of-use asset on 1 January 20X3 after netting off is £2,000.

Entity A adopts FRS 102 with a date of transition of 1 January 20X5 and prepares its first FRS 102 financial statements for the accounting period beginning 1 January 20X6. It applies the IFRS 16 election in paragraph 35.10(x). The carrying amount of the right-of-use asset in Entity A's IFRS financial statements immediately before the date of transition is £1,200.†

As stated above, we believe that the entity must exclude the effect of netting off previously made under IFRS. Therefore, on the date of transition, Entity A would recognise the right-of-use asset at the amount calculated under IFRS 16 being £2,700 (grossed up for the grant),** with a related lease liability (unchanged from IFRS) of £2,845.††

Section 24 allows for an accounting policy choice between the accruals model and performance model for government grants (on a class-by-class basis) whereas IAS 20 requires the accruals model to be applied. [FRS 102.24.5B, FRS 102.24.5C]. Entity A, under FRS 102, chooses to apply the accruals model as its accounting policy, and so the grossing up of the grant would result in recognition of deferred income of £1,500[†]. On the date of transition, the journal entry is:

Dr	Right-of-use asset	£1,500	
	Cr	Deferred income	£1,500
*	This is calculated as the present value of £1,000 annual payments made in advance over 5 years using a discount rate of 5.56%.		
**	The carrying amount of the right-of-use asset before deducting the grant calculated under IFRS 16 is £2,700 (£4,500 less £1,800 for two years of depreciation).		
†	Under the accruals model under IFRS or Section 24, grants related to assets, including right-of-use assets, are recognised in income on a systematic basis over the expected useful life of the asset. Therefore, the deferred income recognised under the accruals model is £1,500 (£2,500 less £1,000 for amounts recognised in income over the two years since lease commencement).		
††	This is calculated as the present value of £1,000 annual payments made in advance over 3 years (remaining period) using a discount rate of 5.56%.		
‡	This is £2,000 of initial amount of right-of-use asset after netting off the grant x 3/5 (based on three years remaining of a 5-year lease term).		

- Under IFRS 16, when an entity enters into a sale and leaseback transaction and the transfer of the asset from the seller-lessee to the buyer-lessor qualifies as a sale in accordance with the requirements of IFRS 15 *Revenue from Contracts with Customers*, the seller-lessee is required to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. [IFRS 16.100(a)]. Under Section 20 however, where an entity enters into a sale and leaseback transaction and the transfer of the asset qualifies as a sale in accordance with Section 23, entities have an accounting policy choice in respect of the measurement of the right-of-use asset and the treatment of any gain to either: [FRS 102.20.123(a)]
 - Measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor (a policy aligned to the required approach under IFRS 16 - although IFRS provides more guidance than Section 20 on how this approach might be applied (see Chapter 23 at 9.2.1.A)).
 - Or
 - Measure the right-of-use asset arising from the leaseback at cost in accordance with the general principles of initial measurement in paragraph 46 of Section 20 (the normal initial measurement requirements for right-of-use assets), with any excess of the sale proceeds over the previous carrying amount of the asset deferred, and amortised over the lease term, and any shortfall of the sales proceeds under the carrying amount recognised immediately in profit or loss. This option is not available under IFRS 16 (see Chapter 23 at 2.7).

Any off-market terms arising from the sale and leaseback transaction must be adjusted (see Chapter 23 at 9.2.3). [FRS 102.20.124, FRS 102.20.125].

If a seller-lessee that is a first-time adopter previously applied IFRS or FRS 101, it is likely to apply the IFRS 16 election and therefore use the first option above if it had entered into a sale and leaseback prior to the date of transition to FRS 102.

5.12 Revenue from contracts with customers

As part of the Periodic Review 2024 amendments, the legacy Section 23 *Revenue*, which included revenue recognition requirements based on IAS 11 *Construction Contracts* and IAS 18 *Revenue*, was entirely replaced with a new Section 23, providing a new five-step revenue recognition model based on IFRS 15 for accounting for revenue from contracts with customers. [FRS 102.B23.1].

Section 35 includes the following transition exemptions in relation to Section 23. The requirements of Section 23 are discussed in Chapter 25.

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(b) Revenue from Contracts with Customers

A first-time adopter may apply the transitional provisions in paragraph 1.65. If a first-time adopter decides to apply those transitional provisions, it shall also apply paragraph 1.66.

For the purposes of applying paragraph 1.65 in the context of this paragraph:

(i) references to the date of initial application shall be read as to the beginning of the reporting period; and

(ii) a completed contract is a contract for which an entity has transferred all of the goods or services identified in accordance with the entity's previous financial reporting framework.

A first-time adopter shall disclose the information required by paragraph 1.65.

First-time adopters that do not take advantage of the transition exemption in paragraph 35.10(y) would apply the new requirements in Section 23 fully retrospectively, i.e., as if those requirements had applied since the inception of all of its contracts with customers that are presented in the financial statements.

As the transition arrangements available to ongoing FRS 102 reporters do not apply to first-time adopters (unless included in Section 35), a first-time adopter must apply the requirements of Section 23 using the full retrospective method (and cannot use the modified retrospective method set out in paragraph 1.61(a) for ongoing reporters – see Chapter 25 at 12.2.4). However, to ease the potential burden of applying Section 23's requirements fully retrospectively, paragraph 35.10(y) allows a first-time adopter to make use of the same optional practical expedients as set out in paragraph 1.65 (for ongoing FRS 102 reporters).

[FRS 102.1.65, FRS 102.35.10(y)].

Accordingly, a first-time adopter is permitted to use one or more of the following practical expedients when applying Section 23 retrospectively and not to restate for contracts that were completed before the earliest period presented (i.e., the date of transition to FRS 102). [FRS 102.35.10(y)].

Below are the practical expedients in paragraph 1.65 as applied to a first-time adopter: [FRS 102.1.65, FRS 102.35.10(y)]

(a) For completed contracts, an entity need not restate for contracts that:

(i) Begin and end within the same annual reporting period.

Or

(ii) Are completed contracts at the date of transition to FRS 102. [FRS 102.1.65].

(b) For completed contracts that have variable consideration, an entity is allowed to use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods. The FRC's FRS 102 Factsheet 7 *Transition to FRS 102* clarifies that this exemption is available for contracts with variable consideration which are completed by the reporting date (i.e., the end of the first FRS 102 reporting period).²⁵²

(c) For contracts that were modified before the beginning of the reporting period, an entity need not retrospectively restate the contract for those contract modifications in accordance with paragraphs 23.15 and 23.16 (see Chapter 25 at 4.4). Instead, an entity is permitted to reflect the aggregate effect of all of the modifications that occur before the date of transition to FRS 102 or before the beginning of the reporting period when: [FRS 102.23.15, FRS 102.23.16]

(i) Identifying the satisfied and unsatisfied performance obligations.

(ii) Determining the transaction price.

(iii) Allocating the transaction price to the satisfied and unsatisfied performance obligations.

(d) For prior periods presented, an entity need not disclose the quantitative or qualitative explanation of the significance of unsatisfied performance obligations and when they are expected to be satisfied as required by paragraph 23.137 (see Chapter 25 at 11.4.1.D). [FRS 102.23.137].

For the purposes of Section 23, paragraph 35.10(y) defines a 'completed contract' as "a contract for which the entity has transferred all of the goods or services identified in accordance with the entity's previous

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financial reporting framework." [FRS 102.35.10(y)]. See 5.12.1 below for discussion of completed contracts. See 5.12.2.D below for the accounting for completed contracts that are not restated under new Section 23. Even where the previous financial reporting framework was IFRS or FRS 101, this practical expedient might be relevant to use.

A first-time adopter is allowed to elect to apply one, some, or all of these expedients. However, if an entity elects to use any of them, it must apply that expedient consistently to all contracts and periods presented and disclose that fact. Section 23, unlike IFRS 15, does not require a qualitative assessment of the estimated effect of applying each of those expedients. [FRS 102.35.10(y), FRS 102.1.66, IFRS 15.C6].

The FRC notes that the practical expedients in paragraph 1.65 (b) and (c) allow greater use of hindsight when estimating variable consideration and evaluating contract modifications than was permitted for ongoing IFRS reporters and first-time adopters of IFRS implementing IFRS 15's requirements for the first time. [FRS 102.B23.9]. The use of hindsight is explained in detail in Chapter 25 at 12.2.3 and 12.2.5.

How we see it

While the practical expedients provide some relief, adoption of Section 23 could be challenging if the first-time adopter has not previously applied adopted IFRS or FRS 101 and first-time adopters will still need to use judgement and make estimates. For example, first-time adopters will need to use judgement in estimating stand-alone selling prices if there has been a wide range of selling prices and when allocating the transaction price to satisfied and unsatisfied performance obligations if there have been several performance obligations or contract modifications over an extended period.

Furthermore, if a first-time adopter applies the practical expedient for contract modifications, it will still have to apply Section 23's contract modification requirements (see Chapter 25 at 4.4) to either: (a) modifications made after the beginning of the earliest period presented (i.e., the date of transition to FRS 102); or (b) modifications made after the beginning of the reporting period.

Illustration 5-8 below demonstrates the practical expedient for contract modifications.

Illustration 5-8: Transition practical expedient for contract modifications

Entity A entered into a contract with a customer to sell equipment for £1 million and provide services for five years for £20,000 annually.

The equipment was delivered on 1 January 20X1 and the service contract commenced at that time. The equipment and the service contract are separate performance obligations.

On 1 July 20X3, the contract was modified to extend the provision of service by two years.

On 1 July 20X4, the contract was further modified to extend the provision of service by three years.

On 1 July 20X5, the contract was further modified to provide an additional piece of equipment for £1 million. The additional equipment will be delivered during 20X6 and is a separate performance obligation.

Entity A adopts FRS 102. The date of transition is 1 January 20X5 and Entity A prepares its first FRS 102 financial statements for the accounting period beginning 1 January 20X6. It applies the practical expedient on contract modifications in accordance with paragraph 1.65(c). [FRS 102.35.10(y), FRS 102.1.65(c)].

Entity A has two options:

- Entity A could elect to reflect the aggregate effect of modifications that occurred before 1 January 20X6 (the beginning of the reporting period). The total transaction price for the modified contract is £2,200,000 [(£1 million (equipment)) + £1 million (equipment) + (10 years × £20,000 (service))], which is allocated to the two products and the service contract based on the relative stand-alone selling price of each performance obligation.
- Entity A could elect to reflect the aggregate effect of modifications that occurred before 1 January 20X5 (the date of transition). In this instance, the total transaction price for the modified contract occurred before 1 January 20X5 is £1,200,000 [£1 million (equipment) + (10 years × £20,000 (service))], which is allocated to the first product and the service contract based on the relative stand-alone selling price of each performance obligation.

Entity A is still required to apply Section 23's contract modification requirements to modifications made after 1 January 20X5. Accordingly, the modification on 1 July 20X5 for an additional piece of equipment is accounted for from that date applying paragraphs 23.13 to 23.16 (see Chapter 25 at 4.4). This approach is the same as IFRS 15. [IFRS 15.C5(a)(ii)].

See Chapter 25 at 7 for discussion on allocating the transaction price to performance obligations. In both cases above, the transaction price allocated to the second piece of equipment and the remaining unperformed services would be recognised when or as they are transferred to the customer.

When adopting Section 23 as part of its transition to FRS 102, a first-time adopter needs to analyse each of its contracts to determine the appropriate timing and pattern of recognition, considering the specific criteria and requirements of the standard. In some instances, this could result in a change in the timing and/or pattern of revenue recognition compared to its previous financial reporting framework. An example of such a change in the timing of revenue recognition would be a contract manufacturer that produces goods designed to a customer's unique specifications where the goods do not have an alternative use. If the manufacturer also has an enforceable right to payment for performance completed to date, the third criterion in Section 23 to recognise revenue over time would be met, [FRS 102.23.81(c)], (see Chapter 25 at 8.1 for further discussion), even though the manufacturer might have recognised revenue at a point in time under its previous financial reporting framework (e.g., based on the number of units produced or units delivered).

Other application issues that could make adopting Section 23 as part of transitioning to FRS 102 difficult and/or time-consuming, include the following:

- A first-time adopter will have to perform an allocation of the transaction price because of changes to the identified deliverables, the transaction price or both. If its previous financial reporting framework required a method that is similar to the requirements in Section 23 or IFRS 15 (which will often be the case for a first-time adopter of FRS 102), this step might be straightforward. Regardless, a first-time adopter is required to determine the stand-alone selling price of each performance obligation as at inception of the contract. Depending on the age of the contract, this information might not be readily available, and the prices could differ significantly from current stand-alone selling prices. While the practical expedients in paragraph 1.65 are clear about when it is acceptable to use hindsight in respect of variable consideration to determine the transaction price (see Chapter 25 at 6.2 for a discussion on variable consideration), the practical expedients are silent on whether the use of hindsight is acceptable for other aspects of the model (e.g., for the purpose of allocating the transaction price) or whether it is acceptable to use current pricing information if that were the only information available.
- Estimating variable consideration for all contracts for prior periods is likely to require significant judgement. The standard is clear that hindsight cannot be used for contracts that are not completed. As a result, entities must make this estimate based only on information that was available at contract inception for contracts that are not completed. Contemporaneous documentation clarifying what information was available to management, and when it was available, is likely to be needed to support these estimates. In addition to estimating variable consideration using the expected value or a most likely amount method, a first-time adopter must make conclusions about whether such variable consideration is subject to the constraint (see Chapter 25 at 6.2.3 for further discussion). In particular, it is important to note that Section 23's requirements on variable consideration differ from those in IFRS 15 (see Chapter 25 at 2.4).

5.12.1 Definition of a completed contract

For the purposes of Section 25, a 'completed contract' is a contract for which the entity has transferred all of the goods or services identified in accordance with the entity's previous financial reporting framework. [FRS 102.35.10(y)(ii)].

Depending on the practical expedients a first-time adopter chooses to apply, it need not apply Section 23 to contracts if it has completed performance before the earliest period presented, i.e., the date of transition to FRS 102, even if it has not yet received the consideration and that consideration is still subject to variability (see further discussion in Chapter 25 at 12.2.1). It also need not apply Section 23 to completed contracts that begin and end within the same annual reporting period (for example, that started and finished in the comparative period).

FRS 102 does not provide guidance on the meaning of 'transferred all of the goods or services.' However, with reference to IFRS 15, the IASB noted in the Basis for Conclusions that the phrase is not meant to imply that an entity would apply the 'transfer of control' notion in IFRS 15 to goods or services that have been identified in accordance with previous financial reporting framework. Rather, it is performance in accordance with the previous financial reporting framework. [IFRS 15.BC441]. For example, if the previous financial reporting framework has similar requirements to legacy revenue requirements in IFRS (i.e., IAS 11, IAS 18 and related Interpretations), legacy Section 23 of FRS 102, in many situations the term 'transferred' would mean 'delivered' within the context of contracts for the sale of goods and 'performed' within the context of contracts for rendering services and construction contracts. In some situations, the entity would use judgement when determining whether it has transferred goods or services to the customer. [IFRS 15.BC445D].

5.12.2 Implementation questions on definition of a completed contract

5.12.2.A Elements in a contract to be considered

When determining whether a contract meets the definition of a completed contract, a first-time adopter must consider all of the elements (or components) in a contract that give rise to revenue in its previous financial reporting framework. It does not consider the elements of a contract that do not result in recognition of revenue when assessing whether a contract is completed.

For example, under its previous financial reporting framework, an entity might have accounted for a financing component (i.e., separating the interest income or expense from the revenue). Doing so effectively splits the contract into a revenue component and a financing component.

How we see it

In our view, the financing component generally would not be considered in determining whether the goods or services have transferred to the customer (i.e., it would generally not affect the assessment of whether the contract meets the definition of a completed contract). In addition, income elements that are not within the scope of Section 23 need not be considered even if they were covered by revenue requirements in the previous financial reporting framework.

None of the following, for example, would be considered when determining whether a contract meets the definition of a completed contract because they are within the scope of Sections 11 and 12, not Section 23:

- Dividends [FRS 102.11.14A, FRS 102.12.9A]
 - Fees integral to the issuance of a financial instrument (see Chapter 13 at 6.2) [FRS 102.11.18]
- Or
- Interest income that is accounted for in accordance with the effective interest method (see Chapter 13 at 6.2) [FRS 102.11.14(a)]

5.12.2.B Identification of a contract under previous financial reporting framework

When determining whether a contract is completed, a first-time adopter considers the requirements of its previous financial reporting framework and not Section 23.

How we see it

In order to determine whether a contract is completed, a first-time adopter needs to determine the boundaries of a contract, including the term of the contract, whether it was combined with other contracts, whether it was modified, etc. That is, a first-time adopter must identify what is the contract in order to assess if it meets the definition of a completed contract as discussed further below.

Section 23 provides detailed requirements to assist entities in identifying a contract, including determining the contract duration. Considering the requirements of Section 23 could lead to different outcomes from the previous financial reporting framework (e.g., an entity might conclude a contract is of a shorter duration than the stated contractual term in certain circumstances under Section 23). See Chapter 25 at 4.2 for further discussion.

If the previous financial reporting framework was IFRS or FRS 101, IFRS 15 provides detailed guidance on the identification of the contract as a starting point for determining the revenue recognition. [IFRS 15.9-16].

While a first-time adopter's previous financial reporting framework might not have provided detailed requirements for identifying the contract, its accounting policies and past practice might be informative in identifying the contract, including determining: (a) what the first-time adopter considered the contract to be (e.g., master supply agreement or individual purchase orders); and (b) the contract duration (i.e., the stated contractual term or a shorter period). Consider the examples in Illustration 5-9 below.

Illustration 5-9: Definition of completed contract: contract duration**Scenario 1**

On 30 June 20X4, Entity B entered into a contract with a customer to provide services for 24 months. The customer was required to pay a fixed monthly fee of £150, which remained constant during the contract term of 24 months, regardless of the time needed to provide the services or the actual usage from the customer each day. The customer could cancel the contract at any time without penalty by giving Entity B one month's notice. Entity B had not received any cancellation notice up to 1 January 20X5 and, based on past experience, Entity B did not expect customers to cancel within the first year. For this contract, Entity B had concluded that the contract duration under its previous financial reporting framework was the stated contractual term of 24 months.

Entity B's accounting policy for these types of contracts under its previous financial reporting framework stated that revenue from providing monthly services to customers was recognised over the service period, on a monthly basis. While not explicitly stated in its accounting policy, Entity B had typically treated the stated contractual term as the duration of the contract (unless the customer cancelled or the contract was modified), and considered this to be the period over which the contractual rights and obligations were enforceable.

Assume that Entity B adopts FRS 102 for the first time for the year ended 31 December 20X6. Entity B uses the practical expedient in paragraph 1.65(a)(ii) not to restate contracts that are completed contracts at the date of transition to FRS 102 (i.e., 1 January 20X5; Entity B presents one comparative period only). [FRS 102.1.65(a)(ii)].

Under Section 23, Entity B is likely to conclude that the contract is a month-to-month contract. However, when determining whether the contract is completed, Entity B only considers the requirements of its previous financial reporting framework. Entity B might have noted that its previous accounting policy did not focus on the identification of contract duration and, therefore, perhaps the contract is neither a 24-month contract nor a month-to-month contract. Entity B had accounted for this type of service contract based on monthly invoicing and, arguably, that accounting treatment is similar to the accounting treatment of a month-to-month contract. However, while not explicitly stated, Entity B had generally viewed the stated contractual term as the period over which the rights and obligations are enforceable.

Furthermore, Entity B cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which would limit Entity B's obligation to provide services for the next 30 days from the notification date. Since no cancellation notice had been submitted by the customer at least one month before 1 January 20X5, approximately 18 months of services still had to be provided as at the date of transition to FRS 102 (i.e., 1 January 20X5). Therefore, Entity B concludes that the contract does not meet the definition of a completed contract and would need to be transitioned to Section 23.

Scenario 2

Assume the same facts as Scenario 1, with the exception that the customer submitted an early termination notice on 30 November 20X4.

Similar to Scenario 1, the contract duration under previous financial reporting framework would have been the stated contractual term of 24 months. However, in this scenario, the customer has submitted the termination notice on 30 November 20X4. Therefore, Entity B concludes that the term of the contract ceased on 31 December 20X4.

Entity B cannot cancel the contract with the customer and is obliged to render services for the entire contract period of 24 months, unless a termination notice is provided by the customer which limits Entity B's obligation to provide service to the next 30 days from the notification date. Since Entity B had provided all services prior to 31 December 20X4, Entity B concludes that the contract is a completed contract. Entity B continues to apply its previous accounting policy to any remaining consideration still to be recognised.

Scenario 3

Assume the same facts as Scenario 1, with the exception that the customer was required to pay a non-refundable upfront fee of £50 at commencement of the contract (in addition to the monthly fixed fee). The customer can cancel the contract at any time without penalty, with a month's notice period. The customer cancelled the contract on 30 November 20X4.

In its financial statements, Entity B's accounting policy for these types of contracts under its previous financial reporting framework stated that revenues from non-refundable upfront fees were deferred over the average customer retention period. The customer retention period was estimated to be two years, and the deferred revenue was recognised as revenue on a straight-line basis over the next 24 months.

Similar to Scenario 2, the contract duration under its previous financial reporting framework would have been the stated contractual term of 24 months. However, the customer had submitted the termination notice on 30 November 20X4 and, therefore, Entity B concludes that the term of the contract ceases on 31 December 20X4.

Entity B's previous accounting policy for the non-refundable upfront fee referred to recognition of deferred income over the average customer retention period, not the contractual term. The definition of a completed contract is not dependent on all revenue being recognised, but rather on all goods and services being transferred to the customer. Furthermore, the period over which revenue is recognised does not affect the contract duration. As such, recognition of this upfront fee is not relevant in determining whether the contract is a completed contract. All previously contracted services had been provided to the customer up to the date of cancellation. Therefore, the contract is a completed contract.

Entity B continues applying its previous accounting policy to any remaining consideration still to be recognised. However, given that the customer has terminated the contract early, Entity B needs to reassess, in line with the requirements of its previous financial reporting framework, the period over which this remaining revenue arising from the non-refundable upfront fee would be recognised.

5.12.2.C Some or all of the revenue has not been recognised under previous financial reporting framework

If some or all of the revenue has not been recognised under a first-time adopter's previous financial reporting framework, this could possibly prevent the contract from being completed.

How we see it

The definition of a completed contract is not dependent on a first-time adopter having recognised all related revenue. However, the requirements in its previous financial reporting framework with respect to the timing of recognition might provide an indication of whether the goods or services have been transferred.

Illustration 5-10 below discusses a scenario where revenue has not been recognised under a first-time adopter's previous financial reporting framework that was IFRS:

Illustration 5-10: Revenue has not been recognised under previous financial reporting framework

On 31 December 20X4, a first-time adopter, previously applying IFRS, sells a product to a customer for £121 that is payable 24 months after delivery. The customer obtains control of the product at contract inception. The contract permits the customer to return the product within 90 days. The product is new and the entity has no relevant historical evidence of product returns or other available market evidence.

The cash selling price of the product is £100, which represents the amount that the customer would pay upon delivery for the same product sold under otherwise identical terms and conditions as at contract inception. The entity's cost of the product is £80. Assume that the contract appropriately includes a significant financing component under IFRS 15.

The entity does not recognise revenue under IFRS 15 when control of the product transfers to the customer. This is because the existence of the right of return and the lack of relevant historical evidence means that the entity cannot conclude that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur in accordance with paragraphs 56-58 of IFRS 15. Consequently, revenue is recognised after three months, when the right of return lapses (i.e., in 20X5).

On 1 January 20X5, the entity transitions to FRS 102. The entity concludes that the contract is a completed contract under previous financial reporting framework (IFRS). This is because the entity has transferred all of the goods or services identified in accordance with its previous financial reporting framework. Consequently, the revenue to be recognised in 20X5 is to be accounted for under IFRS.

5.12.2.D Accounting for completed contracts excluded from transition

Depending on the practical expedients a first-time adopter applies, it might exclude contracts that meet the definition of a completed contract from the population of contracts to be transitioned to Section 23 (i.e., it would not need to restate those contracts) (see Illustration 5-10 in section 5.12.2.B above).

Section 35 clarifies that if a first-time adopter chooses not to apply Section 23 to completed contracts, it must continue to account for the completed contracts in accordance with its accounting policies based on its previous financial reporting framework. [FRS 102.35.10(y), FRS 102.1.65(a)(ii)].

A first-time adopter that previously reported under IFRS or FRS 101 (and, therefore, applied IFRS 15) also needs to consider if it has contracts that were 'completed contracts' when it first adopted IFRS 15 to which it is still applying legacy accounting standards (e.g., IAS 18). In these cases, the first-time adopter continues to apply the legacy accounting standards for those contracts.

In addition, use of the practical expedient not to restate completed contracts would still allow a previous IFRS or FRS 101 reporter to make use of simplifications in Section 23 compared to IFRS 15 when accounting for its ongoing contracts, without restating completed contracts on the same basis. For example, it would be possible for a first-time-adopter not to adjust payments received in advance for the effects of the time value of money on contracts that are not completed contracts by the reporting date, [FRS 102.23.59, FRS 102.35.10(y)], even if a significant financing component was previously identified in accordance with IFRS 15 on these contracts and on similar contracts which have not been restated because they are completed contracts.

5.12.3 Transition issues where a previous IFRS or FRS 101 reporter applies Section 23

The only transition provisions in Section 35 and paragraph 1.65 relating to revenue recognition address completed contracts (see 5.12, 5.12.1 and 5.12.2 above) and contract modifications that occurred before the beginning of the reporting period (see 5.12 above). [FRS 102.35.10(y), FRS 102.1.65].

Entities will therefore need to apply the full retrospective method to contracts that are not completed contracts at the date of transition. A previous IFRS or FRS 101 reporter is not expected to have many transition adjustments given the alignment of the new Section 23 with IFRS 15. However, as there are some differences between IFRS 15 and Section 23 (see Chapter 25 at 2), entities will need to consider the following transition issues:

- **Constraining estimates of variable consideration**

Section 23 requires an entity to include in the transaction price the estimate of variable consideration to the extent that it is highly probable that the entity will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved. [FRS 102.23.46]. Under IFRS 15, however, the entity recognises some or all of the estimated variable consideration to the extent that it is highly probable that a significant reversal of the amount of cumulative revenue recognised will not occur when the variable consideration is subsequently resolved. [IFRS 15.56, IFRS 15.57]. Accordingly, unlike IFRS 15 that requires an entity to consider both the likelihood and the magnitude of the revenue reversal to apply the constraint, the assessment under Section 23 only requires consideration of likelihood. Consequently, unless the estimated variable consideration is nil, earlier recognition of some variable consideration might be expected under IFRS 15 compared to Section 23 in certain instances.

- **Time value of money**

A key difference between Section 23 and IFRS 15 relates to advance payments received from customers. Section 23 does not require (but offers a policy choice) to adjust the promised amount of consideration for the effects of the time value of money and recognise the resulting interest expense. [FRS 102.23.59]. See further discussion in Chapter 25 at 6.5.2. However, under IFRS 15, there is no such policy choice or exemption from accounting for the effects of a significant financing component arising from advance payments. [IFRS 15.60].

IFRS 15 includes examples of several situations which do not provide the customer or the entity with a significant benefit of financing, and therefore, no adjustment for financing component is required. [IFRS 15.62]. However, Section 23 does not provide similar guidance.

- **Application of residual approach when estimating stand-alone selling prices and allocation of a discount or variable consideration**

In applying the residual approach when estimating stand-alone selling prices and when allocating discount or variable consideration to performance obligations, IFRS 15 is more prescriptive than Section 23. [IFRS 15.79(c), IFRS 15.83, IFRS 15.85, IFRS 15.86, FRS 102.23.70(c), FRS 102.23.74, FRS 102.BC.B23.9]. See Chapter 25 at 2.3 and 2.4 for further information.

- **Capitalisation of costs to obtain a contract**

Under IFRS 15, an entity recognises as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. [IFRS 15.91]. Unlike IFRS 15, Section 23 allows an accounting policy choice on whether to expense or capitalise incremental costs to obtain a contract with a customer that the entity expects to recover. [FRS 102.23.113]. See Chapter 25 at 10.3.1 for further information.

In certain areas (such as the treatment of bill and hold arrangements, uninstalled materials when using the input method to measure progress based on cost incurred, non-cash consideration, and situations where consideration payable to the customer exceeds the fair value of goods the distinct goods or services received), Section 23 does not provide specific guidance. In these situations, according to the hierarchy outlined in Section 10, an entity may refer to the accounting treatments adopted under IFRS 15.

Illustration 5-11 below demonstrates examples related to revenue on transition:

Illustration 5-11: Revenue from contracts with customers - transition example

Entity A is a first-time adopter. The date of transition is 1 January 20X5 and Entity A prepares its first FRS 102 financial statements for the accounting period beginning 1 January 20X6. Its previous financial reporting framework is IFRS. It entered into the following contracts with its customers:

Contract 1

On 1 July 20X4, Entity A entered into a contract to provide a certain service to Customer X. The contract's terms and conditions include a fixed fee of £500, plus variable consideration for a performance bonus related to the timing of Entity A completing the work. Based on Entity A's historical experience, the bonus amounts and associated probabilities for achieving each bonus are, as follows:

Bonus Amount	Probability of outcome
-	15%
£50	40%
£100	45%

Assume that Entity A, while applying IFRS 15, determined that using the expected value method would better predict the amount of consideration to which it will be entitled than using the most likely amount method. Under that method, Entity A estimated variable consideration of £65 $[(0 \times 15\%) + (£50 \times 40\%) + (£100 \times 45\%)]$. Having considered the effect of applying the constraint on variable consideration (i.e., none of the factors in IFRS 15.57 or any other factors indicate a likelihood of a significant revenue reversal), Entity A concluded that £65 is the appropriate estimate of variable consideration to include in the transaction price. The total transaction price is, therefore, £565.

Assume, Entity A estimates that it will complete the work by 31 December 20X5. It recognises revenue over time using output method. On 31 December 20X4, it recognised revenue of £113 (assume that it has completed 20% of work).

The contract was completed on 30 November 20X5. Entity A receives the bonus amounting to £100.

Entity A adopts FRS 102. Entity A concludes that the contract is not a completed contract as of 1 January 20X5, but it is a completed contract as of 1 January 20X6.

Entity A could choose to apply the full retrospective method to this contract (without electing any practical expedient). Entity A then assesses the variable consideration and determines that, as of the date of transition, it is not highly probable that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved in accordance with paragraph 23.46, and as a result, concludes that the total transaction price is £500 and adjusts its retained earnings at the date of transition equal to a decrease of £13 $[£113 - (£500 \times 20\%)]$.

Alternatively, Entity A could choose to apply the transition exemption in paragraph 35.10(y) by applying the practical expedient in paragraph 1.65(b). Entity A then uses the transaction price at the date the contract was completed which is £600 $(£500 + £100 \text{ bonus})$ rather than estimating the variable consideration. Entity A adjusts its retained earnings at the date of transition equal to a credit of £7 $[(£600 \times 20\%) - £113]$. As a reminder, for any of the practical expedients in paragraph 1.65 that an entity uses, the entity would apply that expedient consistently to all contracts and periods presented (see 5.12 above).

Contract 2

On 31 December 20X4, Entity A entered into a contract with Customer Y to sell an asset. Control of the asset will transfer to the customer in two years (i.e., the performance obligation will be satisfied at a point in time). The contract includes two alternative payment options: payment of £500 in two years when the customer obtains control of the asset or payment of £400 when the contract is signed. The customer elects to pay £400 when the contract is signed.

While applying IFRS 15, the entity concluded that the contract contains a significant financing component because of the length of time between when the customer pays for the asset and when the entity transfers the asset to the customer, as well as the prevailing interest rates in the market. The interest rate implicit in the transaction is 11.8 per cent, which is the interest rate necessary to make the two alternative payment options economically equivalent. The entity evaluated the rate and concluded that it is commensurate with the rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. Therefore, the entity recorded the contract liability at £400 and accreted interest at 11.8 per cent

thereafter. On 31 December 20X5, it recorded an interest expense of £47 with a corresponding credit to contract liability.

Entity A adopts FRS 102. Entity A concludes that the contract is not a completed contract as of 1 January 20X5. Therefore, it must apply the full retrospective method to this contract. Entity A assesses that the payment is received in advance. The entity's accounting policy, under FRS 102, is to not recognise the effects of the time value of money for payments received in advance in accordance with paragraph 23.59. Therefore, the entity accounts for the contract liability at £400 as at 1 January 20X5 (the date of transition) but derecognises the interest expense of £47 recognised in 20X5 (the comparative period).

5.13 Compound financial instruments

FRS 102 requires an entity to split a convertible debt or similar compound financial instrument (that, from the issuer's perspective, contains both a liability and equity component) into its liability and equity components at the date of issue. A first-time adopter need not separate those two components if the liability component is not outstanding at the date of transition to FRS 102. [FRS 102.22.13, FRS 102.35.10(g), FRS 102 Appendix I].

If the liability component of a compound financial instrument is no longer outstanding, a full retrospective application of Section 22 would involve identifying two components, one representing the original equity component and the other representing the cumulative interest or fair value movements on the liability component (depending on whether accounted at amortised cost or at fair value through profit or loss), both of which are accounted for in equity (see Chapter 12 at 4.5.3).

This transition exemption appears to be of limited practical effect as Section 22 merely requires that the proceeds be allocated between the liability and equity component, and that the allocation between the liability and equity component is not revised in later periods. [FRS 102.22.13, FRS 102.22.14]. Section 22 does not mandate that the equity component must be credited to a separate component in equity nor does it prohibit a subsequent transfer within equity. The increase in equity arising on an issue of shares is presented in the statement of financial position as determined by applicable laws. [FRS 102.22.10].

5.14 Designation of previously recognised financial instruments

An entity is permitted to designate, as at the date of transition to FRS 102, any financial asset or financial liability at fair value through profit or loss provided the asset or liability meets the criteria in paragraph 11.14(b) at that date. [FRS 102.35.10(s)].

Debt instruments (that meet the conditions in paragraph 11.8(b) or paragraph 11.8(bA) of FRS 102 to qualify as basic financial instruments) and commitments to receive a loan and to make a loan to another entity (that meet the conditions in paragraph 11.8(c) of FRS 102 to qualify as basic financial instruments) are permitted, upon their initial recognition, to be designated by the entity as at fair value through profit or loss, if the conditions in paragraph 11.14(b) of FRS 102 are met. The conditions in paragraph 11.14(b) for designation at fair value through profit or loss comprise 'elimination or significant reduction of an accounting mismatch' or 'a group of debt instruments or financial assets and debt instruments is managed and its performance evaluated on a fair value basis'. [FRS 102.11.14(b)]. These are described further in Chapter 13 at 6.4.

Examples of debt instruments include accounts, notes and loans receivable and payable. [FRS 102.11.8(b), FRS 102.11.8(bA)]. Consequently, the term 'debt instruments' includes both financial assets and financial liabilities.

The transition exemption allows a first-time adopter to make the designation as of its date of transition.

How we see it

In our view, this designation can be made retrospectively, providing it is made before the date of approval of the first FRS 102 financial statements.

5.15 Assets and liabilities of subsidiaries, associates and joint ventures

Within groups, some subsidiaries, associates and joint ventures could have a different date of transition to FRS 102 from the parent, investor or venturer. As this could result in permanent differences between the FRS 102 figures in a subsidiary's own financial statements and those it reports to its parent, FRS 102 includes a special exemption regarding the assets and liabilities of subsidiaries, associates and joint ventures.

Paragraph 35.10(r) contains detailed guidance on the approach to be adopted when a parent adopts FRS 102 before its subsidiary (see 5.15.1 below) and also on when a subsidiary adopts FRS 102 before its parent (see 5.15.2 below).

These provisions also apply when FRS 102 is adopted at different dates by:

- An associate and the entity that has significant influence over it (i.e., the investor in the associate).
Or
- A joint venture and the entity that has joint control over it (i.e., the venturer in the joint venture).

In the discussion that follows, 'parent' includes an investor in an associate or a venturer in a joint venture, and 'subsidiary' includes an associate or a joint venture. References to consolidation adjustments are to be read as including similar adjustments made when applying equity accounting. Paragraph 35.10(r) also addresses the requirements for a parent that adopts FRS 102 at different dates for the purposes of its consolidated and its separate financial statements (see 5.15.4 below).

5.15.1 Subsidiary becomes a first-time adopter later than its parent

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(r) Assets and liabilities of subsidiaries, associates and joint ventures

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall in its financial statements measure its assets and liabilities at either:

- (i) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to this FRS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary; or
- (ii) the carrying amounts required by the rest of this FRS, based on the subsidiary's date of transition to this FRS. These carrying amounts could differ from those described in (i) when:
 - (a) the exemptions in this FRS result in measurements that depend on the date of transition to this FRS; or
 - (b) the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in Section 17 *Property, Plant and Equipment*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

...

A subsidiary that becomes a first-time adopter later than its parent therefore has the option to measure its assets and liabilities at the carrying amounts included in the parent's consolidated financial statements, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary. [FRS 102.35(r)(i)]. If a subsidiary does not take advantage of the exemption, it applies Section 35, based on its own date of transition to FRS 102 and would prepare its own FRS 102 financial statements, completely ignoring the Section 35 elections that its parent used when it adopted FRS 102 for its consolidated financial statements. [FRS 102.35(r)(ii)].

How we see it

FRS 102 does not elaborate on exactly what constitutes 'consolidation procedures', for the purposes of paragraph 35.10(r)(i) but, in our view, these would encompass adjustments required in order to harmonise a subsidiary's accounting policies with those of the group, as well as purely 'mechanical' consolidation adjustments such as the elimination of intragroup balances, profits and losses.

The following Illustration, which is adapted from an example included in IFRS 1, which has a comparable transition exemption, [IFRS 1.D16], shows how an entity applies these requirements. [IFRS 1.IG Example 8].

Illustration 5-12: Parent adopts FRS 102 before subsidiary*Background*

Entity A presented its first FRS 102 consolidated financial statements in 20X6 (having transitioned from IFRS in its group accounts in advance of moving its subsidiaries from FRS 101 to FRS 102). Subsidiary B, wholly owned by Entity A (its parent) since formation, prepares information under FRS 102 for internal consolidation purposes from that date, but Subsidiary B does not present its first FRS 102 financial statements until 20X8.

Application of requirements

If Subsidiary B applies option (i) in paragraph 35.10(r), the carrying amounts of its assets and liabilities are the same in both its opening FRS 102 statement of financial position at 1 January 20X7 and Entity A's consolidated statement of financial position (except for adjustments for consolidation procedures) and are based on Entity A's date of transition to FRS 102.

Alternatively, Subsidiary B may apply option (ii) in paragraph 35.10(r), and measure all its assets or liabilities based on its own date of transition to FRS 102 (1 January 20X7). However, the fact that Subsidiary B becomes a first-time adopter in 20X8 does not change the carrying amounts of its assets and liabilities in Entity A's consolidated financial statements.

Under option (i), the numbers in a subsidiary's FRS 102 financial statements would be as close to those used by its parent as possible. However, differences other than those arising from business combinations (and consolidation adjustments) will still exist in many cases, for example:

- A subsidiary may have hedged an exposure by entering into a transaction with a fellow subsidiary. Such a transaction could qualify for hedge accounting in the subsidiary's own financial statements but not in the parent's consolidated financial statements.

Or

- A pension plan may have to be classified as a defined contribution plan from the subsidiary's point of view, but is accounted for as a defined benefit plan in the parent's consolidated financial statements.

The transition exemption will rarely succeed in achieving more than a moderate reduction of the number of reconciling differences between a subsidiary's own reporting and the numbers used by its parent.

How we see it

Importantly, the choice of option (i) prevents the subsidiary from electing to apply all the other voluntary exemptions offered by Section 35, since the parent had already made the choices for the group at its date of adoption. Therefore, use of option (i) might not be appropriate for a subsidiary that prefers to use a different exemption, e.g., fair value as deemed cost for property, plant and equipment. However, in our view, application of option (i) would allow the subsidiary to adopt a new edition of FRS 102 that becomes effective during any of the periods presented in the same manner it was adopted by the parent.

Illustration 5-13 below explains the interaction between option (i) and the business combination exemption applied by its parent.

Illustration 5-13: Interaction between option (i) and the business combination exemption applied by its parent

Entity D has been a subsidiary of Entity C since 20X0. Entity E was acquired by Entity D in 20X2 and Entity D accounted for the acquisition under its previous financial reporting framework. Entity C transitioned from previous financial reporting framework to FRS 102 with a date of transition of 1 January 20X3 and decided to apply the exemption in paragraph 35.10(a) to this acquisition. Entity D adopted FRS 102 from its date of transition of 1 January 20X6 and chose to apply option (i) in paragraph 35.10(r).

Can Entity D apply Section 19 retrospectively to the acquisition of Entity E in its first FRS 102 financial statements?

How we see it

In our view, Entity D cannot apply Section 19 to the acquisition of Entity E because, applying option (i) in paragraph 35.10(r) of FRS 102, a subsidiary which becomes a first-time adopter later than its parent measures its assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to FRS 102. Therefore, Entity D cannot apply Section 19 retrospectively, meeting the primary objective of using the option (i) election in keeping one set of books.

A subsidiary might become a first-time adopter later than its parent, because it previously prepared a reporting package under FRS 102 for consolidation purposes, but did not present a full set of financial statements under FRS 102. Adjustments made centrally to an unpublished reporting package are not considered to be corrections of errors for the purposes of the disclosure requirements in FRS 102. However, a subsidiary is not permitted to ignore misstatements that are immaterial to the consolidated financial statements of its parent but material to its own financial statements. [IFRS 1.IG31].

How we see it

If a subsidiary was acquired after the parent's date of transition to FRS 102, then it cannot apply option (i) because there are no carrying amounts included in the parent's consolidated financial statements, based on the parent's date of transition. Therefore, the subsidiary is unable to use the carrying amounts recognised in the group accounts when it was acquired, since push-down of the group's purchase accounting values is not allowed in the subsidiary's financial statements.

Unlike the comparable IFRS 1 transition exemption, FRS 102 does not explicitly address the situation where a subsidiary that is excluded from consolidation under FRS 102 (and is measured at fair value, either through profit or loss or through other comprehensive income – see Chapter 8 at 3.4) adopts FRS 102 after its parent adopts FRS 102 in its consolidated financial statements.

However, it would make sense for a subsidiary excluded from consolidation to apply option (ii), i.e., to use the carrying amounts of assets and liabilities based on its own date of transition.

Implementation difficulties in applying option (i) might arise if the parent and its subsidiary have different financial years, as explained below.

How we see it

Application of option (i) is more difficult when a parent and its subsidiary have different financial years. In that case, Section 35 would seem to require the carrying amounts of the subsidiary's assets and liabilities under FRS 102 to be based on the parent's date of transition to FRS 102, which might not even coincide with an interim reporting date of the subsidiary; the same applies to any joint venture or associate.

The exemption is also available to associates and joint ventures. This means that in many cases an associate or joint venture that wants to apply option (i) will need to choose which shareholder it considers its investor or venturer for FRS 102 purposes and determine the FRS 102 carrying amount of its assets and liabilities by reference to that investor's or venturer's date of transition to FRS 102.

5.15.2 Parent becomes a first-time adopter later than its subsidiary

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

- (a) ...
- (r) Assets and liabilities of subsidiaries, associates and joint ventures

...

However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation (and equity accounting) adjustments and for the effects of the business combination in which the entity acquired the subsidiary (or transaction in which it acquired the associate or joint venture). Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

While located within the transition exemptions, paragraph 35.10(r) does not offer a choice between different accounting alternatives. The parent itself must use the FRS 102 measurements already used in the subsidiary's financial statements, adjusted as appropriate for consolidation procedures and the effects of the business combination in which the parent acquired the subsidiary.

This does not preclude the parent from adjusting the subsidiary's assets and liabilities for a different accounting policy (e.g., cost or revaluation for accounting for property, plant and equipment) but does, however, limit the choice of exemptions (e.g., the deemed cost exemption) with respect to the subsidiary in the consolidated financial statements at the date of transition.

The following Illustration, which is adapted from an example included in IFRS 1, which has a comparable transition exemption, [IFRS 1.D17], shows how an entity applies these requirements. [IFRS 1 IG Example 9].

Illustration 5-14: Subsidiary adopts FRS 102 before parent

Entity C presents its first consolidated FRS 102 financial statements for the accounting period ending 31 December 20X6. Subsidiary D, wholly owned by Entity C since formation (so not acquired in a business combination), presented its first FRS 102 financial statements in 20X4 (as it had been incorporated that year and chose to adopt FRS 102 early). Until 20X6, Subsidiary D prepared information for internal consolidation purposes under Entity C's previous financial reporting framework.

The carrying amounts of Subsidiary D's assets and liabilities at 1 January 20X5 (the date of transition for Entity C) are the same in both Entity C's opening FRS 102 consolidated statement of financial position and Subsidiary D's own financial statements (except for adjustments for consolidation procedures) and are based on Subsidiary D's date of transition to FRS 102. The fact that Entity C becomes a first-time adopter in 20X6 does not change those carrying amounts.

How we see it

When a subsidiary adopts FRS 102 before its parent, this will limit the parent's ability to choose first-time adoption exemptions in Section 35 freely as related to that subsidiary, as shown in the Illustration below.

Illustration 5-15: Limited ability to choose first-time adoption exemptions

Entity E presents its first consolidated FRS 102 financial statements for the accounting period ending 31 December 20X6 and its date of transition is 1 January 20X5. Subsidiary F adopted FRS 102 in 20X2 and its date of transition was 1 December 20X0:

- (a) *Subsidiary F and Entity E both account for their property, plant and equipment at historical cost under Section 17.*

Upon first-time adoption, Entity E may only adjust the carrying amounts of Subsidiary F's assets and liabilities for the effects of consolidation and business combinations. Entity E can therefore not apply the exemption to use fair value as deemed cost of Subsidiary F's property, plant and equipment as at its own date of transition (1 January 20X5).

- (b) *Subsidiary F accounts for its property, plant and equipment at revalued amounts under Section 17, while Entity E accounts for its property, plant and equipment at historical cost under Section 17.*

Entity E would not be allowed to apply the exemption to use fair value as deemed cost of Subsidiary F's property, plant and equipment at its own date of transition because paragraph 35.10(r) would only permit adjustments for the effects of consolidation and business combinations. Although a consolidation adjustment would be necessary, this would only be to adjust Subsidiary F's revalued amounts to figures based on historical cost.

5.15.3 Implementation guidance

The Implementation Guidance in IFRS 1 (which discusses the equivalent paragraphs in IFRS 1 to paragraph 35.10(r) in FRS 102) notes the following issues, which have been adapted for the context of an FRS 102 first-time adopter. [IFRS 1.D16, IFRS 1.D17].

Use of the transition exemption in paragraph 35.10(r) does not override the following requirements of Section 35: [IFRS 1.IG30]

- The parent's election to use the business combinations exemption in paragraph 35.10(a) (see 5.2 above), which applies to assets and liabilities of a subsidiary acquired in a business combination that occurred before the parent's date of transition to FRS 102. However, the rules summarised at 5.15.2 above (parent adopting FRS 102 after subsidiary) apply to assets and liabilities acquired and assumed by the subsidiary after the business combination and still held and owned by it at the parent's date of transition to FRS 102.

- To apply the requirements in Section 35 in measuring all assets and liabilities for which the provisions summarised in paragraph 35.10(r) regarding different parent and subsidiary adoption dates are not relevant (e.g., the use of the exemption to measure assets and liabilities at the carrying amounts in the parent's consolidated financial statements does not affect the restrictions in paragraph 35.9(c) concerning changing valuation assumptions or estimates made at the same dates under the first-time adopter's previous financial reporting framework (see 4.2 above))

And

- A first-time adopter must give all the disclosures required by Section 35 as of its own date of transition. See 6 below.

5.15.4 Adoption of FRS 102 on different dates in separate and consolidated financial statements

Sometimes, an entity becomes an FRS 102 first-time adopter for its separate financial statements at a different date than for its consolidated financial statements. Such a situation could arise for example where the parent takes advantage of an exemption from preparing consolidated financial statements. Subsequently, if the parent ceases to be entitled to the exemption or chooses not to use it, the parent could apply FRS 102 in its consolidated financial statements.

Another example might be if a parent prepares IFRS consolidated financial statements but applies FRS 102 in its separate financial statements. The parent might subsequently decide to prepare FRS 102 consolidated financial statements instead of IFRS consolidated financial statements, for example, following a delisting or change in ownership.

If a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it must measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments. [FRS 102.35.10(r)].

How we see it

The requirement is merely that the 'same amounts', except for consolidation adjustments, be used for the measurement of the assets and liabilities in both sets of financial statements, without being explicit as to which set of financial statements is used as the benchmark. However, we believe that it is clear from the context that the intention is that the measurement basis used in whichever set of financial statements first comply with FRS 102 must also be used when FRS 102 is subsequently adopted in the other set.

For a UK company (or LLP) preparing statutory accounts, the Regulations (and LLP Regulations) require that any differences in accounting rules between the parent company's individual accounts and its group accounts for the financial year be disclosed in a note to the group accounts, with reasons for the difference given. [6 Sch 4, 3 Sch 4 (LLP)]. However, application of paragraph 35.10(r) would mean that, in most cases, no differences would arise.

5.16 Hedge accounting

As noted at 4.1.1 above, an FRS 102 reporter has an accounting policy choice of applying the following to the recognition and measurement of financial instruments: [FRS 102.11.2, FRS 102.12.2]

(a) Section 11 and Section 12 of FRS 102.

(b) IAS 39 (as adopted in the relevant jurisdiction) and as the standard applies prior to the application of IFRS 9 (referred to as 'IAS 39' below).

Or

(c) IFRS 9 (as adopted in the relevant jurisdiction) and IAS 39 (as amended following the publication of IFRS 9) (together referred to as 'IFRS 9' below).

See Chapter 13 at 3.

However, following the Periodic Review 2024 amendments, a first-time adopter is only permitted to choose to apply IAS 39 (i.e., option (b) above) if this would make the entity's accounting policy choice consistent with those adopted in the consolidated financial statements in which the entity is included. [FRS 102.35.8C].

Section 12, IAS 39, and IFRS 9 all require derivatives to be recognised at fair value and all distinguish three types of hedging relationship between a hedging instrument and hedged item – cash flow hedges, fair value hedges, and hedges of a net investment in a foreign operation. The hedge accounting requirements of

Section 12 are discussed in Chapter 14, while IFRS 9 is discussed in the most recent version of EY's publication, International GAAP® (which also addresses the main differences between IAS 39 and IFRS 9). Section 12, IAS 39, and IFRS 9 also all require the designation and documentation of hedging relationships, but the detailed requirements for hedge accounting differ. For example, the ongoing eligibility criteria for hedge accounting in Section 12 are more relaxed compared to both IAS 39 and IFRS 9. However, in all cases, ineffectiveness must still be measured and recognised in profit or loss where appropriate, and the criteria for hedge accounting need to be assessed and continue to be met.

There are specific transition provisions regarding hedge accounting depending on whether the FRS 102 reporter applies Section 12 (see 5.16.2 below), [FRS 102.35.10(t)(i)-(iii)], or IAS 39 or IFRS 9 (see 5.16.3 below), [FRS 102.35.10(t)(iv)], to the recognition and measurement of financial instruments. The transition provisions are the same regardless of the previous financial reporting framework applied to financial instruments, although the consequences of applying the transition provisions will depend on the nature of any hedge accounting undertaken under the previous financial reporting framework. Section 35 sets out various hedge accounting exemptions for entities applying Section 12 under FRS 102, but its requirements for entities applying IAS 39 or IFRS 9 under FRS 102 (which are based on IFRS 1's requirements, with certain concessions over the timing of completing designation and documentation of hedging relationships) are mandatory.

An FRS 102 first-time adopter (whatever policy choice is applied to the recognition and measurement of financial instruments) will need to:

- Recognise derivatives at fair value and eliminate any deferred gains and losses arising or synthetic accounting from hedge accounting under its previous financial reporting framework (except where permitted by the transition provisions), as required by the general rules on transition to FRS 102 (see 3.4 above). [FRS 102.12.3, FRS 102.12.7, FRS 102.12.8, FRS 102.35.7(a)-(b)]. Such adjustments are reflected in retained earnings (or, if appropriate, another component of equity). [FRS 102.35.8].
- Reflect hedging relationships in the opening statement of financial position (where required or permitted by the transitional provisions). The transition provisions, which differ depending on whether Sections 11 and 12, or IFRS 9/IAS 39 are applied, explain the adjustments required (see 5.16.2 and 5.16.3 below respectively).
- With fair value hedges, adjustments to the carrying amounts of assets and liabilities are reflected in retained earnings (or, if appropriate, another component of equity). With cash flow hedges, adjustments are generally reflected in a cash flow hedge reserve although the situation is more complicated. For example, under Sections 11 and 12, if an entity chooses not to reflect an existing or past hedging relationship in the opening statement of financial position, the adjustments to back out the previous hedge accounting are reflected in retained earnings (or, if appropriate, another component of equity). [FRS 102.35.8]. See 5.16.2.C and 5.16.2.D below (for Section 12) and 5.16.3 below (for IAS 39 and IFRS 9) for discussion of the adjustments made on transition for existing and past hedging relationships. Under IFRS 9, 'costs of hedging' adjustments are reflected in a separate component of equity (see 3.4.5.C above). [IFRS 9.6.5.15, IFRS 9.6.5.16].
- Designate and document hedging relationships (required where hedge accounting is to be applied, under all the standards) in accordance with the requirements of the accounting policy choice followed under FRS 102. The transition provisions, however, include a relief over the timing of when such designation and documentation is completed (whatever accounting policy choice is applied to the recognition and measurement of financial instruments). [FRS 102.35.10(t)(i), (iii)-(iv)].

And

- Consider the subsequent accounting for hedging relationships reflected in the opening statement of financial position, in accordance with the accounting policy choice followed under FRS 102.

Previous IFRS and FRS 101 reporters would already measure derivatives at fair value. [IFRS 9.4.1.4, IFRS 9.4.2.1(a)]. However, IAS 39 and IFRS 9 (the latter in respect of financial liabilities only) may require separation of certain embedded derivatives. [IAS 39.10-12, IFRS 9.4.3.1-7]. Sections 11 and 12 do not permit separation of embedded derivatives. Therefore, if a previous IFRS or FRS 101 reporter applies Sections 11 and 12 as an accounting policy choice under transition to FRS 102, financial instruments containing embedded derivatives will be measured as a hybrid instrument and it will not be possible to designate an embedded derivative as a hedging instrument (as it will no longer be separated).

Given that hedge accounting under Section 12 is simpler than under IFRS, situations could arise where an economic hedging relationship was not hedge accounted for by a previous IFRS or FRS 101 reporter or the hedging relationship failed the detailed conditions in IFRS 9 (or IAS 39, where applied) for hedge accounting, but hedge accounting would be possible under Section 12. For a first-time adopter where Section 12 is applied, the transition provisions (see 5.16.2.A below) would allow, but not require, such

existing hedging relationships to be reflected in the opening statement of financial position on transition to FRS 102 (see 5.16.2.D below). Where IAS 39 or IFRS 9 is applied as an accounting policy choice under FRS 102, a new hedging relationship not previously identified would not be reflected in the opening statement of financial position (see 5.16.3 below). This is because retrospective designation prior to the date of transition is not permitted.

There is a relief available in respect of the timing of designation and documentation of a hedging relationship available for the first FRS 102 financial statements where Section 12, IAS 39, or IFRS 9 are followed (see 5.16.2.A and 5.16.3 below). Once an entity ceases to be a first-time adopter (i.e., in subsequent FRS 102 financial statements), the usual requirements on designation and documentation of a hedging relationship apply, regardless of which accounting policy choice is followed for the recognition and measurement of financial instruments.

5.16.1 Reporter previously applied IAS 39 or IFRS 9 to hedge accounting

As there is no change in the hedge accounting requirements, it is not expected that transition adjustments will generally be required where an entity previously applying IAS 39 or IFRS 9 to hedge accounting chooses to apply the same accounting policy choice to the recognition and measurement of financial instruments under FRS 102. See 3.4.5 above and 5.16.3 below. Some IFRS or FRS 101 reporters may have continued to apply the hedge accounting requirements in IAS 39, when they adopted IFRS 9, as permitted under the transitional provisions in that standard. [IFRS 9.7.2.1].

How we see it

As explained in 3.4.5.A above, we believe that an entity already applying IFRS 9 and applying IAS 39 to its hedges can continue to adopt this accounting policy on transition to FRS 102.

Adjustments might arise where an entity previously applying IAS 39 or IFRS 9 makes a different accounting policy choice under FRS 102. Given the restrictions on a first-time adopter applying IAS 39 as a policy choice (see 5.16 above), [FRS 102.35.8C], this discussion focuses on a change in policy from IAS 39 (hedge accounting) to Section 12 or IFRS 9, or from IFRS 9 to Section 12. See 5.16.1.A below for some examples of areas that may give rise to adjustments to hedge accounting.

Entities will, however, need to ensure that all hedge relationships meet the qualifying conditions for hedge accounting which differ depending on the accounting policy followed. See Chapter 14 and the most recent version of EY's publication, International GAAP®.

Implementation issues, including accounting for rebalancing of hedge relationships and 'costs of hedging', when an entity moves from IAS 39 to IFRS 9 are discussed at 3.4.5.C above. See the most recent version of EY's publication, International GAAP® for further discussion of rebalancing and 'costs of hedging'.

5.16.1.A Key differences on hedge accounting between Section 12, IAS 39 and IFRS 9

An entity previously applying IAS 39 (to hedge accounting) or IFRS 9 that chooses to apply a different accounting policy choice to the recognition and measurement of financial instruments on transition to FRS 102 will need to consider both the different transition provisions and the ongoing requirements for hedge accounting. An appreciation of the differences between Section 12, IAS 39 and IFRS 9 would be important when determining which accounting policy choice to make and assessing what, if any, adjustments are required.

Some key differences between Section 12, IAS 39 and IFRS 9 which may give rise to adjustments when applying a different accounting policy choice under FRS 102 include:

- More hedging relationships could be eligible under Section 12 or IFRS 9 (compared to IAS 39) so new relationships could be designated, where the specified conditions are met. An example is that Section 12 and IFRS 9 both permit the identification of a separately identifiable and reliably measurable risk component of a non-financial hedged item. [FRS 102.12.16, FRS.102.12.16C, IFRS 9.6.3.1, IFRS 9 6.3.7, IFRS 9.B6.3.8]. See Chapter 14 at 4.2.2 and the most recent version of EY's publication, International GAAP®.
- Section 12 has simpler requirements than the hedge accounting requirements of IAS 39 or IFRS 9. For example, in determining whether the qualifying conditions for hedge accounting continue to apply, [FRS 102.12.18, FRS 102.12.18A], Section 12 has no retrospective effectiveness assessment and only has a simple prospective one.
- However, there can be some situations for which Section 12 is more restrictive, in particular compared to IFRS 9. For example, Section 12 requires that if a group of items (including components of items) are designated as the hedged item in a hedge relationship, those items must consist of items that are

individually eligible hedged items, share the same risk and cannot contain offsetting positions, and be managed together on a group basis for risk management purposes. [FRS 102.12.16, FRS 102.12.16B]. IFRS 9 does not have the same restrictions in all circumstances, although for risk management purposes, the items in the group must also be individually eligible hedged items and managed together on a group basis. [IFRS 9.6.6.1]. Therefore, more complex hedging relationships can be found under IFRS 9. IFRS 9 would permit a cash flow hedge of a net position attributable to foreign exchange risk (for example, because of forecast foreign purchases and sales) where certain conditions are met, [IFRS 9.6.6.1(c)]. This would not be permitted under Section 12. See Chapter 14 at 4.2.3.

- Where the intrinsic value of the option or the spot risk element of a foreign currency contract is designated as the hedging instrument, the fair value movements on the time value of the option (or on the forward element of the forward contract) are recognised in profit or loss under Section 12 and IAS 39 (as these fall outside the hedging relationship). [FRS 102.12.17A(c), IAS 39.74]. This differs from IFRS 9, which requires that the fair value movements on the time value of an option are initially recognised as 'costs of hedging' in other comprehensive income. IFRS 9 also allows (but does not require) an entity to elect on a hedge-by-hedge basis a similar accounting for the 'costs of hedging' (as applied to the time value of the option) for the forward element of a foreign currency contract. [IFRS 9.6.5.15, IFRS 9.6.5.16]. This accounting will reduce profit and loss volatility compared to Section 12 and IAS 39. See Chapter 14 at 4.3 and the most recent version of EY's publication, International GAAP®.

Section 12 (and IAS 39) do not allow for separation of foreign currency basis spreads when designating a hedging relationship. [FRS 102.12.17A, IAS 39.74]. This is permitted by IFRS 9 which also allows (but does not require) an entity to elect on a hedge-by-hedge basis to account for the 'costs of hedging' in the same way as for time value of options. [IFRS 9.6.5.16]. See the most recent version of EY's publication, International GAAP®.

An entity applying IFRS 9 might be required to rebalance the hedge ratio on transition (and on an ongoing basis), with an adjustment in profit or loss. [IFRS 9.6.4.1(c)(iii), IFRS 9.6.5.5]. See the most recent version of EY's publication, International GAAP®. This is not the case if applying Section 12 or IAS 39 hedge accounting, as rebalancing is not a feature of Section 12 or IAS 39. As a consequence, some hedges may show more ongoing ineffectiveness under Section 12 or IAS 39 compared to IFRS 9, but the hedge accounting will be simpler.

IFRS 9 does not permit an entity to voluntarily discontinue a hedge relationship prospectively whereas an entity may document an election to do so under Section 12 or IAS 39 hedge accounting, providing more flexibility over subsequent accounting for hedging relationships. [FRS 102.12.25, IFRS 9.6.5.6]. See Chapter 14 at 4.10 and the most recent version of EY's publication, International GAAP®.

An entity applying Section 12 on transition to FRS 102 has a choice of whether to reflect existing or past hedging relationships meeting specified conditions in the opening statement of financial position (see 5.16.2 below). [FRS 102.35.10(xi)-(ii)]. This flexibility is not available when applying IAS 39 or IFRS 9 on transition to FRS 102 (see 5.16.3 below). As discussed at 5.16.2.B below, the choices made on transition will impact the future results.

It is not the intention of this discussion to provide a list of all the differences in the hedge accounting requirements of Section 12, IAS 39, and IFRS 9. See the most recent version of EY's publication, International GAAP® for a summary of differences between hedge accounting under IAS 39 and IFRS 9. See also Chapter 14 at 2 for differences between hedge accounting in Section 12 and IFRS.

5.16.2 Transition exemptions - FRS 102 reporter applying Section 12 to the recognition and measurement of financial instruments

The transition exemptions for hedge accounting under Section 12 are set out at 5.16.2.A below. Implementation issues in applying the exemptions are discussed at 5.16.2.B to 5.16.2.E.

5.16.2.A Optional exemption - hedge accounting

Section 35 includes the following exemptions in relation to hedge accounting when the entity chooses to apply Sections 11 and 12 in the recognition and measurement of financial instruments.

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(t) Hedge accounting

(i) A hedging relationship existing on the date of transition

A first-time adopter may choose to apply hedge accounting to a hedging relationship of a type described in paragraph 12.19 which exists on the date of transition between a hedging instrument and a hedged item, provided the conditions of paragraphs 12.18(a) to (c) are met on the date of transition to this FRS and the conditions of paragraphs 12.18(d) and (e) are met no later than the date the first financial statements that comply with this FRS are authorised for issue. This choice applies to each hedging relationship existing on the date of transition.

Hedge accounting as set out in Section 12 *Other Financial Instruments* of this FRS may commence from a date no earlier than the conditions of paragraphs 12.18(a) to (c) are met. In a fair value hedge the cumulative hedging gain or loss on the hedged item from the date hedge accounting commenced to the date of transition, shall be recognised in retained earnings (or if appropriate, another category of equity). In a cash flow hedge and net investment hedge, the lower of the following (in absolute amounts) shall be recognised in equity (in respect of cash flow hedges in the cash flow hedge reserve):

(a) the cumulative gain or loss on the hedging instrument from the date hedge accounting commenced to the date of transition; and

(b) the cumulative change in fair value (ie the present value of the cumulative change of expected future cash flows) on the hedged item from the date hedge accounting commenced to the date of transition.

(ii) A hedging relationship that ceased to exist before the date of transition because the hedging instrument has expired, was sold, terminated or exercised prior to the date of transition

A first-time adopter may elect not to adjust the carrying amount of an asset or liability for previous financial reporting framework effects of a hedging relationship that has ceased to exist.

A first-time adopter may elect to account for amounts deferred in equity in a cash flow hedge under a previous financial reporting framework, as described in paragraph 12.23(d) from the date of transition. Any amounts deferred in equity in relation to a hedge of a net investment in a foreign operation under a previous financial reporting framework shall not be reclassified to profit or loss on disposal or partial disposal of the foreign operation.

(iii) A hedging relationship that commenced after the date of transition

A first-time adopter may elect to apply hedge accounting to a hedging relationship of a type described in paragraph 12.19 that commenced after the date of transition between a hedging instrument and a hedged item, starting from the date the conditions of paragraphs 12.18(a) to (c) are met, provided that the conditions of paragraphs 12.18(d) and (e) are met no later than the date the first financial statements that comply with this FRS are authorised for issue.

The choice applies to each hedging relationship that commenced after the date of transition.

(iv) ...

5.16.2.B General comments where Section 12 is applied to hedge accounting

The elections described at 5.16.2.A above provide considerable flexibility for an entity applying Section 12 to begin, cease, or continue hedge accounting on transition to FRS 102. These allow entities to apply a degree of hindsight in deciding whether or not to apply hedge accounting, since they provide a relief on the timing of completing hedge documentation for both existing hedging relationships at the date of transition (see 5.16.2.D below) and those entered into after the date of transition. In the Basis of Conclusions to FRS 102, it is stated that: "The FRC was mindful of this possible exploitation of the transitional arrangements, nevertheless, on balance, it believed that in the interests of the majority of entities, especially entities that have not applied hedge accounting before, flexibility should take precedence over restrictions aimed at preventing abuse." [FRS 102.BC.B11.63].

However, once a hedge accounting relationship has been documented in line with paragraphs 12.18(d) and (e) (conditions on hedge documentation), any subsequent election to discontinue the hedge accounting must be documented and takes effect prospectively. [FRS 102.12.25].

The transition provision distinguishes between the situation where a hedging relationship exists or does not exist on the date of transition. The hedging relationship exists where there is a cash flow hedge, fair value hedge or hedge of a net investment of a foreign operation, and the hedging instrument and hedged item both exist at the date of transition. A hedging relationship, therefore, does not exist where the hedging instrument is terminated (even if there is still a hedged item).

The transition provision permits but does not require an entity to reflect existing hedging relationships meeting the specified conditions in the opening statement of financial position (see 5.16.2.A above and 5.16.2.D below). This choice is available on a hedge-by-hedge basis.

How we see it

While the transition provision is not explicit on this matter, we also consider that an entity can choose whether or not to reflect certain past hedging relationships in the opening statement of financial position on a hedge-by-hedge basis (see 5.16.2.A above and 5.16.2.C below).

Where the elections to apply hedge accounting are not taken, FRS 102's requirements are retrospectively applied and the hedge accounting adjustments made under an entity's previous financial reporting framework would therefore need to be eliminated to retained earnings (or other category of equity) on transition. [FRS 102.35.7, FRS 102.35.8].

The way in which an entity accounts for past and existing hedging relationships on transition will, to a large extent, dictate the effect on its ongoing FRS 102 financial statements. For example, an entity's future results will, for a cash flow hedge, be different depending on whether the entity decides to reflect an existing hedging relationship in the opening statement of financial position (by establishing a cash flow hedge reserve) or not. Amounts accumulated in a cash flow hedge reserve at the date of transition will be reclassified from equity to profit or loss at a later date (or, for a hedge of a forecast transaction for a non-financial asset or non-financial liability, adjust the initial cost or carrying amount of the asset or liability). However, if a previous IFRS or FRS 101 reporter does not reflect a hedging relationship recognised under IFRS, it will transfer the cash flow hedge reserve previously recognised at the date of transition directly to retained earnings (and there would be no subsequent reclassification from equity).

Similarly, an entity's future results would be affected depending on whether a past or an existing fair value hedge is reflected in the opening statement of financial position or not. For short-term hedges (e.g., of anticipated sales and inventory purchases) these effects are likely to work their way out of the FRS 102 financial statements relatively quickly. However, for some hedges (e.g., hedges of long-term borrowings) an entity's results may be affected for many years. See further discussion of the choices available at 5.16.2.C and 5.16.2.D below.

5.16.2.C Accounting for past hedging relationships

Where the conditions in the transition provision in paragraph 35.10(t)(ii) (see 5.16.2.A above) are met, the entity could choose to reflect a past hedging relationship in the opening statement of financial position. [FRS 102.35.10(t)(ii)].

The transition provision sets out optional exemptions that apply to a hedging relationship that ceased to exist before the date of transition because the hedging instrument has expired, was sold, terminated or exercised prior to the date of transition. Therefore, the transition provision does not address situations where the hedging relationship still existed on transition, but for which hedge accounting had ceased prior to transition (e.g., the designation of the hedge was revoked (if IAS 39 was applied to hedge accounting),

the hedge ceased to be effective, or the forecasted transaction in a cash flow hedge ceased to be highly probable but was still expected to occur). Such situations are addressed at 5.16.2.D below.

Certain implementation issues associated with the transition provision on past relationships are discussed below:

- (a) A first-time adopter could elect not to adjust the carrying amount of an asset or liability for previous financial reporting framework effects of a hedging instrument that has ceased to exist.

[FRS 102.35.10(t)(ii)].

Therefore, where hedging gains (losses) from a hedge of a forecast purchase or committed purchase of inventory or property, plant and equipment have been included in the carrying amount of the asset before the date of transition, there is no requirement to adjust the carrying amount of the asset to eliminate the effects of hedging gains (losses) as at the date of transition.

Also, if an entity previously applying IAS 39 or IFRS 9 hedge accounting had applied fair value hedge accounting for a fixed to floating interest rate swap (now terminated) hedging a fixed rate loan (that still exists), no change is needed to the hedge accounting adjustments made to the loan, as at the date of transition.

How we see it

Section 35 does not spell out the subsequent accounting. In our view, this establishes a deemed carrying amount for the item and no further adjustments to the carrying amount for ongoing hedging gains and losses are made from the date of transition. However, as for a discontinuance, we consider that any adjustment to the carrying amount (arising from fair value hedge accounting) of a hedged financial instrument carried at amortised cost using the effective interest method must be amortised to profit and loss. This requirement is similar to the corresponding requirements in IAS 39 and IFRS 9.

- (b) Not all past hedging relationships are permitted to be reflected in the opening statement of financial position, even if the hedged item still exists.
- (c) A first-time adopter could elect to account for amounts deferred in equity in a cash flow hedge under a previous financial reporting framework, as described in paragraph 12.23(d) (which sets out the subsequent accounting for amounts accumulated in the cash flow hedge reserve) from the date of transition. [FRS 102.35.10(t)(ii)].

This is consistent with the ongoing requirements for discontinued cash flow hedges in Section 12 (see Chapter 14 at 4.10). This situation is likely to arise where the first-time adopter previously applied IAS 39 or IFRS 9 hedge accounting, for example:

- Where a floating to fixed interest rate swap (now terminated) hedged a floating rate loan (that still exists), the amounts deferred in equity in the cash flow hedge would not change as at the date of transition (where this election is taken). Instead, the deferred amounts are subsequently reclassified to profit or loss, as required by paragraph 12.23(d). If the hedged future cash flows are no longer expected to occur as at the date of transition, the deferred amounts in equity need to be reclassified immediately to retained earnings as at that date. [FRS 102.12.25A]. This election, in effect, allows the existing treatment on discontinuation previously followed under IAS 39 or IFRS 9 to endure.
- Where gains and losses were deferred in equity in relation to a cash flow hedge of a forecast transaction that subsequently resulted in the recognition of a non-financial asset or a non-financial liability (e.g., a purchase of a non-financial asset such as property, plant and equipment or inventory).

How we see it

The transition provision refers to paragraph 12.23(d), which requires inclusion of the associated gains and losses previously recognised through other comprehensive income in the initial cost or other carrying amount of the asset or liability (this treatment, often referred to as a 'basis adjustment', was also available by choice in IAS 39 and is required under IFRS 9 hedge accounting). Therefore, it appears that a first-time adopter that has already recognised the non-financial asset or liability prior to the date of transition would need to retrospectively adjust its carrying amount on transition to reflect the equivalent of a basis adjustment in order to comply with paragraph 12.23(d), if this treatment had not been followed under its previous financial reporting framework.

- (d) The transition provision clarifies that amounts deferred in equity in relation to a hedge of a net investment in a foreign operation under an entity's previous financial reporting framework are not reclassified to profit or loss on disposal or partial disposal of the foreign operation (consistent with the requirements of paragraph 12.24 of FRS 102 (see Chapter 14 at 4.9), but different to the requirements of IFRS). [FRS 102.12.24, IAS 21.48, IAS 21.48A, IAS 21.48B].

The transition provision does not spell out the accounting treatment where an entity does not take up the elections it permits for now ceased hedging relationships. However, entities that elect not to apply the FRS 102 hedge accounting requirements must comply with the applicable measurement requirements for assets and liabilities set out elsewhere in FRS 102 from the date of transition. [FRS 102.BC.B11.64].

How we see it

In our view, if the first-time adopter chose not to apply these exemptions, this means that the old hedge accounting would be reversed and the previously hedged items would need to be held in the opening FRS 102 statement of financial position at the appropriate carrying amount on application of FRS 102 without regard to any previous hedge accounting (with an adjustment to retained earnings or, if appropriate, another category of equity). Similarly, the amounts relating to a cash flow hedge that were previously deferred in a cash flow hedge reserve would be reclassified to retained earnings or, if appropriate, another category of equity.

5.16.2.D Hedging relationships existing at the date of transition

The exemption for existing hedging relationships in paragraph 35.10(t)(i) (see 5.16.A above) applies to hedging relationships of a type described in paragraph 12.19 (i.e., a cash flow hedge, fair value hedge, or hedge of a net investment in a foreign operation, see Chapter 14 at 4.6), meeting the eligibility and documentation conditions for hedge accounting required by the transition provision. See Chapter 14 at 4.2 to 4.4.

It is clear from the context that a hedging relationship can only exist at the date of transition if there is both an eligible hedged item and hedging instrument at that date. If the hedging instrument has ceased to exist before the date of transition, the transition provision on past hedging relationships may apply (see 5.16.2.C above).

A first-time adopter has two possibilities for hedging relationships existing at the date of transition:

- (a) Choose not to (or is not permitted to) hedge account

This applies if the conditions in (b) below are met (but the entity chooses not to hedge account) or if the conditions in (b) below are not met.

Or

- (b) Choose to apply hedge accounting

Where one of the three permitted types of hedging relationship exists at the date of transition, the first-time adopter is permitted to choose to apply hedge accounting provided:

- The conditions in paragraphs 12.18(a) to (c) (i.e., the existence of an economic relationship between an eligible hedging instrument and eligible hedged item, where the hedging relationship is consistent with the entity's risk management objectives for undertaking hedges – see Chapter 14 at 4.4) are met on the date of transition.
- And
- The conditions of paragraphs 12.18(d) and (e) (i.e., documentation of the hedging relationship and the determination, and documentation of causes of ineffectiveness – see Chapter 14 at 4.4.4) are met not later than the date the first FRS 102 financial statements are authorised for issue.

This choice applies to each hedging relationship existing on the date of transition. [FRS 102.35.10(t)(i)].

Because Section 12 does not have the same requirements as IAS 39 for ongoing effectiveness tests, this means that even if hedge accounting under IAS 39 ceased because the hedge relationship failed the effectiveness test (but the entity continued with the hedge economically), arguably hedge accounting could be reinstated in the opening FRS 102 statement of financial position, where the above conditions are met. However, if hedge accounting ceased because a forecasted transaction in a cash flow hedge was no longer highly probable, the hedging relationship would not meet the criteria in paragraph 12.18(a) and hedge accounting could not be reinstated.

Where the entity does not re-establish hedge accounting for an existing hedging relationship or the conditions to apply hedge accounting on transition are not met, the question arises as to whether the entity can continue to reflect the hedge accounting under its previous financial reporting framework for the

discontinued hedge in the statement of financial position and apply Section 12's requirements for discontinuance of hedge accounting prospectively from the date of transition (which would generally result in similar accounting to that already applied under IAS 39 or IFRS 9). Entities that elect not to apply the FRS 102 hedge accounting requirements have to comply with the applicable measurement requirements for assets and liabilities set out elsewhere in FRS 102 from the date of transition. [FRS 102.BC.B11.64].

How we see it

Where the elections to reflect the hedge accounting in the opening statement of financial position have not been taken, the FRC presumably intended that FRS 102 is applied retrospectively to the measurement of the hedged item and hedging instrument, without any regard to the hedge accounting provisions. The hedging relationship is not reflected in the opening FRS 102 statement of financial position and the hedge accounting adjustments under the previous financial reporting framework are eliminated to retained earnings (or, if appropriate, another component of equity) at the date of transition.

Hedge accounting as set out in Section 12 may commence from a date no earlier than the conditions of paragraphs 12.18(a) to (c) are met. [FRS 102.35.10(t)(i)].

How we see it

This would appear to allow first-time adopters some flexibility over choosing when hedge accounting commences from. If hedge accounting commences at the date of transition, there will be no amounts deferred in equity for a cash flow hedge or hedge of net investment in a foreign operation, and no adjustments made to the carrying amount of the hedged item for a fair value hedge. If hedge accounting commences from the date of inception of the hedging relationship, this is likely to avoid the ineffectiveness that might result where the hedging instrument has a non-zero fair value at the commencement of hedge accounting.

The choice whether or not to hedge account for existing hedging relationships meeting the above conditions is available whatever the entity's previous financial reporting framework and also whether or not the entity previously applied hedge accounting to that existing relationship. The nature of the adjustments required, however, might well depend on what previous accounting was followed. Where an entity previously applying IAS 39 or IFRS 9 chooses to continue to hedge account for a hedging relationship permitted under Section 12, there might often be no adjustment required on transition but differences may occur, for example:

- Section 12 does not allow for rebalancing a hedging relationship (as required under IFRS 9); and where this has occurred, it is possible that differences in the level of ineffectiveness may occur from the date at which the hedging relationship is established under Section 12.
- The accounting for the 'costs of hedging' where the entity designates the time value of options or the spot risk of forward currency contracts in a hedging relationship under Section 12 differs, or could differ, from that followed under IFRS 9. See 5.16.1.A above.

Where an entity chooses to apply hedge accounting to a hedging relationship existing at the date of transition, the transition provisions (see 5.16.2.A above) describe how a fair value hedge, cash flow hedge or net investment hedge must be reflected at the date of transition.

How we see it

The intention here appears to be to reflect the same adjustments as at the date of transition, as if hedge accounting under FRS 102 had been applied from the date chosen to commence hedge accounting, using the transition exemption. Therefore, in accordance with paragraph 12.23(d), the effects of reclassifications required from the cash flow hedge reserve where the hedged item would have affected profit or loss in prior periods (had hedge accounting under FRS 102 been applied) would be reflected in retained earnings at the date of transition. See Chapter 14 at 4.7 to 4.9.

For a UK company (or an LLP) preparing statutory accounts in accordance with FRS 102, the fair value accounting rules in the Regulations (and LLP Regulations) require that the cash flow hedge reserve is included in the statutory fair value reserve. [1 Sch 40-41, 1 Sch 40-41 (LLP)].

5.16.2.E Subsequent accounting for existing hedging relationships

Where an existing hedging relationship is reflected in the opening FRS 102 statement of financial position, [FRS 102.35.10(t)(i)], (see 5.16.2.A and 5.16.2.D above) or a hedging relationship that commences after the date of transition is hedge accounted, [FRS 102.35.10(t)(iii)], (see 5.16.2.A above), an entity could either:

- Continue hedge accounting

This would apply where the hedging relationship continues to comply with the conditions for hedge accounting in Section 12 (and meets the documentation requirements set out in the transition provisions). [FRS 102.12.18]

Or

- Discontinue hedge accounting prospectively

This would apply where an entity subsequently elects to discontinue hedge accounting; the hedging instrument has expired, is sold or terminated; or the conditions for hedge accounting cease to be met. [FRS 102.12.25]

The entity accounts for the continuance or discontinuance of hedge accounting in accordance with Section 12 (see Chapter 14).

5.16.3 Transition provisions - FRS 102 reporter applying IAS 39 or IFRS 9 (not Sections 11 and 12) to the recognition and measurement of financial instruments

5.16.3.A Mandatory requirement - hedge accounting

The transition provisions for hedge accounting relating to a first-time adopter choosing to apply IAS 39 or IFRS 9 to the recognition and measurement of financial instruments are set out in paragraph 35.10(t)(iv) of FRS 102.

How we see it

While positioned within the list of transition exemptions in Section 35, the wording of the transition provision in paragraph 35.10(t)(iv) means that it sets out mandatory requirements where IAS 39 or IFRS 9 is applied to hedge accounting. This differs to the situation where a first-time adopter applies Section 12, where there is a choice whether or not to apply the transition exemptions for hedge accounting (see 5.16.2 above).

Most FRS 102 reporters will have previously applied IFRS or FRS 101. As explained at 3.4.5.A above, adjustments are not generally expected to be required at the date of transition where IFRS 9 is applied as a policy choice to the recognition and measurement of financial instruments under FRS 102. As noted in that section, we believe that an entity already applying IFRS 9 and applying IAS 39 to the accounting for its hedges can continue to adopt this policy on transition to FRS 102. Considerations where an entity previously applied IAS 39 to the accounting for hedges under its previous financial framework but chooses to apply IFRS 9 (including its hedge accounting provisions) under FRS 102 are discussed at 3.4.5.C above.

Extract from Section 35

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this FRS:

(a) ...

(t) Hedge accounting

(i) ...

(iv) Entities taking the accounting policy choice under paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) to apply IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*

A first-time adopter adopting an accounting policy set out in paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) shall not apply the transitional provisions of paragraphs (i) to (iii) above. Such a first time adopter shall apply the transitional requirements applicable to hedge accounting in IFRS 1 *First-time adoption of International Financial Reporting Standards*, paragraphs B4 to B6, except that the designation and documentation of a hedging relationship may be completed after the date of transition, and no later than the

date the first financial statements that comply with this FRS are authorised for issue, if the hedging relationship is to qualify for hedge accounting from the date of transition.

A first-time adopter adopting an accounting policy set out in paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) that has entered into a hedging relationship as described in IAS 39 or IFRS 9 in the period between the date of transition and the reporting date for the first financial statements that comply with this FRS may elect to apply hedge accounting prospectively from the date all qualifying conditions for hedge accounting in IAS 39 or IFRS 9 are met, except that an entity shall complete the formal designation and documentation of a hedging relationship no later than the date the first financial statements that comply with this FRS are authorised for issue.

The requirements under IFRS 9 for designation and documentation of hedging relationships and the ongoing requirements for hedge accounting where the qualifying conditions are met (and for discontinuance of hedging relationships, where the qualifying conditions are not met) are discussed in the most recent version of EY's publication, International GAAP® (which also addresses the main differences between IAS 39 and IFRS 9).

The concession on timing of completion of the designation and documentation of the hedging relationship is discussed at 5.16.3.C below.

5.16.3.B Requirements of paragraphs B4 to B6 of IFRS 1

The requirements of paragraphs B4 to B6 of IFRS 1 (which are applied subject to the concession over the timing of completion of the designation and documentation of the hedging relationship) are as follows. The *Annual Improvements to IFRS Accounting Standards - Volume 11* issued in July 2024 by the IASB made amendments to clarify the requirements of paragraphs B4 to B6 of IFRS 1 which are reflected in the discussion below.

As required by IAS 39 or IFRS 9, at the date of transition, an entity must: [IFRS 1.B4]

- Measure all derivatives at fair value.
- And
- Eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets and liabilities.

An entity must not reflect in its opening statement of financial position a hedging relationship of a type that does not qualify for hedge accounting (under the relevant IFRS that is followed). [IFRS 1.B5]. Entities can only designate one of three types of hedging relationships - a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. For hedges of foreign currency risk of a firm commitment, an entity could designate either a fair value hedge or a cash flow hedge. [IAS 39.86, IAS.39.87, IFRS 9.6.5.2, IFRS 9.6.5.3, IFRS 9.6.5.4].

Paragraph B5 gives various examples of ineligible types of hedging relationships (which differ depending on whether IAS 39 or IFRS 9 is applied). The requirements on eligible types of hedging relationships for IFRS 9 (which are set out in paragraph 6.4.1(a) of IFRS 9) are discussed further in the most recent version of EY's publication, International GAAP® (which also addresses the main differences between IAS 39 and IFRS 9). [IFRS 1.B5, IFRS 9.6.4.1(a)].

If before the date of transition, an entity had designated a hedging relationship that was of an eligible type for hedge accounting, but the hedging relationship does not meet all the conditions for hedge accounting in IAS 39 (or qualifying criteria in paragraphs 6.4.1(b)-(c) of IFRS 9), the entity must apply paragraphs 91 and 101 of IAS 39 (or paragraphs 6.5.6 and 6.5.7 of IFRS 9) to discontinue hedge accounting prospectively immediately after transition. Transactions entered into before the date of transition to IFRS must not be retrospectively designated as hedges. [IFRS 1.B6].

How we see it

While paragraphs B4 to B6 now refer only to IFRS 9, in the context of their application under Section 35, our view is that these are to be read to include references to IAS 39 as this standard remains available for use under FRS 102.

The implementation guidance in IFRS 1 on accounting for cash flow hedges, fair value hedges and net investment hedges is not referred to by the transition provision. [FRS 102.35.10(xiv)]. However, most first-time adopters of FRS 102 will have applied IFRS or FRS 101 in their last set of financial statements.

How we see it

For a previous IFRS or FRS 101 reporter, paragraphs B4 to B6 of IFRS 1 are expected to provide sufficient guidance.

The most recent version of EY's publication, International GAAP® provides further guidance on IFRS 1's transition requirements for hedge accounting.

5.16.3.C Concession on designation and documentation of hedging instruments

A hedging relationship not specifically identified under an entity's previous financial reporting framework could meet the conditions for hedge accounting under IAS 39 or IFRS 9 as at the date of transition to FRS 102 or at a later date (except that the entity completes the designation and documentation of the hedging relationship after the date of transition but before the date of approval of the financial statements).

How we see it

In such circumstances, we consider that the transition provisions would allow hedge accounting prospectively from the date of transition (or from that later date) but that the hedging relationship must not be reflected in the opening FRS 102 statement of financial position. In essence, whereas IFRS 1 would have required the designation and documentation to be in place by the date of transition in order to hedge account prospectively from the date of transition for such a relationship, the transition provision in FRS 102 extends the deadline for completing the designation and documentation to the date of authorisation of the financial statements.

As the designation and documentation of hedging relationships (which will include how effectiveness is to be assessed) are only required to be completed by the date of authorisation of the first FRS 102 financial statements, the first-time adopter must likewise have more time to perform the effectiveness assessments required. Under IFRS 9, the entity must continue to assess the ongoing effectiveness requirements, whereas both retrospective and prospective effectiveness tests are required under IAS 39. Clearly, these effectiveness tests will need to be completed and satisfied at the latest by the date of authorisation of the first FRS 102 financial statements.

This concession over the timing of completion of designation and documentation is optional. Therefore, an entity could still account for a hedging relationship from the date all the requirements (including designation and documentation) for hedge accounting are met.

However, this concession might still be helpful to a previous IFRS or FRS 101 reporter that applied IAS 39 to hedge accounting in its most recent IFRS financial statements and instead applies IFRS 9's hedge accounting provisions on first-time adoption of FRS 102 (particularly where the documentation needs to be improved to meet IFRS 9's requirements).

5.17 Dormant entities

A company within the Companies Act definition of a dormant company (section 1169 of the CA 2006), or an LLP within the definition of a dormant LLP as set out in *The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008* (SI 2008/1911), is permitted to elect to retain its accounting policies for reported assets, liabilities and equity at the date of transition to FRS 102 until there is any change to those balances or the company undertakes any new transactions, that would cause the company to cease to be dormant within the Act's definition, or the LLP to cease to be dormant under the definition in SI 2008/1911. [FRS 102.35.10(m)]. Hence, so long as a company or LLP remains dormant, it can retain its accounting policies under its previous financial reporting framework.

Without this transition exemption, dormant companies and LLPs would be required to assess whether there are changes to the existing accounting under FRS 102 compared to its previous financial reporting framework. A change in accounting could lead to the company or LLP ceasing to be dormant. For UK companies and LLPs, this could impact on the requirements to prepare and file statutory accounts (as exemptions are available to qualifying dormant subsidiary companies/LLPs supported by a statutory guarantee from a UK parent) and on the availability of audit exemptions. [s394A-s394C, s448A-s448C, s480-s481, s394A (LLP)-s394C (LLP), s448A (LLP)-s448C (LLP), s480 (LLP)-s481 (LLP)].

Dormant entities must, like all FRS 102 reporters, give a complete and unreserved statement of compliance with FRS 102. [FRS 102.3.3].

Where there is potential to become non-dormant in the future, a dormant company/LLP might consider whether it is beneficial to take (and accordingly state use of) other exemptions which would not affect its dormant status under the CA 2006. An example of this would be the election to use deemed cost on transition in relation to the cost of investments in subsidiaries, associates and jointly controlled entities – see 5.7 above. [FRS 102.35.10(f)]. This is because, if the company/LLP becomes non-dormant in the future and can no longer retain its existing accounting policies, it will no longer be a first-time adopter (and so cannot make use of new exemptions at that time). However, in many cases, dormant companies/LLPs might have simple affairs and other transition exemptions might not be relevant.

How we see it

While the exemption does not explicitly state this, we consider that the wording of the exemption, in particular its references to accounting policies at the date of transition, more closely supports the view that the exemption is only available to companies and LLPs that are dormant at the date of transition (until such time as they cease to be dormant) rather than being available to companies and LLPs that become dormant during the period prior to the first reporting period in which FRS 102 is applied.

5.18 Insurance contracts

As noted in Chapter 38, FRS 103 is a transaction-based standard applying to FRS 102 reporters falling within its scope.

An entity applying both FRS 102 and FRS 103 together at the first time (i.e., a first-time adopter of FRS 102) must apply both Section 35 and the transitional provisions set out in Section 6 of FRS 103.

[FRS 103.6.1, FRS 103.62].

An entity applying FRS 103 for the first time need not disclose information about claims development that occurred earlier than five years before the end of the first financial year in which it applies FRS 103. Furthermore, if it is impracticable, when an entity first applies FRS 103, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with FRS 103, the entity must disclose that fact. [FRS 103.6.3, FRS 103.4.8(b)(iii)].

If an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as a financial asset at fair value through profit or loss provided those assets meet the criteria in paragraph 11.14(b) of FRS 102 (or the relevant requirements of either IAS 39 (as adopted in the relevant jurisdiction) – where this policy choice is allowed (see 3.4.1 and 4.1.1 above) – or IFRS 9 (as adopted in the relevant jurisdiction), depending on the policy choice made) at that date. This reclassification is permitted if an insurer changes accounting policies when it first applies FRS 103 and if it makes a subsequent policy change permitted by paragraph 2.3 of FRS 103. The reclassification is a change in policy to which Section 10 of FRS 102 applies. [FRS 103.6.4].

When preparing financial statements at the date of transition, an insurer whose previous financial reporting framework was adopted IFRS, or included an approach and methodology for accounting for insurance contracts that is equivalent to adopted IFRS, must disregard its existing accounting policies for insurance contracts and apply FRS 103 as if it were setting accounting policies in relation to insurance contracts for the first time (see paragraph 1.5 of FRS 103). [FRS 103.6.5, FRS 103.1.5, FRS 103.2.3].

These transitional provisions also apply when an entity already applying FRS 102 first applies FRS 103 and are discussed in more detail in Chapter 38. [FRS 103.6.1].

6 Presentation and disclosure

Section 35 does not exempt a first-time adopter from any of the presentation and disclosure requirements in other sections of FRS 102.

6.1 Comparative information

An entity's first FRS 102 financial statements are required to be a complete set of financial statements and therefore must include at least two statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements of cash flows (unless exempt) and two statements of changes in equity and related notes, including comparative information. [FRS 102.3.17, FRS 102.3.20, FRS 102.7.1A, FRS 102.7.1B, FRS 102.35.5]. Where permitted by the standard, two statements of income and retained earnings may be included in place of the statements of comprehensive income and statements of changes in equity. [FRS 102.3.18, FRS 102.6.4]. An opening statement of financial position at the date of transition is not required. [FRS 102.35.7].

Small entities are not required to present a cash flow statement. [FRS 102.7.1B], and small entities applying Section 1A are required to present at least two statements of financial position, two income statements and related notes, including comparative information. [FRS 102.1A.8]. In addition, a small entity applying Section 1A of FRS 102 may need to present a statement of comprehensive income when it recognises gains or losses in other comprehensive income and/or a statement of changes in equity (or, where appropriate, a statement of income and retained earnings) when it has changes in equity other than profit or loss. [FRS 102.1A.9]. See Chapter 5 at 3.3.3.

Except where FRS 102 permits or requires otherwise, comparative information in respect of the preceding period is required for all amounts presented in the financial statements, as well as for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. [FRS 102.3.14, FRS 102.35.6]. An entity is permitted to present comparative information for more than one preceding period.

FRS 103 provides certain disclosure reliefs for information on claims development (see 5.18 above). [FRS 103.6.3].

6.2 Explanation of transition to FRS 102

A first-time adopter is required to explain how the transition from its previous financial reporting framework to FRS 102 affected its reported financial position, and financial performance. [FRS 102.35.12]. FRS 102 does not require an explanation of how the transition affected cash flows.

Following the Periodic Review 2024 amendments, the standard now requires an entity to state which, if any, of the transitional exemptions described in paragraph 35.10 has been adopted on transition to FRS 102, and provide explanation of material changes to its reported financial position that are not presented in the reconciliation required by paragraph 35.13 (see 6.3 below). [FRS 102.35.12A, FRS 102.35.12B].

If a first-time adopter did not present financial statements for previous periods this fact must be disclosed in its first financial statements that conform to FRS 102. [FRS 102.35.15]. For example, entities might not have prepared consolidated financial statements under their previous financial reporting framework and newly incorporated entities might never have prepared financial statements at all. In such cases, an explanation of how the transition to FRS 102 affects the entity's financial position and performance cannot be presented because relevant comparative information under the entity's previous financial reporting framework does not exist.

If it is impracticable for an entity to make one or more of the adjustments required by paragraph 35.7 at the date of transition (see 3.4 above), the entity must apply paragraphs 35.7 to 35.10 (i.e., retrospective application of FRS 102, subject to the transition exceptions and exemptions) for such adjustments in the earliest period for which it is practicable. The entity must identify which amounts in the financial statements have not been restated. If it is impracticable for an entity to provide any disclosures required by FRS 102 for any period before the period in which it prepares its first FRS 102 financial statements, it must disclose the omission. [FRS 102.35.11]. See 3.4.4 above for discussion of the meaning of 'impracticable'.

If it is not practical on first-time adoption to apply a particular requirement of paragraph 18 of IFRS 6 (impairment of exploration and evaluation assets) to previous comparative amounts an entity must disclose that fact. [FRS 102.34.11C].

6.3 Disclosure of reconciliations

A first-time adopter is required to present in its first financial statements prepared using FRS 102: [FRS 102.35.13(b), FRS 102.35.13(c)]

- Reconciliations of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with FRS 102 at:
 - The date of transition to FRS 102.
 - And
 - The end of the latest period presented in the entity's most recent annual financial statements determined in accordance with its previous financial reporting framework.
- And
- A reconciliation of the profit or loss determined in accordance with its previous financial reporting framework for the latest period in the entity's most recent annual financial statements to its profit or loss determined in accordance with FRS 102 for the same period.

First-time adopters must also describe the nature of each change in accounting policy. [FRS 102.35.13(a)]. As noted at 6.2 above, the transition exemptions, if any, applied must also be stated. [FRS 102.35.12A].

If the entity becomes aware of errors made under its previous financial reporting framework, the reconciliations must, to the extent practicable, distinguish the correction of those errors from changes in accounting policies. [FRS 102.35.14]. This means that the adoption of FRS 102 must not be used to mask the error.

FRS 102 does not specify the format of the reconciliations of equity or profit or loss. In FRS 102 Factsheet 7 *Transition to FRS 102*, the FRC give two example layouts (in both cases, with supporting notes explaining the adjustments):

- A line-by-line reconciliation of the statement of financial position at the date of transition and at the end of the comparative period, and of the profit or loss account for the comparative period.
- Or
- A reconciliation of total equity at the date of transition and at the end of the comparative period, and of the total profit or loss for the comparative period.

How we see it

A line-by-line reconciliation may be particularly appropriate when a first-time adopter needs to make transition adjustments that affect a significant number of line items in the primary financial statements. If the adjustments are less pervasive, a straightforward reconciliation of equity and profit or loss may be able to provide an equally effective explanation.

Following the Periodic Review 2024, an entity must also provide an explanation of material changes to its reported financial position that are not presented in the reconciliation, explaining whether the changes identified arose from errors or changes in accounting policy. [FRS 102.35.12B].

How we see it

This requirement would mean, for example, that material presentational changes to the statement of financial position need to be explained. While Section 35 does not explicitly require an explanation to be given of presentational changes to the profit and loss account, certain statutory disclosures referred to below may be relevant in this regard.

A UK company (or LLP) will also need to comply with any requirements of the Regulations (or LLP Regulations), for example, the requirements of paragraph 7(2) to disclose any adjustment made to corresponding amounts or to give particulars of the non-comparability, [1 Sch 7(2), 1 Sch 7(2)(LLP)], in respect of corresponding amounts that have been adjusted or are not comparable (see Chapter 6 at 2.4.1). In most cases, the reconciliations required by Section 35 combined with an adequate explanation of the transition adjustments and how these relate to the restated figures are likely to provide sufficient information to meet these requirements. However, this statutory disclosure requirement needs to be borne in mind by entities when explaining the transition.

Moreover, the particulars of, and reason for any change of formats (e.g., moving from the statutory to adapted formats on transition, say, from FRS 101 to FRS 102) would need to be explained in the notes to the financial statements. [1 Sch 2(2), 1 Sch 2(2)(LLP)]. See Chapter 6 at 3.3.

How we see it

In our view, a first-time adopter must include all disclosures required by Section 35 within its first FRS 102 financial statements and not cross-refer to any previously reported information. Any additional voluntary information regarding the conversion to FRS 102 that was previously published but that is not specifically required by Section 35 need not be repeated in the first FRS 102 financial statements.

6.4 Repeat application of FRS 102

An entity that has applied FRS 102 in a previous reporting period but not in its most recent annual financial statements, as described in paragraph 35.2 (see 3.1.2 above), must disclose: *[FRS 102.35.12C]*

- The reason it stopped applying FRS 102.
 - The reason it is resuming the application of FRS 102.
- And
- Whether it has applied Section 35 or has applied FRS 102 retrospectively in accordance with Section 10 of FRS 102.

This disclosure is therefore only required in the accounting period in which the entity reapplies FRS 102.

6.5 Interim financial statements

FRS 102 does not address the presentation of interim financial reports; it merely requires that an entity that prepares such reports must describe the basis for preparing and presenting the information. FRS 104 *Interim Financial Reporting* sets out a basis for the preparation and presentation of interim financial reports that an FRS 102 reporter may apply. *[FRS 102.3.25]*.

FRS 104 is not a mandatory standard to apply. Issuers subject to the Disclosure and Transparency Rules that are not required to prepare consolidated financial statements and choose to report under FRS 102 may give a responsibility statement that the condensed set of financial statements has been prepared in accordance with FRS 104. However, we would generally expect FRS 104 to be applied where interim financial statements are prepared by an FRS 102 reporter. See Chapter 39 at 2.2 for further discussion of the scope of FRS 104.

FRS 104 (rather than Section 35) addresses the disclosures concerning transition required in interim financial reports applying FRS 102 that cover part of the first financial reporting period. *[FRS 104.16B]*. See Chapter 39 at 11. Where changes to accounting policies or the use of exemptions are made between the first FRS 102 interim financial report and the first FRS 102 financial statements, neither FRS 104 nor Section 35 require disclosure of these changes (including an update to the reconciliations) in the annual financial statements. This disclosure is, however, required by an IFRS reporter. *[IFRS 1.27A]*.

How we see it

We would encourage disclosure of changes to accounting policies made between the first FRS 102 interim report and the first FRS 102 financial statements, where material, as relevant information in the first FRS 102 financial statements.

Appendix A – Defined terms

Extract from FRS 102

Appendix I

Glossary

adopted IFRS	IFRS Accounting Standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. In the Republic of Ireland, this refers to EU-adopted IFRS.
carrying amount	The amount at which an asset, a liability or equity is recognised in the statement of financial position.
date of transition	The beginning of the earliest period for which an entity presents full comparative information in a given standard in its first financial statements that comply with that standard.
deemed cost	An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost.
fair value	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of any specific guidance provided in the relevant section of this FRS, the guidance in Section 2A <i>Fair Value Measurement</i> shall be used in determining fair value.
first-time adopter of this FRS	An entity that presents its first annual financial statements that conform to this FRS, regardless of whether its previous financial reporting framework was adopted IFRS or another set of accounting standards.
reporting date	The end of the latest period covered by financial statements or by an interim financial report.
reporting period	The period covered by financial statements or by an interim financial report.

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Chapter 38

FRS 103 - Insurance contracts

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Overview

FRS 103 *Insurance Contracts* is relevant to entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and addresses the accounting for insurance contracts (including reinsurance contracts) that an entity issues and reinsurance contracts that it holds, including financial instruments that an entity issues with a discretionary participation feature (DPF).

FRS 103 is a transaction-based standard that applies to insurance and non-insurance entities that issue contracts which meet the definition of an insurance contract, regardless of whether the entity is an insurer for legal or supervisory purposes. FRS 103 generally permits entities to continue with their existing accounting policies for insurance contracts; however, an entity that has previously applied IFRS 17 *Insurance Contracts* cannot carry forward the accounting principles from IFRS 17 and must instead apply FRS 103 as if it were setting accounting policies in relation to insurance contracts for the first time.

The requirements in FRS 103 are based in part on IFRS 4 *Insurance Contracts*. However, IFRS 4 did not set specific requirements for the underlying recognition and measurement of insurance contracts, which reflects the fact that it was an interim standard issued by the IASB to facilitate harmonisation between jurisdictions pending completion of the second phase of its insurance contracts project (i.e., IFRS 17). Therefore, in developing FRS 103, the text of IFRS 4 was supplemented with some of the existing requirements and practice in accounting for insurance contracts in the UK and Republic of Ireland.

The *Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* (SI 2008/410) require the individual financial statements of an insurance company to comply with Schedule 3 to the Regulations; however, a company that issues insurance contracts which is not an insurance company is not required to prepare its individual financial statements in accordance with Schedule 3 to the Regulations.

What you need to know

- An entity that applies FRS 102 must apply FRS 103 to insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds, and to financial instruments that the entity issues with a DPF.
- FRS 103, accompanied by non-mandatory Implementation Guidance, is based on the International Accounting Standard Board's (IASB) standard IFRS 4, the requirements of FRS 27 *Life Assurance* and aspects of the Association of British Insurers' Statement of Recommended Practice on Accounting for Insurance Business (the ABI SORP).
- FRS 103 permits insurers to continue applying their existing accounting policies for insurance contracts on transition; except when the insurer's previous financial reporting framework was adopted IFRS or included insurance contract accounting equivalent to adopted IFRS, in which case the insurer must apply FRS 103 as if it were setting accounting policies regarding insurance contracts for the first time.

1 Introduction

An entity that applies FRS 102, whether or not it is an 'insurance company', must apply FRS 103 to insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds, and to financial instruments that the entity issues with a DPF. [FRS 103.BC2].

FRS 103 (and the accompanying non-mandatory Implementation Guidance) consolidates pre-existing financial reporting requirements and guidance for insurance contracts. The requirements (and the guidance in the accompanying non-mandatory Implementation Guidance) are based on the IASB's IFRS 4 *Insurance Contracts* extant in 2013 (except to the extent that it was amended by IFRS 13 *Fair Value Measurement*), the requirements of FRS 27 (prior to it being withdrawn by FRS 103) and elements of the ABI SORP (published in December 2005 and amended in December 2006 prior to it being withdrawn by FRS 103). [FRS 103.BC1]. FRS 103 has since been updated for changes in the UK regulatory framework and as part of the Periodic Review 2024 for the amendments made to IFRS 4 by IFRS 13 which are now reflected in FRS 103 (see 1.1 below).

FRS 103, generally, allows entities to continue with their previous accounting practices for insurance contracts but permits entities the same flexibility to make improvements (subject to legal and regulatory requirements) as entities in the UK and Republic of Ireland applying EU-adopted IFRS or FRS 101.

[FRS 103.BC16, FRS 103.BC17].

1.1 Updates to FRS 103

FRS 103 was issued originally in March 2014 and effective for accounting periods beginning on or after 1 January 2015. Revised versions were issued in February 2017, March 2018, January 2022 and September 2024. This chapter reflects the September 2024 version of FRS 103. The main changes made to FRS 103 since the March 2018 version are as follows:

- December 2020 amendments to reflect changes in UK company law following the UK exit from the European Union. [FRS 103.1.11C].
- March 2024 amendments as set out in the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS - Periodic Review 2024*, which incorporates the new definition of fair value introduced as part of Section 2A Fair Value Measurement of FRS 102, these are consistent with the consequential amendments made to IFRS 4, which FRS 103 is partly based, as a result of the introduction of IFRS 13. [FRS 103.BC59]. The amendments are effective for periods beginning on or after 1 January 2026, except for the amendments to Section 6 *Transition of FRS 103*, which must be applied for periods beginning on or after 1 January 2024. Early application of the amendments other than those in Section 6 of FRS 103 is permitted, provided that all those other amendments are applied at the same time. [FRS 103.1.11D].

1.2 FRS 103 and IFRS 17 Insurance Contracts

IFRS 17 was issued by the IASB in May 2017, amended in June 2020 and December 2021, and effective for accounting periods beginning on or after 1 January 2023. IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features issued. IFRS 17 replaced IFRS 4 (upon which FRS 103 is based).

It is stated in the Basis for Conclusions that the FRC will review the requirements of FRS 103 in the light of IFRS 17 but that the timing of this review is yet to be determined. [FRS 103.BC57]. The FRC did not consider whether and how to align FRS 103 with IFRS 17 as part of their Periodic Review 2024²⁵³. The Basis for Conclusions states that the FRC is likely to wait for several years' implementation experience before considering alignment of FRS 103 with IFRS 17. Further, as noted in the Basis for Conclusions to FRS 101, conflicts between IFRS 17 and company law have led the FRC to conclude previously that it is not currently possible to apply IFRS 17 in Companies Act accounts (i.e., accounts prepared in accordance with the FRC's FRSSs) whilst continuing to maintain compliance with company law. [FRS 103.BC57A].

²⁵³ [FRC revises UK and Ireland accounting standards](#), FRC, March 2024

Section 6 of FRS 103 requires an insurer that previously applied IFRS, or an equivalent financial reporting framework, and subsequently transitions to FRS 103 for the first time, to disregard its existing accounting policies for insurance contracts. The provisions in FRS 103 for an insurer largely to continue with its existing accounting policies for insurance contracts on transition were not intended to provide a mechanism for importing accounting principles from IFRS 17. Such an insurer must instead apply FRS 103 as if it were setting accounting policies in relation to insurance contracts for the first time (see 3.3 below).

[FRS 103.BC57B].

1.3 Entities applying FRS 103 for the first time

New entrants to the insurance market would not have existing accounting policies for insurance contracts. Therefore, to provide these new entrants with the same benchmark accounting policies and the same flexibility to make improvements, new entrants must first consider the sections of FRS 103 (which is based on the requirements of FRS 27 and the ABI SORP (see 1 above)) as a means of establishing current practice before considering whether to 'improve' those benchmark accounting policies. [FRS 103.BC18].

Furthermore, to maintain a consistent starting point for insurers in selecting their accounting policies for insurance contracts for the first time, the Basis for Conclusions observes that existing entities are not required to change their accounting policies, although the change in regulatory regime may be a trigger for some entities to 'improve' their accounting policies, to make them more consistent with the Solvency II regulatory framework (see 9 below). [FRS 103.BC53].

Entities that are setting accounting policies for long-term insurance business, or other financial instruments with discretionary participation features, for the first time, must either: [FRS 103.1.5]

- First consider the requirements of Section 3 of FRS 103 *Recognition and Measurement: Requirements for entities with long-term insurance business*, the Regulations and any relevant parts of FRS 102, as a benchmark before assessing whether to set accounting policies that differ from those benchmark policies in accordance with paragraph 2.3 of FRS 103.

Or

- Establish accounting policies that are based on the rules under the Solvency II Directive for the recognition and measurement of technical provisions, and any relevant requirements of FRS 103, the Regulations and FRS 102. In doing so, an entity must make appropriate adjustments to the Solvency II rules to ensure that the accounting policies result in information that is relevant and reliable. This is consistent with the requirements of the Regulations for the computation of the long-term business provision to have due regard to the actuarial principles of Solvency II (see 8.4.4 below).

Entities setting accounting policies for general insurance business for the first time appear to be excluded from this guidance although these entities could still follow this guidance in the absence of any other requirements.

1.4 Non-insurance transactions and balances

Recognition, measurement and disclosure of non-insurance transactions and balances of an insurer are accounted for in accordance with FRS 102 and are discussed in the relevant chapters of this publication.

1.5 Implementation guidance accompanying FRS 103

FRS 103 is accompanied by non-mandatory implementation guidance. The Implementation Guidance is not part of, and does not carry the authority of, an accounting standard. It provides guidance on applying:

[FRS 103.1.4]

- The requirements of FRS 103.
- The requirements or principles of FRS 102 by entities with general insurance business or long-term insurance business.

And

- The requirements of Schedule 3 to the Regulations.

The Implementation Guidance has been developed from material that was previously included in either FRS 27 or the ABI SORP. Paragraphs that have been sourced from the ABI SORP, and to a lesser extent those from FRS 27, have been revised where required, for example to reflect new legislative requirements or for consistency with FRS 102. Each section of the Implementation Guidance specifies the requirements to which it relates. [FRS 103.IG.Overview (iii)].

A number of the sections of FRS 102 exclude insurance contracts from their scope. However, FRS 102 requires entities developing accounting policies for transactions, other events or conditions not specifically addressed in FRS 102 (or another FRS) to consider the applicability of the requirements and guidance in FRS 102 (or another FRS) dealing with similar or related issues. Therefore, where relevant, the Implementation Guidance includes guidance on the application of certain principles of FRS 102 to insurance contracts, even though insurance contracts may not be within the scope of those sections. This is consistent with setting accounting policies in accordance with the principles of FRS 102 and FRS 103.

[FRS 103.IG.Overview (ii)].

2 Comparison between FRS 103 and IFRS 17

FRS 103 and IFRS 17 both address the accounting for insurance contracts but differ significantly in terms of measurement, recognition and disclosure. As discussed at 1 above, FRS 103 is based largely on IFRS 4 and consolidates pre-existing financial reporting requirements and guidance for insurance contracts. IFRS 4 did not prescribe detailed measurement and recognition requirements for insurance contracts but, instead, allowed entities to use a wide variety of accounting practices for insurance contracts, that reflected national accounting requirements and variations of those requirements. Similarly, FRS 103 allows entities to continue using their existing accounting policies for insurance contracts, except when the entity has previously applied IFRS 17, with some modifications to ensure compliance with UK Company Law.

IFRS 17 superseded IFRS 4 and became effective for accounting periods beginning on or after 1 January 2023. Unlike IFRS 4, IFRS 17 does not contain transitional provisions that 'grandfather' conclusions under previous GAAP. Instead IFRS 17 requires the same recognition and measurement model for insurance contracts instead of diverse local practices and represents a fundamental change for insurers.

IFRS 17 applies a current value approach to measuring insurance contracts and recognises profit as services are provided. The general model in IFRS 17 requires insurance contract liabilities to be measured using discounted probability-weighted current estimates of future cash flows, a risk adjustment for non-financial risk and a contractual service margin representing the profit expected from fulfilling the contracts. IFRS 17 also has specific modifications to the general model including a simplified measurement approach, the premium allocation approach intended for short-term contracts, and an adaptation of the general model, the variable fee approach for contracts with a DPF. There are also modifications to the basic measurement rules for reinsurance contracts held, which must be accounted for separately from the underlying insurance contracts issued.

IFRS 17 is a complex standard that covers the accounting for a wide range of contracts that insurers and non-insurers issue and provides detailed guidance on many areas (such as contract boundaries, contract aggregation for measurement purposes, modifications of contracts and business combination accounting) on which IFRS 4 was silent. The transition requirements must be applied retrospectively unless impractical and in which case IFRS 17 addresses how insurers deal with impracticability by requiring two alternative approaches to fully retrospective application, a modified retrospective approach and a fair value approach.

IFRS 17 represents a major overhaul, introducing a detailed measurement model based on current estimates, risk adjustments and contractual service margins. It requires regular remeasurement and detailed aggregation of insurance contracts, and it aims to provide more transparent and comparable information globally across entities. In contrast, FRS 103 maintains continuity with existing practices, allowing entities to use their established accounting policies with minor modifications. IFRS 17 presents a more dynamic and standardised approach.

2.1 Insurance contracts with discretionary participation features

FRS 103 states that an entity can only recognise a DPF in an insurance contract as equity if permitted by the Regulations. [FRS 103.2.30(b)]. However, the Regulations require that the fund for appropriations (FFA) is classified as a liability (see 8.2.10 below). Therefore, there is no option to classify the DPF in UK insurance contracts as equity.

Under IFRS 17, entities must make a best estimate of the liability due to policyholders (both current and future) under the contracts and amounts attributable to shareholders are part of shareholders' equity.

2.2 Financial instruments with discretionary participation features

Financial instruments with discretionary participation features are scoped out of Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues* of FRS 102. However, FRS 103 requires some disclosures to be made in respect of those contracts that are set out in Section 11 of FRS 102.

IFRS 17 applies to investment contracts with discretionary participation features that the entity issues, provided that it also issues insurance contracts; however, where an entity issues contracts with discretionary participation features but does not issue any insurance contracts, those contracts would fall within the scope of IAS 32 and IFRS 9.

2.3 Accounting for financial instruments

Under FRS 102, as an alternative to applying the recognition and measurement requirements of Sections 11 and 12 for financial instruments, the recognition and measurement requirements of IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 are available as an accounting policy choice. However, a change introduced by the Periodic Review 2024 means that entities are no longer permitted to change their accounting policy from applying Section 11 and Section 12 or a combination of IFRS 9 and IAS 39 to applying IAS 39, except to make their policies consistent with the consolidated financial statements in which the entity is included. [FRS 102.11.2, FRS 102.12.2].

2.4 Disclosure differences

There are many disclosure differences between IFRS 17 and FRS 103.

Disclosures required by FRS 103 are discussed at 11 below. In addition, insurers are required by Schedule 3 to the Regulations to make various additional disclosures in respect of insurance contracts which do not apply to IFRS reporters.

3 The objectives, scope of and transition to FRS 103

3.1 The objectives of FRS 103

In developing the requirements of financial reporting standards, including FRS 103, the overriding objective is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. *[FRS 103.BC3]*.

The FRC notes that FRS 103:

- Provides a financial reporting framework for entities with insurance contracts that allows them to generally continue with their existing policies whilst consolidating and modernising the relevant accounting requirements. *[FRS 103.BC5]*.
- Is deregulatory in some areas (e.g., by permitting entities to improve their accounting policies and by including best practice guidance that allows entities some flexibility in complying with the disclosure principles). *[FRS 103.BC5]*.
- Was supplemented with the text of IFRS 4 by some of the existing requirements and practice in accounting for insurance contracts in the UK and Republic of Ireland and, as a result, much of FRS 27 has been incorporated into FRS 103 or the accompanying Implementation Guidance, along with elements of the ABI SORP and company law applicable to insurance companies. *[FRS 103.BC7, FRS 103.BC8]*.
- Consolidates all relevant, existing accounting requirements and guidance applicable to entities with insurance contracts, other than company law and the requirements of the PRA handbook, which is consistent with the FRC's general approach to setting accounting standards and eliminates unnecessary duplication. *[FRS 103.BC9]*.

In summary, FRS 103:

- Allows entities, generally, to continue with their existing accounting policies for insurance contracts including the appropriate measurement of long-term insurance business, whilst permitting limited improvements to accounting by insurers.
- Requires disclosure that:
 - Identifies and explains the amounts in an insurer's financial statements arising from the insurance contracts (including reinsurance contracts) it issues and reinsurance contracts that it holds.
 - Relates to the financial strength of entities carrying on long-term insurance business.
 - Helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from those insurance contracts.

3.2 The scope of FRS 103

3.2.1 Key definitions

Extract from FRS 103

Appendix I**Glossary**

Cedant	The policyholder under a reinsurance contract.
discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
guaranteed benefits	Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.
insurance contract	A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix II for guidance on this definition.)
insurance liability	An insurer's net contractual obligations under an insurance contract.
insurance risk	Risk, other than financial risk, transferred from the holder of a contract to the issuer.
insured event	An uncertain future event that is covered by an insurance contract and creates insurance risk.
insurer	The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.
policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs.
reinsurance assets	A cedant's net contractual rights under a reinsurance contract.
reinsurance contract	An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant. Retrocession is the reinsurance outwards of risks previously accepted by an insurer as reinsurance inwards. The recipient is known as the retrocessionaire.
reinsurer	The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.

3.2.2 Transactions within the scope of FRS 103

FRS 103 applies to financial statements prepared by an entity that applies FRS 102 and that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. [FRS 103.1.1].

Unless specifically excluded from its scope (see 3.2.3 below) an entity that applies FRS 102 must apply FRS 103 to: [FRS 103.1.2]

- Insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.
- And
- Financial instruments (other than insurance contracts) that it issues with a DPF (see 7.2 below).

FRS 103 applies to entities as follows: [FRS 103.1.3]

Extract from FRS 103

- 1.3** This FRS applies to entities with insurance contracts and financial instruments with discretionary participation features within the scope of paragraph 1.2 as follows:
- (a) Section 1 *Scope*, Section 2 *Accounting Policies, Recognition and Measurement*, Section 4 *Disclosure* and Section 6 *Transition to this FRS* apply to all entities applying this FRS.
 - (b) Section 3 *Recognition and Measurement: Requirements for entities with long-term insurance business* and Section 5 *Disclosure: Additional requirements for with-profits business* only apply to entities with long-term insurance business.
 - (c) Appendix II *Definition of an insurance contract* applies to all entities.
- The Regulations (or other legal framework that applies to the entity) may set out requirements in addition to those within this FRS.

It can be seen from this that FRS 103 applies to insurance contracts and not just to entities that specialise in issuing insurance contracts. It is a transaction-based standard. Consequently, non-insurance entities will be within its scope if they issue contracts that meet the definition of an insurance contract.

FRS 103 describes any entity that issues an insurance contract as an insurer whether or not the entity is regarded as an insurer for legal or supervisory purposes. [FRS 103.1.9].

Section 11 and Section 12 of FRS 102 contain scope exemptions for insurance and reinsurance contracts issued by an entity and for reinsurance contracts held by an entity and for financial instruments issued by an entity with a DPF (see 7 below). [FRS 102.11.7(f), FRS 102.11.7(g), FRS 102.12.3(d), FRS 102.12.3(j)]. Financial instruments that do not meet the definition of an insurance contract and do not contain a DPF are within the scope of either Section 11 or Section 12 of FRS 102. This will be the case even if they have the legal form of an insurance contract. [FRS 103.1.8]. These contracts are commonly referred to as 'investment contracts'.

The following table illustrates the standards applying.

Type of contract	Recognition and Measurement	Disclosure
Insurance contract issued (both with and without a DPF)	FRS 103	FRS 103
Reinsurance contract held and issued	FRS 103	FRS 103
Investment contract with a DPF	FRS 103	FRS 103
Investment contract without a DPF	Section 11 or Section 12 of FRS 102	Section 11 or Section 12 of FRS 102

A reinsurance contract is a type of insurance contract and therefore all references in FRS 103 to insurance contracts apply equally to reinsurance contracts. [FRS 103.1.10].

Since insurance contracts and investment contracts with a DPF are scoped out of Sections 11 and 12 of FRS 102, FRS 103 applies to all the assets and liabilities arising from these contracts, which include:

- Insurance and reinsurance receivables owed by the policyholder direct to the insurer
- Insurance receivables owed by an intermediary to an insurer on behalf of the policyholder where the intermediary is acting in a fiduciary capacity (discussed at 3.2.2.A below)

- Insurance claims agreed with the policyholder and payable
- Insurance contract policy liabilities
- Claims handling cost provisions
- The present value of acquired in-force business (discussed at 10.1 below)
- Deferred or unearned premium reserves
- Reinsurance assets (i.e., expected reinsurance recoveries in respect of claims incurred)
- Deferred acquisition costs
- Liabilities related to discretionary participation features

Receivables due from intermediaries to insurers that have a financing character and balances due from intermediaries not acting in a fiduciary capacity, for example loans to intermediaries repayable from commissions earned, are outside the scope of FRS 103 as these do not arise from insurance contracts.

3.2.2.A Amounts receivable from an intermediary

When a policyholder has paid premiums to an intermediary, and the intermediary has not remitted the premiums to the insurer, it is not initially obvious whether the resulting premium receivable would be within the scope of FRS 103 or Sections 11 and 12 of FRS 102. IFRS accounting standards permit an accounting policy choice to apply either IFRS 17 or IFRS 9 to amounts receivable from an intermediary when a policyholder has discharged its obligation to an insurer. Schedule 3 requires debtors arising out of insurance operations to be split between those due from policyholders and those due from intermediaries (see 8.2.5 below). However, Schedule 3 does not specify whether the balances due from intermediaries are within the scope of FRS 103 or Sections 11 and 12 of FRS 102.

How we see it

When a policyholder has paid premiums to an intermediary and the payment by the policyholder discharges the policyholder's obligation under the insurance contract, an insurer could refer to Section 10 *Accounting Policies, Estimates and Errors* of FRS 102 and use the hierarchy to develop an accounting policy due to the lack of specific guidance in FRS 103. However, when a policyholder has paid premiums to an intermediary but has not discharged its obligation to an insurer until the intermediary has remitted the premiums to the insurer, the premium receivable remains in the scope of FRS 103.

3.2.3 Transactions not within the scope of FRS 103

FRS 103 applies only to accounting for insurance contracts and financial instruments with a DPF. The recognition, measurement and disclosure requirements for all other assets held and liabilities assumed by an insurer are contained in FRS 102. In particular, the recognition, measurement and disclosure requirements for financial assets held and financial liabilities assumed are contained in Sections 11, 12 and Section 34 *Specialised Activities* of FRS 102. [FRS 103.1.6].

FRS 103 describes transactions to which FRS 103 is not applied. These primarily relate to transactions covered by sections of FRS 102 that could potentially meet the definition of an insurance contract. These transactions are discussed below.

3.2.3.A Product warranties

Product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of FRS 103. These are accounted for under Section 21 *Provisions and Contingencies* and Section 23 *Revenue from Contracts with Customers* of FRS 102. [FRS 103.1.7(a)]. Without this exemption many product warranties would have been in the scope of FRS 103 as these would normally meet the definition of an insurance contract.

However, a product warranty is within the scope of FRS 103 if it is not issued by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer.

Other types of warranty are not specifically excluded from the scope of FRS 103. For example, a warranty given by a vendor to the purchaser of a business, such as in respect of contingent liabilities related to unagreed tax computations of the acquired entity, is an example of a transaction that may also fall within the scope of this standard. However, since FRS 103 does not prescribe a specific accounting treatment, issuers of such warranties are likely to be able to apply their existing accounting policies although they would be subject to the disclosure requirements in FRS 103.

3.2.3.B Assets and liabilities arising from employment benefit plans

Employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans are excluded from the scope of FRS 103. These are accounted for under Section 26 *Share-based Payment*, Section 28 *Employee Benefits*, and Section 34 of FRS 102.

[FRS 103.1.7(b)].

Many defined benefit pension plans and similar post-employment benefits meet the definition of an insurance contract because the payments to pensioners are contingent on uncertain future events, such as the continuing survival of current or retired employees. Without this exception these would have been within the scope of FRS 103.

3.2.3.C Contingent rights and obligations related to non-financial items

Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, variable and other contingent lease payments and similar items) are excluded from the scope of FRS 103, as well as a lessee's residual value guarantee embedded in a finance lease. These are accounted for under Section 18 *Intangible Assets other than Goodwill*, Section 20 *Leases* and Section 23 of FRS 102. [FRS 103.1.7(c)].

3.2.3.D Financial guarantee contracts

Financial guarantee contracts are excluded from the scope of FRS 103 unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either Section 21 of FRS 102 or FRS 103 to these financial guarantee contracts. The issuer may make that election on a contract-by-contract basis, but the election for each contract is irrevocable. [FRS 103.1.7(d)].

When an insurer elects to use FRS 103 to account for its financial guarantee contracts, its accounting policy defaults to its previous GAAP for such contracts (subject to any limitations discussed at 9 below) unless subsequently modified as permitted by FRS 103 (see 9 below).

FRS 103 does not elaborate on the phrase 'previously asserted explicitly'. However, under the FRS 102 hierarchy in Section 10, insurers could look to the guidance in IAS 39 or IFRS 9 which states that assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements. [IAS 39.AG4A, IFRS 9.B2.6]. Therefore, it is likely that insurers that have previously issued financial guarantee contracts and accounted for them under an insurance accounting and regulatory framework will meet these criteria. It is unlikely that an entity not subject to an insurance accounting and regulatory framework, or existing insurers that had not previously issued financial guarantee contracts, would meet these criteria because they would not have previously made the necessary assertions.

3.2.3.E Contingent consideration payable or receivable in a business combination

Contingent consideration payable or receivable in a business combination is outside the scope of FRS 103. This is accounted for under Section 19 *Business Combinations and Goodwill* of FRS 102 (see Chapter 19 at 2.5.2 and Chapter 19 at 3.6) [FRS 103.1.7(e)].

3.2.3.F Direct insurance contracts in which the entity is the policyholder

Accounting by policyholders of direct insurance contracts (i.e., those that are not reinsurance contracts) is excluded from the scope of FRS 103. However, holders of reinsurance contracts (cedants) must apply FRS 103. [FRS 103.1.7(f)].

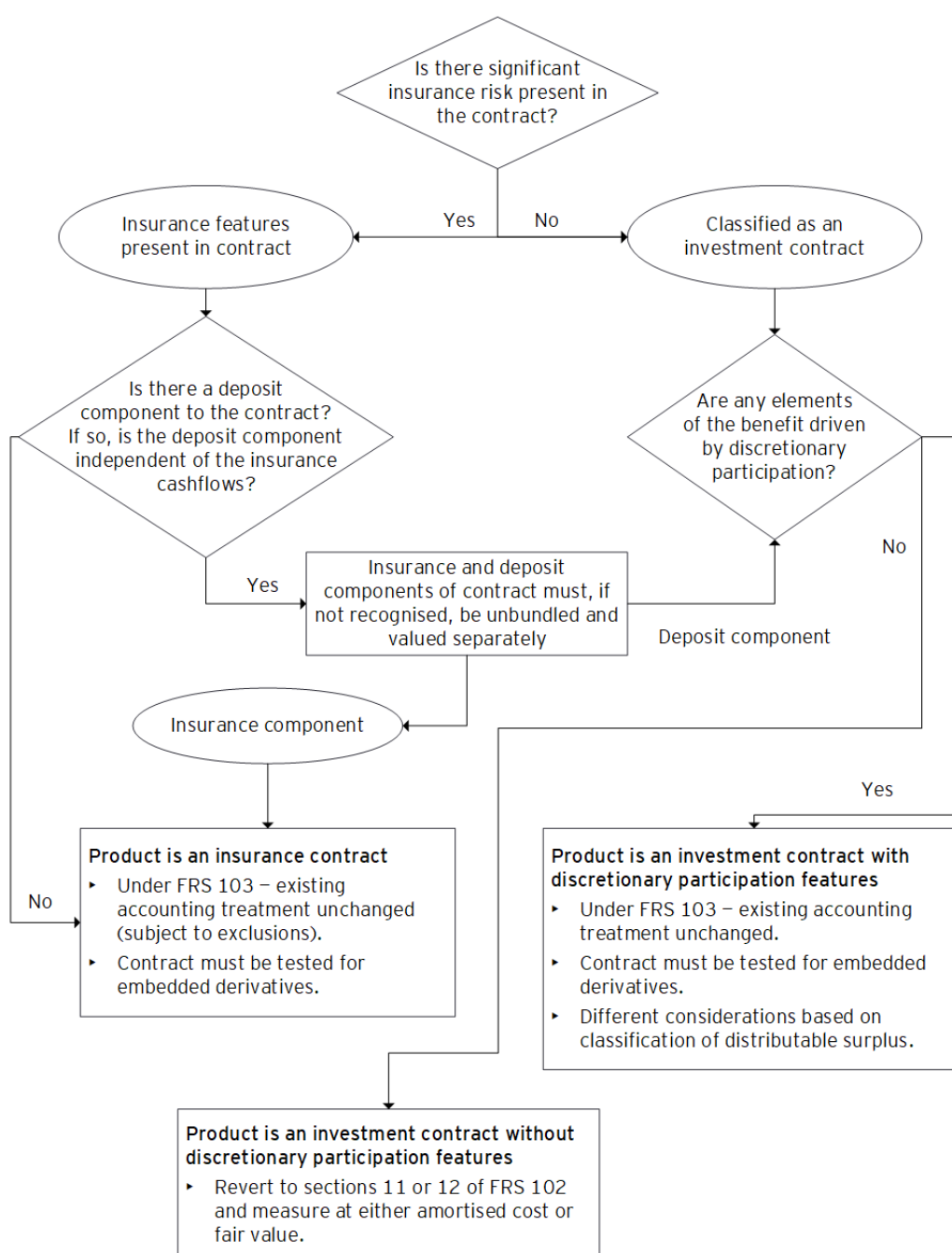
FRS 102 does contain some guidance on accounting for rights under insurance contracts held. In particular, Section 21 of FRS 102 addresses accounting for reimbursements from insurers of expenditure required to settle a provision and permits recognition of the reimbursement as a separate asset only when it is virtually certain that the entity will receive the reimbursement on settlement of the obligation. [FRS 102.21.9]. In addition, Section 17 *Property, Plant and Equipment* of FRS 102 addresses accounting for compensation from third parties for items of property, plant and equipment that are impaired, lost or given up and states that such compensation must be included in profit or loss only when the compensation is virtually certain. [FRS 102.17.25]. However, for all other aspects of accounting for insurance contracts held, a policyholder is required to develop its accounting policies applying Section 10 of FRS 102 which sets out a hierarchy of guidance to use (see Chapter 9 at 3.1).

3.2.4 The product classification process

Insurers need to determine which transactions are within the scope of FRS 103 and which transactions are not within its scope. Therefore, one of the main procedures required of insurers, when applying FRS 103 for the first time, is to conduct a product classification review.

The assessment of the appropriate classification for a contract will include an assessment of whether the contract contains significant insurance risk (discussed at 4.6 below), and whether the contract contains embedded derivatives (discussed at 5 below), deposit components (discussed at 6 below) or discretionary participation features (discussed at 7 below).

The diagram below illustrates a product classification decision tree.



3.3 Transition to FRS 103

Section 35 *Transition to this FRS* of FRS 102 also applies to a first-time adopter of FRS 103 (see Chapter 37). [FRS 103.6.2].

FRS 103 contains no exemption or transitional relief from the basic requirement of Section 35 of FRS 102, which requires that transition is applied retrospectively.

However, in applying paragraph 4.8(b)(iii) of FRS 103, an entity need not disclose information about claims development (see 11.3.5 below) that occurred earlier than five years before the end of the first financial year in which it applies the standard. Furthermore, if it is impracticable, when an entity first applies FRS 103, to prepare information about claims development that occurred before the beginning of the earliest period for which an entity presents full comparative information that complies with FRS 103, the entity must disclose that fact. [FRS 103.6.3].

FRS 103 specifically permits an insurer to change its accounting policies for insurance contracts on adoption of FRS 103. [FRS 103.2.3]. Such a change must be applied retrospectively and the change must satisfy the criteria of FRS 103 for accounting policy changes (see 9 below). In addition, FRS 103 observes that one basis for changing accounting policies might be to enable them to be more consistent with the rules under the Solvency II Directive for the recognition and measurement of technical provisions. In doing so, an entity must make appropriate adjustments to the Solvency II rules to meet the requirements of paragraph 2.3 of FRS 103. [FRS 103.2.3A]. If an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets as a financial asset at fair value through profit or loss provided those assets meet the criteria in paragraph 11.14(b) of FRS 102 (or if the entity has made the accounting policy choice under paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement provisions of either IAS 39 or IFRS 9, the relevant requirements of IAS 39 or IFRS 9, as applicable) at that date. This reclassification is permitted if an insurer changes accounting policies when it first applies FRS 103 and if it makes a subsequent policy change permitted by paragraph 2.3 of FRS 103. The reclassification is a change in accounting policy to which Section 10 of FRS 102 applies. [FRS 103.6.4].

When an insurer, whose previous financial reporting framework was IFRS, or included an approach and methodology for accounting for insurance contracts that is equivalent to IFRS, prepares financial statements at the date of transition to FRS 103, that entity must disregard its existing accounting policies for insurance contracts and apply FRS 103 as if it were setting accounting policies in relation to insurance contracts for the first time (see 1.3 above). [FRS 103.6.5]. This clause is intended to prevent insurers applying IFRS 17 as a grandfathered accounting policy within FRS 103.

4 The definition of an insurance contract

4.1 The definition

FRS 103 defines an insurance contract as follows. *[FRS 103 Appendix I]*.

Extract from FRS 103

Appendix I Glossary

insurance contract

A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix II for guidance on this definition.)

This definition determines which contracts are within the scope of FRS 103 rather than within the scope of FRS 102.

Contracts which have the legal form of insurance contracts are not necessarily insurance contracts under FRS 103. Conversely, contracts which may not legally be insurance contracts can be insurance contracts under FRS 103.

This section discusses the definition of an insurance contract in more detail and addresses the following issues:

- The term 'uncertain future event' (see 4.2 below)
- Payments in kind (see 4.3 below)
- The distinction between insurance risk and other risks (see 4.4 below)
- Examples of insurance contracts (see 4.5 below)
- Significant insurance risk (see 4.6 below)
- Changes in the level of insurance risk (see 4.7 below)

4.2 Uncertain future event

The uncertainty (or risk) present in an insurance contract is explained in FRS 103 as follows. *[FRS 103.A2.2]*.

Extract from FRS 103

Appendix II Definition of an insurance contract

Uncertain future event

- A2.2 Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
- (a) whether an insured event will occur;
 - (b) when it will occur; or
 - (c) how much the insurer will need to pay if it occurs.

In some insurance contracts, the insured event is discovery of the loss during the term of the contract, even if the loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event occurring during the term of the contract, even if the resulting loss is discovered after the end of the contract term. *[FRS 103.A2.3]*.

Some insurance contracts cover events that have already occurred but whose financial effect is still uncertain (i.e., retroactive contracts). An example is a reinsurance contract that covers a direct insurer against adverse development of claims already reported by their policyholders. In such contracts, the insured event is the discovery of the ultimate cost of those claims. *[FRS 103.A2.4]*.

4.3 Payments in kind

Insurance contracts that require or permit payments to be made in kind are treated the same way as contracts where payment is made directly to the policyholder. For example, some insurers replace a stolen article directly rather than compensating the policyholder. Others use their own employees, such as medical staff, to provide services covered by the contract. *[FRS 103.A2.5]*.

4.3.1 Service contracts

Some fixed-fee service contracts in which the level of service depends on an uncertain event may meet the definition of an insurance contract. However, in the UK, these are not regulated as insurance contracts. For example, a service provider could enter into a maintenance contract in which it agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions but it is uncertain whether a particular machine will break down. The malfunction of the equipment adversely affects the owner and the contract compensates the owner (in kind, rather than cash). Similarly, a contract for car breakdown services in which the provider agrees, for a fixed annual fee, to provide roadside assistance or tow the car to a nearby garage could meet the definition of an insurance contract even if the provider does not agree to carry out repairs or replace parts. *[FRS 103.A2.6]*.

In respect of the type of service contracts described above, their inclusion seems an unintended consequence of the definition of an insurance contract. However, the FRC considers that applying FRS 103 to these contracts is likely to be no more burdensome than applying FRS 102 if such contracts were outside the scope of FRS 103, since:

- There are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred.
- If the service provider applied accounting policies consistent with Section 23 of FRS 102, this would be acceptable either as an existing accounting policy or, possibly, an improvement of existing policies unless they involve practices prohibited by paragraph 2.13 of FRS 103 (see 9 below).
- If FRS 103 did not apply to the contracts, the service provider would apply Section 21 of FRS 102 to determine whether its contracts were onerous. *[FRS 103.A2.7]*.

4.4 The distinction between insurance risk and financial risk

The definition of an insurance contract refers to 'insurance risk' which is defined as "risk, other than financial risk, transferred from the holder of a contract to the issuer." *[FRS 103 Appendix I]*.

A contract that exposes the reporting entity to financial risk without significant insurance risk is not an insurance contract. *[FRS 103.A2.8]*. 'Financial risk' is defined as "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract." *[FRS 103 Appendix I]*.

An example of a non-financial variable that is not specific to a party to the contract is an index of earthquake losses in a particular region or an index of temperature in a particular city. An example of a non-financial variable that is specific to a party to the contract is the occurrence or non-occurrence of a fire that damages or destroys an asset of that party.

The risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects not only changes in the market prices for such assets (a financial variable) but also the condition of a specific non-financial asset held by a party to the contract (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in that car's condition, that risk is insurance risk. *[FRS 103.A2.9]*. This is illustrated by the following example.

Illustration 4-1: Residual value insurance

Entity A issues a contract to Entity B that provides a guarantee of the fair value at the future date of an aircraft (a non-financial asset) held by B. A is not the lessee of the aircraft (residual value guarantees given by a lessee under a lease are within the scope of Section 20 of FRS 102).

This is an insurance contract (unless changes in the condition of the asset have an insignificant effect on its value). The risk of changes in the fair value of the aircraft is not a financial risk because the fair value reflects not only changes in market prices for similar aircraft but also the condition of the specific asset held.

[IFRS 4.IG2.E1.15].

However, if the contract compensated B only for changes in market prices and not for changes in the condition of B's asset, the contract would be a derivative and within the scope of Section 12 of FRS 102.

Some contracts expose the issuer to financial risk in addition to significant insurance risk. For example, many life insurance contracts guarantee both a minimum rate of return to policyholders, which creates financial risk, and promise death benefits that in some cases significantly exceed the policyholder's account balance, which creates insurance risk in the form of mortality risk. Such contracts are insurance contracts. [FRS 103.A2.10].

Contracts where an insured event triggers the payment of an amount linked to a price index are insurance contracts provided the payment that is contingent on the insured event is significant. This is illustrated by the following example.

Illustration 4.2: Contract with life contingent annuity linked to price index

Entity A issues a life-contingent annuity the value of which is linked to a cost of living index.

The contract is an insurance contract because the payment is triggered by an uncertain future event, the survival of the annuitant. The link to the price index is an embedded derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the insurance risk transferred is significant, the embedded derivative meets the definition of an insurance contract in which case it is not separated from the host contract (see 5 below for a discussion of derivatives embedded within insurance contracts. [FRS 103.A2.11].

The definition of insurance risk refers to a risk that the insurer accepts from the policyholder. In other words, insurance risk is a pre-existing risk transferred from the policyholder to the insurer. Thus, a new risk created by the contract is not insurance risk. [FRS 103.A2.12]. Examples of new risks created by an insurance contract that are not insurance risk, include:

- The loss of the ability to charge the policyholder for future investment management fees, for example if the ability to collect fees ceases if the policyholder of an investment-linked life insurance contract dies (this loss does not reflect insurance risk).
- The waiver on death of charges that would be made on cancellation or surrender of the contract (because the contract brought these charges into existence and therefore they do not compensate the policyholder for a pre-existing risk).
- A payment conditional on an event that does not cause a significant loss to the holder of the contract.
- Possible reinsurance recoveries (accounted for separately).
- The original policy premium (but not additional premiums payable in the event of claims experience).

For a contract to be an insurance contract the insured event must have an adverse effect on the policyholder. [FRS 103.A2.13]. In other words, there must be an insurable interest. Without the notion of insurable interest, the definition of an insurance contract would have encompassed gambling.

The adverse effect on the policyholder is not limited to an amount equal to the financial impact of the adverse event. So, the definition includes 'new for old' coverage that replaces a damaged or lost asset with a new asset. Similarly, the definition does not limit payment under a term life insurance contract to the financial loss suffered by a deceased's dependents nor does it preclude the payment of predetermined amounts to quantify the loss caused by a death or accident. [FRS 103.A2.13].

A contract that requires a payment if a specified uncertain event occurs which does not require an adverse effect on the policyholder as a precondition for payment is not an insurance contract. Such contracts are not insurance contracts even if the holder uses the contract to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying non-financial variable that is correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows of the asset. Conversely, the definition of an insurance contract refers to an uncertain event for which an adverse effect on the policyholder is a contractual precondition for payment. This contractual precondition does not require the insurer to investigate whether the uncertain event actually caused an adverse effect, but permits the insurer to deny payment if it is not satisfied that the event caused an adverse effect.

[FRS 103.A2.14].

The following Illustration explains the concept of insurable interest.

Illustration 4-3: Reinsurance contract with 'original loss warranty' clause

Entity A agrees to provide reinsurance cover to airline insurer B for £5m against losses suffered. The claims are subject to an original loss warranty of £50m meaning that only losses suffered by B up to £5m from events exceeding a cost of £50m in total can be recovered under the contract. This is an insurance contract as B can only recover its own losses arising from those events.

If the contract allowed B to claim up to £5m every time there was an event with a cost exceeding £50m regardless of whether B had suffered a loss from that event then this would not be an insurance contract because there would be no insurable interest in this arrangement.

4.4.1 Lapse, persistency and expense risk

Lapse or persistency risk (the risk that the policyholder will cancel the contract earlier or later than the issuer had expected in pricing the contract) is not insurance risk because, although this can have an adverse effect on the issuer, the cancellation is not contingent on an uncertain future event that adversely affects the policyholder. [FRS 103.A2.15].

Similarly, expense risk (the risk of unexpected increases in the administrative costs incurred by the issuer associated with the serving of a contract, rather than the costs associated with insured events) is not insurance risk because an unexpected increase in expenses does not adversely affect the policyholder. [FRS 103.A2.15].

Therefore, a contract that exposes the issuer to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the issuer to significant insurance risk. [FRS 103.A2.16].

4.4.2 Insurance of non-insurance risks

If the issuer of a contract which does not contain significant insurance risk mitigates the risk of that contract by using a second contract to transfer part of that first contract's risk to another party, this second contract exposes that other party to insurance risk. This is because the policyholder of the second contract (the issuer of the first contract) is subject to an uncertain event that adversely affects it and thus it meets the definition of an insurance contract. [FRS 103.A2.16]. This is illustrated by the following example.

Illustration 4-4: Insurance of non-insurance risks

Entity A agrees to compensate Entity B for losses on one or more contracts issued by Entity B that do not transfer significant insurance risk. The contract issued by Entity A to compensate Entity B is a direct insurance contract if it transfers significant insurance risk from Entity B to Entity A. Entity B is a policyholder of an insurance contract issued by Entity A and not the holder of a reinsurance contract. FRS 103 does not apply if the entity is the holder of an insurance contract that is not a reinsurance contract (see 3.2.3.F above).

4.4.3 Self insurance, pooling of insurance risk by insurance mutuals, and intragroup insurance contracts

An insurer can accept significant insurance risk from a policyholder only if the insurer is an entity separate from the policyholder. [FRS 103.A2.17].

Therefore, 'self insurance', such as a self-insured deductible where the insured cannot claim for losses below the excess limit of an insurance policy, is not insurance risk because there is no insurance contract. Accounting for self insurance and related provisions is covered by Section 21 of FRS 102 which requires that a provision is recognised only if there is a present obligation as a result of a past event, it is probable that an outflow of resources will occur, and a reliable estimate can be determined. [FRS 102.21.4].

A mutual insurer (as defined in the PRA Rulebook) accepts risk from each policyholder and pools that risk. Although policyholders bear the pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract and therefore FRS 103 applies to those contracts. [FRS 103.A2.17].

When there are insurance contracts between entities in the same group, these would be eliminated in the consolidated financial statements as required by Section 9 *Consolidated and Separate Financial Statements* of FRS 102. [FRS 102.9.15]. If any intragroup insurance contract is reinsured with a third party that is not part of the group, this third party reinsurance contract must be accounted for as a direct insurance contract in the consolidated financial statements of a non-insurer because the intragroup contract will be eliminated on consolidation. This residual direct insurance contract (i.e., the policy with the third party) is outside the scope of FRS 103 from the viewpoint of the consolidated financial statements of a non-insurer because policyholder accounting is excluded from the standard as discussed at 3.2.3.F above.

4.5 Examples of insurance and non-insurance contracts

FRS 103 provides various examples of insurance and non-insurance contracts.

4.5.1 Examples of insurance contracts

The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant: [FRS 103.A2.18]

- (a) Insurance against theft or damage to property.
- (b) Insurance against product liability, professional liability, civil liability or legal expenses.
- (c) Life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance contract).
- (d) Life-contingent annuities and pensions (contracts that provide compensation for the uncertain future event - the survival of the annuitant or pensioner - to assist the annuitant or pensioner in maintaining a given standard of living, which would otherwise be adversely affected by his or her survival).
- (e) Disability and medical cover.
- (f) Surety bonds, fidelity bonds, performance bonds and bid bonds (contracts that provide compensation if another party fails to perform a contractual obligation, for example an obligation to construct a building).
- (g) Credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. Although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract and are within the scope of Section 21 of FRS 102 and not FRS 103 unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to such contracts (see 3.2.3.D above).
- (h) Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of FRS 103. However, as discussed at 3.2.3.A above, product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of FRS 103.
- (i) Title insurance (insurance against the discovery of defects in title to land that were not apparent when the contract was written), in which case, the insured event is the discovery of a defect in the title, not the defect itself.
- (j) Travel assistance (compensation in cash or in kind to policyholders for losses suffered while they are travelling).
- (k) Catastrophe bonds that provide for reduced payments of principal, interest or both if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk, for example if the event is a change in interest rate or a foreign exchange rate).
- (l) Insurance swaps and other contracts that require a payment based on changes in climatic, geological and other physical variables that are specific to a party to the contract.

And

- (m) Reinsurance contracts.

These examples are not intended to be an exhaustive list.

4.5.2 Examples of transactions that are not insurance contracts

The following are examples of transactions that are not insurance contracts: *[FRS 103.A2.19]*

- (a) Investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk, for example life insurance contracts in which the issuer bears no significant mortality risk.
- (b) Contracts that have the legal form of insurance, but pass all significant risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses, for example some financial reinsurance contracts or some group contracts.
- (c) Self insurance in which the risk, that could have been covered by insurance, is retained. There is no insurance contract because there is no agreement with another party (see 4.4.3 above).
- (d) Contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, that the event adversely affects the policyholder. However, this does not preclude the specification of a predetermined payout to quantify the loss caused by a specified event such as a death or an accident (see 4.4 above).
- (e) Derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.
- (f) A credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of a debtor to make payments when due.
- (g) Contracts that require a payment based on a climatic, geological or other physical variable that is not specific to a party to the contract. These are commonly described as weather derivatives and are accounted for under Sections 11 and 12 of FRS 102.

And

- (h) Catastrophe bonds that provide for reduced payments of principal, interest or both, based on a climatic, geological or other physical variable that is not specific to a party to the contract.

If the contracts described at (a) to (h) above create financial assets or financial liabilities, they are within the scope of Sections 11 and 12 of FRS 102. Among other things, this means that the parties to the contract use what is sometimes referred to as deposit accounting, which involves the following:

- One party recognises the consideration received as a financial liability, rather than as revenue.
 - The other party recognises the consideration paid as a financial asset, rather than as an expense.
- [FRS 103.A2.20].*

If the contracts described at (a) to (h) above do not create financial assets or financial liabilities, Section 23 of FRS 102 applies. Under Section 23 of FRS 102, revenue is recognised when (or as) the entity satisfies a performance obligation in an amount that reflects the consideration to which the entity expects to be entitled. *[FRS 103.A2.21].*

When the consideration for a contract meeting the definition of an investment contract comprises both a fee for the origination and an ongoing charge for the provision of (e.g., investment management) services, the insurer must evaluate whether to account for the origination as a separate performance obligation in accordance with paragraphs 17 to 25 of Section 23 of FRS 102 (see Chapter 25 at 5). Otherwise, the fee is included in the transaction price for the contract and is recognised as revenue when those services are provided. *[FRS 103.A2.23].*

The cost of obtaining an investment management contract may be recognised as an asset if it meets the criteria in paragraph 113 of Section 23 of FRS 102 (see Chapter 25 at 2.5 and Chapter 25 at 10.3.1). In which case, the asset is amortised in accordance with the pattern of transfer and revenue recognition of the services to which the asset relates. *[FRS 103.A2.24].*

4.6 Significant insurance risk

A contract is an insurance contract only if it transfers 'significant insurance risk'. *[FRS 103.A2.25].*

Insurance risk is 'significant' if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e., have no discernible effect on the economics of the transaction). *[FRS 103.A2.26].*

If significant additional benefits would be payable in scenarios that have commercial substance, this condition may be met even if the insured event is extremely unlikely or even if the expected (i.e., probability-weighted) present value of contingent cash flows is a small proportion of the expected present value of all the remaining contractual cash flows. [FRS 103.A2.26]. From this, we consider the intention was to make it easier, not more difficult, for contracts regarded as insurance contracts under the entity's previous accounting policies to be insurance contracts under FRS 103.

FRS 103 does not prohibit insurance contract accounting if there are restrictions on the timing of payments or receipts, provided there is significant insurance risk, although clearly the existence of restrictions on the timing of payments may mean that the policy does not transfer significant insurance risk.

4.6.1 The meaning of 'significant'

No quantitative guidance supports the determination of 'significant' in FRS 103. This is consistent with IFRS 4 and IFRS 17. The absence of quantitative guidance was a deliberate decision made by the IASB when drafting IFRS 17 because the IASB considered that if quantitative guidance was provided it would create an arbitrary dividing line that would result in different accounting treatments for similar transactions that fall marginally on different sides of that line, and would therefore create opportunities for accounting arbitrage. [IFRS 17.BC78].

IFRS 4 contained an illustrative example which implied that insured benefits must be greater than 101% of the benefits payable if the insured event did not occur, for there to be insurance risk in an insurance contract. [IFRS 4.IG2.E1.3]. It was not stated how much greater than 101% the insured benefits must be to meet the IFRS 4 definition of 'significant'. There is no equivalent example included in IFRS 17.

This Illustration is based on an example in IFRS 4.

Illustration 4-5: Significant insurance risk

Entity A issues a unit-linked contract that pays benefits linked to the fair value of a pool of assets. The benefit is 100% of the unit value on surrender or maturity and 101% of the unit value on death.

In this situation the implementation guidance states that if the insurance component (the additional death benefit of 1%) is not unbundled then the whole contract is an investment contract. The insurance component in this arrangement is insignificant in relation to the whole contract and so would not meet the definition of an insurance contract in IFRS 4. [IFRS 4.IG2.E1.3].

Some jurisdictions have their own guidance as to what constitutes significant insurance risk. However, as with IFRS 4 and IFRS 17, other jurisdictions offer no quantitative guidance. Some US GAAP practitioners apply a guideline that a reasonable possibility of a significant loss is at least a 10% probability of a loss of at least 10% of premium. [IFRS 17.BC77]. It is not disputed in the Basis for Conclusions that a 10% probability of a loss of at least 10% of premium results in a transfer of significant insurance risk. Indeed, the words 'extremely unlikely' and 'a small proportion' (see 4.6 above) suggests that the IASB envisages that significant insurance risk could exist at a lower threshold than a 10% probability of a loss of at least 10% of premium.

How we see it

The lack of a quantitative definition means that insurers must apply their own judgement as to what constitutes significant insurance risk. The practical impact of the lack of guidance means that insurers must apply their own criteria to what constitutes significant insurance risk and there may be diversity in practice as to what these dividing lines are, at least at the margins.

There is no specific requirement under FRS 103 for insurers to disclose any thresholds used in determining whether a contract has transferred significant insurance risk. However, Section 8 *Notes to the Financial Statements* of FRS 102 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

4.6.2 The level at which significant insurance risk is assessed

Significant insurance risk must be assessed by individual contract, rather than by blocks of contracts or by reference to materiality to the financial statements. Therefore, insurance risk may be significant even if there is a minimal probability of material losses for a whole book of contracts. The purpose of this is to make it easier to classify a contract as an insurance contract. [FRS 103.A2.28].

"However, if a relatively homogeneous book of small contracts is known to consist of contracts that all transfer insurance risk, an insurer need not examine each contract within that book to identify a few non-derivative contracts that transfer insignificant insurance risk." [FRS 103.A2.28].

Multiple, mutually linked contracts entered into with a single counterparty (or contracts that are otherwise interdependent) are considered a single contract for the purposes of assessing whether significant insurance risk is transferred. [FRS 103.A2.28fn4]. This requirement is intended to prevent entities entering into contracts that individually transfer significant insurance risk but collectively do not and accounting for part(s) of what is effectively a single arrangement as (an) insurance contract(s).

If an insurance contract is unbundled (see 6 below) into a deposit component and an insurance component, the significance of insurance risk transferred is assessed by reference only to the insurance component. The significance of insurance risk transferred by an embedded derivative is assessed by reference only to the embedded derivative (see 5 below). [FRS 103.A2.31].

4.6.3 Significant additional benefits

The 'significant additional benefits' mentioned in the definition of 'significant insurance risk' refer to amounts that exceed those that would be payable if no insured event occurred (see 4.6 above). These additional amounts include claims handling and claims assessment costs, but exclude: [FRS 103.A2.27]

- (a) The loss of the ability to charge the policyholder for future services, for example where the ability to collect fees from a policyholder for performing future investment management services ceases if the policyholder of an investment-linked life insurance contract dies. This economic loss does not reflect insurance risk and the future investment management fees are not relevant in assessing how much insurance risk is transferred by a contract.
- (b) The waiver on death of charges that would be made on cancellation or surrender (i.e., to cease paying premiums such that the insurance contracts ceases to have effect) of the contract. The contract brought these charges into existence and therefore the waiver of them does not compensate the policyholder for a pre-existing risk. Hence, they are not relevant in determining how much insurance risk is transferred by a contract.
- (c) A payment conditional on an event that does not cause a significant loss to the holder of the contract, for example where the issuer must pay one million currency units if an asset suffers physical damage causing an insignificant economic loss of one currency unit to the holder. The holder in this case has transferred to the insurer the insignificant insurance risk of losing one currency unit. However, at the same time the contract creates non-insurance risk that the issuer will need to pay 999,999 additional currency units if the specified event occurs.
- (d) Possible reinsurance recoveries, that the insurer will account for separately.

It follows from this that if a contract pays a death benefit exceeding the amount payable on survival (excluding waivers under (b) above), the contract is an insurance contract unless the additional death benefit is insignificant (judged by reference to the contract rather than to an entire book of contracts). Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant. [FRS 103.A2.29]. In this case, the insurer could suffer a significant loss on an individual contract if the annuitant survives longer than expected.

Additional benefits could include a requirement to pay benefits earlier than expected if the insured event occurs earlier, provided the payment is not adjusted for the time value of money. An example could be whole life insurance cover that provides a fixed death benefit whenever a policyholder dies. Whilst it is certain that the policyholder will die, the timing of death is uncertain and the insurer will suffer a loss on individual contracts when policyholders die early, even if there is no overall expected loss on the whole book of contracts. [FRS 103.A2.30].

4.7 Changes in the level of insurance risk

It is implicit within FRS 103 that an assessment of whether a contract transfers significant insurance risk must be made at the inception of a contract. Further, a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire. [FRS 103.A2.33]. This applies even if circumstances have changed such that insurance contingent rights and obligations have expired.

Conversely, contracts that do not transfer insurance risk at inception could become insurance contracts if they transfer insurance risk at a later time. Consider the following Illustration based on an example in

Appendix II of FRS 103, of a contract where the transfer of insurance risk only occurs after a period of time. [FRS 103.A2.32].

Illustration 4-6: Deferred annuity with policyholder election

Entity A issues a deferred annuity contract which provides a specified investment return to the policyholder and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates that Entity A charges other new annuitants at the time the policyholder exercises that option.

This is not an insurance contract at inception because it does not contain significant insurance risk. Entity A remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to it at that time. Such a contract transfers insurance risk to the issuer only after the option is exercised. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract and before exercise there are no insurance cash flows within the boundary of the contract. Consequently, on inception, the contract is a financial instrument within the scope of IFRS 9.

However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to Entity A (the issuer) on issuance because Entity A is exposed to the risk that the annuity rates will be unfavourable when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.

FRS 103 imposes no limitations on when contracts can be assessed for significant insurance risk. The recognition of contracts as insurance contracts occurs based on changing facts and circumstances, although there is no guidance on accounting for the recognition/derecognition.

5 Embedded derivatives

FRS 103 requires an insurer to determine whether it has any separable embedded derivatives and, if the separable embedded derivative is not an insurance contract, the insurer must separate the embedded derivative from its host contract and account for it in accordance with Sections 11 and 12 of FRS 102 as if it were a financial instrument. [FRS 103.2.20].

This also applies when an entity has made the accounting policy choice under paragraphs 11.2(b) or (c), or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement provisions of either IAS 39 or IFRS 9, and the disclosure requirements of Section 11 of FRS 102, as applicable. For an entity that is a financial institution (e.g., all insurers) the disclosure requirements of paragraphs 34.17 to 34.33 of FRS 102 also apply to any separable embedded derivatives. [FRS 103.2.20].

Entities that apply FRS 103 will also apply FRS 102. Sections 11 and 12 of FRS 102 do not require entities to identify separable embedded derivatives but instead, as a simplification from IFRS, require a contract with certain non-typical features to be accounted for at fair value through profit or loss. It was considered whether a similar approach applies to insurance contracts, but the FRC decided that for insurance contracts more relevant information will be provided to users if separable embedded derivatives are recognised and measured separately from the host contract (unless the embedded derivative is itself an insurance contract). [FRS 103.BC23].

FRS 103 defines a derivative, and an embedded derivative as follows. [FRS 103 Appendix I].

Extract from FRS 103

Appendix I

Glossary

derivative

A financial instrument or other contract with all three of the following characteristics:

- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract;
- (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (c) it is settled at a future date.

embedded derivative

A component of a hybrid (combined) instrument that also includes a non-derivative host contract - with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

The following are examples of embedded derivatives that can be found in insurance contracts:

- Benefits, such as death benefits, linked to equity prices or an equity index.
- Options to take life-contingent annuities at guaranteed rates.
- Guarantees of minimum interest rates in determining surrender or maturity values.
- Guarantees of minimum annuity payments where the annuity payments are linked to investment returns or asset prices.
- A put option for the policyholder to surrender a contract. These can be specified in a schedule, based on the fair value of a pool of interest-bearing securities or based on an equity or commodity price index.
- An option to receive a persistency bonus (an enhancement to policyholder benefits for policies that remain in-force for a certain period).

- An industry loss warranty where the loss trigger is an industry loss as opposed to an entity specific loss.
- A catastrophe trigger where a trigger is defined as a financial variable such as a drop in a designated stock market.
- An inflation index affecting policy deductibles.
- Contracts where the currency of claims settlement differs from the currency of loss.
- Contracts with fixed foreign currency rates.

FRS 103 defines a separable embedded derivative as follows. [FRS 103 Appendix I].

Extract from FRS 103

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separable embedded derivative

An embedded derivative where:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss.

The guidance in IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts* shall be used in determining whether an embedded derivative is separable.

FRS 103 provides no further guidance on separable embedded derivatives but refers to 'the guidance in IAS 39 and IFRS 4' to determine whether an embedded derivative is separable. [FRS 103 Appendix I]. However, the embedded derivative is only separable if it is not itself an insurance contract, which means that derivatives embedded within insurance contracts do not have to be separated if the policyholder benefits from the derivative only when the insured event occurs.

As an exception to the requirements described above, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability. However, the requirements to separate embedded derivatives if the derivative is separable, described above, do apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, those requirements also apply if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level). [FRS 103.2.21]. This applies equally to options to surrender a financial instrument containing a discretionary participation feature. [FRS 103.2.22].

5.1 Unit-linked features

Both IAS 39 and IFRS 9 state that a unit-linked feature (i.e., a contractual term that requires payments denominated in units of an internal or external investment fund) embedded in a host insurance contract (or financial instrument) is considered to be closely related to the host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund.

[IAS 39.AG33(g), IFRS 9.B4.3.8(g)].

IAS 39 and IFRS 9 also consider that unit-linked investment liabilities are normally regarded as puttable instruments that can be put back to the issuer at any time for cash equal to a proportionate share of the net asset value of an entity (i.e., they are not closely related). Nevertheless, the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the unit holders had exercised their right to put the instrument back to the issuer. [IAS 39.AG32, IFRS 9.B4.3.7]. This seems somewhat to contradict the fact that the unit-linked feature is regarded as closely related (which means no separation of the feature is required) but the accounting treatment is substantially the same.

6 Unbundling of deposit components

Some insurance contracts contain both an insurance component and a 'deposit component'. [FRS 103.2.23]. Indeed, virtually all insurance contracts have an implicit or explicit deposit component, because the policyholder is generally required to pay premiums before the period of the risk and therefore the time value of money is likely to be one factor that insurers consider in pricing contracts.

FRS 103 defines a deposit component as follows. [FRS 103 Appendix I].

Extract from FRS 103

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deposit component

A contractual component that is not accounted for as a derivative under Sections 11 *Basic Financial Instruments* and 12 *Other Financial Instrument Issues* of FRS 102 and would be within the scope of FRS 102 if it were a separate instrument.

FRS 103 requires an insurer to 'unbundle' those insurance and deposit components in certain circumstances, [FRS 103.2.23], which is explained as accounting for the components of a contract as if they were separate contracts. [FRS 103 Appendix I]. In other circumstances unbundling is either allowed (but not required) or is prohibited.

Unbundling has the following accounting consequences: [FRS 103.2.25]

(a) The insurance component is measured as an insurance contract under FRS 103.

And

(b) The deposit component is measured under Sections 11 or 12 of FRS 102 (or, if the entity has made the accounting policy choice under paragraphs 11.2(b) or (c), or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement provisions of either IAS 39 or IFRS 9, the disclosure requirements of Sections 11 and 12 of FRS 102 and the recognition and measurement provisions of IAS 39 or IFRS 9 as applicable).

FRS 103 does not state what happens to the amounts received for the deposit component. These would not be recognised as revenue, but as changes in the deposit liability. Premiums for the insurance component are typically recognised as written premiums. A portion of any transaction costs incurred at inception is allocated to the deposit component if this allocation has a material effect.

Unbundling is required only if both the following conditions are met: [FRS 103.2.23(a)]

(a) The insurer can measure the deposit component (including any embedded surrender options) separately (i.e., without considering the insurance component).

And

(b) The insurer's accounting policies do not otherwise require it to recognise all the obligations and rights arising from the deposit component.

Unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a) above but its accounting policies require it to recognise all the obligations and rights arising from the deposit component. This is regardless of the basis used to measure those rights and obligations.

[FRS 103.2.23(b)].

Unbundling is prohibited when an insurer cannot measure the deposit component separately.

[FRS 103.2.23(c)].

FRS 103 describes an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. This is where a cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant's accounting policies would otherwise permit it to recognise the compensation as income without recognising the resulting obligation, unbundling is required. [FRS 103.2.24]. In practice, unbundling is unlikely to apply to UK entities because previous UK GAAP required an insurer to recognise all obligations arising from an insurance contract including deposit components.

6.1 Unbundling illustration

The implementation guidance accompanying IFRS 4 provided an illustration of the unbundling of the deposit component of a reinsurance contract which is reproduced in full below. [IFRS 4.IG5.E3].

Illustration 6-1: Unbundling a deposit component of a reinsurance contract

Background

A reinsurance contract has the following features:

- (a) The cedant pays premiums of £10 every year for five years.
- (b) An experience account is established equal to 90% of the cumulative premiums (including the additional premiums discussed in (c) below) less 90% of the cumulative claims.
- (c) If the balance in the experience account is negative (i.e., cumulative claims exceed cumulative premiums), the cedant pays an additional premium equal to the experience account balance divided by the number of years left to run on the contract.
- (d) At the end of the contract, if the experience account balance is positive (i.e., cumulative premiums exceed cumulative claims), it is refunded to the cedant; if the balance is negative, the cedant pays the balance to the reinsurer as an additional premium.
- (e) Neither party can cancel the contract before maturity.
- (f) The maximum loss that the reinsurer is required to pay in any period is £200.

The contract is an insurance contract because it transfers significant risk to the reinsurer. For example, in case 2 discussed below, the reinsurer is required to pay additional benefits with a present value, in year 1, of £35, which is clearly significant in relation to the contract.

The following discussion addresses the accounting by the reinsurer. Similar principles apply to the accounting by the cedant.

Application of requirements: case 1 - no claims

If there are no claims, the cedant will receive £45 in year 5 (90% of the cumulative premiums of £50). In substance, the cedant has made a loan, which the reinsurer will repay in one instalment of £45 in year 5.

If the reinsurer's accounting policies require it to recognise its contractual liability to repay the loan to the cedant, unbundling is permitted but not required. However, if the reinsurer's accounting policies would not require it to recognise the liability to repay the loan, the reinsurer is required to unbundle the contract.

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows: Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying IAS 39 or IFRS 9 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component. Assume that an appropriate discount rate is 10% and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in each year. Each payment of £10 by the cedant is then made up of a loan advance of £6.7 and an insurance premium of £3.3.

The reinsurer accounts for the insurance component in the same way it accounts for a separate insurance contract with an annual premium of £3.3.

The movements in the loan are shown below.

Year	Opening balance	Interest at 10%	Advance (repayment)	Closing balance
	£	£	£	£
0	0.00	0.00	6.70	6.70
1	6.70	0.67	6.70	14.07
2	14.07	1.41	6.70	22.18
3	22.18	2.21	6.70	31.09
4	31.09	3.11	6.70	40.90
5	40.90	4.10	(45.00)	0.00
Total		11.50	(11.50)	

Application of requirements: case 2 - claim of £150 in year 1

Consider now what happens if the reinsurer pays a claim of £150 in year 1. The changes in the experience account, and the resulting additional premiums, are as follows:

Year	Premium	Additional premium	Total premium	Cumulative premium	Claims	Cumulative claims	Cumulative premiums less claims	Experience account
	£	£	£	£	£	£	£	£
0	10	0	10	10	0	0	10	9
1	10	0	10	20	(150)	(150)	(130)	(117)
2	10	39	49	69	0	(150)	(81)	(73)
3	10	36	46	115	0	(150)	(35)	(31)
4	10	31	41	156	0	(150)	6	6
Total		106	156		(150)			

Incremental cash flows because of the claim in year 1

The claim in year 1 leads to the following incremental cash flows, compared with case 1:

Year	Additional premium	Claims	Refund in case 2	Refund in case 1	Net incremental cash flow	Present value at 10%
	£	£	£	£	£	£
0	0	0			0	0
1	0	(150)			(150)	(150)
2	39	0			39	35
3	36	0			36	30
4	31	0			31	23
5	0	0	(6)	(45)	39	27
Total	106	(150)	(6)	(45)	(5)	(35)

The incremental cash flows have a present value, in year 1, of £35 (assuming a discount rate of 10% is appropriate). Applying paragraphs 10 to 12 of IFRS 4, the cedant unbundles the contract and applies IAS 39 or IFRS 9 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the £150 received in year 1 as income and the incremental payments in years 2-5 as expenses. However, in substance, the reinsurer has paid a claim of £35 and made a loan of £115 (£150 less £35) that will be repaid in instalments.

The following table shows the changes in the loan balance. The table assumes that the original loan shown in case 1 and the new loan shown in case 2 meet the criteria for offsetting in IAS 32. Amounts shown in the table are rounded.

Loan to (from) the reinsurer

Year	Opening balance	Interest at 10%	Payments per original schedule	Additional payments in case 2	Closing balance
	£	£	£	£	£
0	-	-	6	-	6
1	6	1	7	(115)	(101)
2	(101)	(10)	7	39	(65)
3	(65)	(7)	7	36	(29)
4	(29)	(3)	6	31	5
5	5	1	(45)	39	0
Total		(18)	(12)	30	

Although the example refers to 'in year' the calculations indicate that most of the cash flows occur at the end of each year. The present value table showing the incremental cash flows resulting from the claim 'in year 1' appear to show the present values at the end of year 1.

6.2 Practical difficulties

How we see it

In unbundling a contract, the principal difficulty is identifying the initial fair value of any deposit component. In the IFRS 4 illustration at 6.1 above, a discount rate is provided but in practice contracts may not have a stated discount rate. The issuer and the cedant will therefore have to determine an appropriate discount rate in order to calculate the fair value of the deposit component. The IFRS 4 illustration at 6.1 above is also unclear as to whether the discount rate is a risk adjusted rate. Fair value measurement would require an adjustment for credit risk.

However, the potential burden on insurers is reduced by the fact that the FRC has limited the requirement to unbundle to only those contracts where the rights and obligations arising from the deposit component are not recognised under insurance accounting.

Some examples of clauses within insurance contracts that might indicate the need for unbundling are:

- 'Funds withheld' clauses where part or all of the premium is never paid to the reinsurer or claims are never received.
- 'No claims bonus', 'profit commission' or 'claims experience' clauses which guarantee that the cedant will receive a refund of some of the premium.
- 'Experience accounts' used to measure the profitability of the contract. These are often segregated from other funds and contain interest adjustments that may accrue to the benefit of the policyholder.
- 'Finite' clauses that limit maximum losses or create a 'corridor' of losses not reinsured under a contract.
- Contracts that link the eventual premium to the level of claims.
- Commutation clauses whose terms guarantee that either party will receive a refund of amounts paid under the contract.
- Contracts of unusual size where the economic benefits to either party are not obviously apparent.

How we see it

The unbundling requirements in FRS 103 do not specifically address the issue of contracts artificially separated through the use of side letters, the separate components of which are considered together. However, FRS 103 does state that linked contracts entered into with a single counterparty (or contracts that are otherwise interdependent) form a single contract, for the purposes of assessing whether significant insurance risk is transferred, although the standard is silent on linked transactions with different counterparties (see 4.6.2 above).

7 Discretionary participation features

FRS 103 defines a discretionary participation feature (DPF) as follows. [FRS 103 Appendix I].

Extract from FRS 103

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discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.

Guaranteed benefits are payments or other benefits to which the policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer. [FRS 103 Appendix I].

Guaranteed benefits are always accounted for as liabilities. Similarly, a guaranteed element is an obligation to pay guaranteed benefits, included in a contract that contains a DPF. [FRS 103 Appendix I].

An example of a discretionary participation feature common in the UK is a bonus added to a policyholder account at the discretion of the insurer. Bonuses are normally based on the investment return generated by the underlying assets but sometimes include allowance for profits made on other contracts.

The following Illustration is an example of a contract with a DPF.

Illustration 7-1: Unitised with-profits policy

Premiums paid by the policyholder are used to purchase units in a 'with-profits' fund at the current unit price. The insurer guarantees that each unit added to the fund will have a minimum value which is the bid price of the unit. This is the guaranteed amount. In addition, the insurer may add two types of bonus to the with-profits units. These are a regular bonus, which may be added daily as a permanent increase to the guaranteed amount, and a final bonus that may be added on top of those guaranteed amounts when the with-profits units are cashed in. Levels of regular and final bonuses are adjusted twice per year. Both regular and final bonuses are discretionary amounts and are generally set based on expected future returns generated by the funds.

DPF can appear in both insurance contracts and investment contracts. However, to qualify as a DPF, the discretionary benefits must be likely to be a 'significant' portion of the total contractual benefits. FRS 103 does not quantify what is meant by 'significant', but it could be interpreted in the same sense as in the definition of an insurance contract (see 4.6.1 above).

How we see it

The lack of a quantitative definition of 'significant' means that insurers must apply their own judgement as to what this constitutes. The practical impact of the lack of guidance means that insurers must apply their own criteria as to what constitutes a significant portion of the total contractual benefits for the contract to qualify as a DPF, and there may be diversity in practice.

Even though there is no specific requirement under FRS 103 for insurers to disclose any thresholds used in determining 'significant', Section 8 of FRS 102 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

With contracts that have discretionary features, the issuer has discretion over the amount and/or timing of distributions to policyholders although that discretion may be subject to some contractual constraints (including related legal and regulatory constraints) and competitive constraints. Distributions are typically made to policyholders whose contracts are still in force when the distribution is made. Thus, in many cases, a change in the timing of a distribution, apart from the change in the value over time, means that a different generation of policyholders might benefit.

The main accounting question is whether the discretionary surplus or fund for future appropriations (i.e., the balance sheet item required by Schedule 3 to the Regulations to comprise all funds the allocation of which, either to policyholders or shareholders, has not been determined by the end of the reporting date), [FRS 103 Appendix I], is a liability or a component of equity. The Regulations require that the fund for future appropriations (FFA) is classified as a liability and disclosed separately on the balance sheet (see 11.4 below). Once the allocation of the FFA has been determined (i.e., by a bonus declaration), the shareholder's share of that allocation is recognised in profit or loss.

7.1 Discretionary participation features in insurance contracts

FRS 103 requires that any guaranteed element within an insurance contract with a DPF is recognised as a liability. In theory, insurers have an option as to whether to present a DPF either as a liability or as a separate component of equity. However, an insurer can classify a DPF as equity only where this is permitted by the Regulations and the Regulations do not generally permit an equity classification for unallocated funds arising from contracts with a DPF (see 7 above).

The following requirements apply: [FRS 103.2.30(a), FRS 103.2.30(b)]

- When the guaranteed element is not recognised separately from the DPF, the whole contract must be classified as a liability.
- When the DPF is recognised separately from the guaranteed element, the DPF can be classified as either a liability or as a separate component of equity (where this is permitted by the Regulations which it does not). FRS 103 does not specify how an insurer determines whether the DPF is a liability or equity. The insurer may split the DPF into liability and equity components but must use a consistent accounting policy for such a split.
- A DPF cannot be classified as an intermediate category that is neither liability nor equity.

An insurer may recognise all premiums received from a contract with a DPF as revenue without separating any portion that relates to any equity component. [FRS 103.2.30(c)]. The use of the word 'may' means that an insurer can classify some of the DPF as equity but continue to record all of the contract premiums as income. Subsequent changes in the measurement of the guaranteed element and in the portion of the DPF classified as a liability must be recognised in profit or loss. If part or all of the DPF is classified in equity, that portion of profit or loss may be attributable to that feature (in the same way that a portion may be attributable to a non-controlling interest). Where legislation permits the discretionary participation feature to be classified as a component of equity, the issuer must recognise the portion of profit or loss attributable to any equity component of a DPF as an allocation of profit or loss, not as expense or income.

[FRS 103.2.30(c)].

FRS 103 also requires that an issuer of a contract with a DPF:

- Must, if it has made an accounting policy choice in accordance with paragraphs 11.2(b) or (c) or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement provisions of either IAS 39 or IFRS 9, and the contract contains an embedded derivative within the scope of IAS 39 or IFRS 9, apply IAS 39 and IFRS 9 to that embedded derivative. [FRS 103.2.30(d)].
- Must continue its existing accounting policies for such contracts, unless it changes those accounting policies in a way that complies with FRS 103 (subject to the constraints noted above and those discussed at 9 below). [FRS 103.2.30(e)].

7.2 Discretionary participation features in financial instruments

As discussed at 3.2.2 above, a financial instrument containing a DPF is also within the scope of FRS 103, not Sections 11 and 12 of FRS 102, and issuers of these contracts are permitted to continue applying their existing accounting policies to these rather than apply the rules in Sections 11 and 12 of FRS 102.

The requirements discussed at 7.1 above therefore apply equally to financial instruments that contain a DPF. However, in addition:

- If the issuer classifies the entire DPF as a liability, it must apply the liability adequacy test discussed at 8.8 below to the whole contract, i.e., to both the guaranteed element and the DPF. The issuer need not determine separately the amount that would result from applying IAS 39, IFRS 9 or Sections 11 and 12 of FRS 102 (depending on the accounting policy choice) to the guaranteed element. [FRS 103.2.31(a)].
- If the issuer classifies part or all of the DPF of that instrument as a separate component of equity, the liability recognised for the whole contract must not be less than the amount that would result from applying IAS 39, IFRS 9 or Sections 11 and 12 of FRS 102 (depending on the accounting policy choice) to the guaranteed element. That amount must include the intrinsic value of an option to surrender the contract but need not include its time value if FRS 103 exempts that option from fair value measurement (see 5 above). The issuer need not disclose the amount that would result from applying IAS 39, IFRS 9 or Sections 11 and 12 of FRS 102 (depending on the accounting policy choice) to the guaranteed element, nor need present the guaranteed amount separately. Furthermore, it need not determine the guaranteed amount if the total liability recognised for whole contract is clearly higher. [FRS 103.2.31(b)].
- Although these contracts are financial instruments, the issuer may continue to recognise all premiums (including the premiums from the guaranteed element) as revenue and recognise as an expense the resulting increase in the carrying amount of the liability. [FRS 103.2.31(c)].
- Although these contracts are financial instruments, an issuer must disclose the total interest expense recognised in profit or loss but need not calculate such interest expense using the effective interest method. [FRS 103.2.31(d)].

7.3 Practical issues

7.3.1 Negative DPF

Cumulative unallocated realised and unrealised returns on investments backing insurance and investment contracts with a DPF may become negative and result in an unallocated amount that is negative (a cumulative unallocated loss).

When the balance on the FFA of a with-profits fund is negative, an entity must explain the nature of the negative balance, the circumstances in which it arose and why no action to eliminate it was considered necessary. [FRS 103.5.5].

7.3.2 Contracts with switching features

Some contracts may contain options for the counterparty to switch between terms that would, *prima facie*, result in classification as an investment contract without DPF features (accounted for under Sections 11 and 12 of FRS 102) and terms that would result in a classification as an investment contract with DPF features (accounted for under FRS 103).

How we see it

The fact that the switch option would make such contracts investment contracts with a DPF means that the issuer must continuously be able to demonstrate that the DPF feature still exists and also be able to demonstrate actual switching in order to classify these contracts as investment contracts with a DPF under FRS 103.

8 Presentation, recognition and measurement of insurance contracts

8.1 Overall requirements for the presentation of the statement of financial position and statement of comprehensive income by insurers

Section 4 *Statement of Financial Position* and Section 5 *Statement of Comprehensive Income and Income Statement* of FRS 102 require that both the Statement of Financial Position and Statement of Comprehensive Income of an entity applying FRS 102 complies with the general rules and formats of the applicable Schedule to the Regulations. [FRS 102.4.2, FRS 102.5.5].

These rules apply to all entities complying with FRS 102 regardless as to whether they are required to comply with the Companies Act 2006 ('CA 2006'). Entities that do not report under the CA 2006 must comply with the Regulations (or, where applicable, the LLP Regulations) where referred to in Sections 4 and 5 of FRS 102, except to the extent that these requirements are not permitted by any statutory framework under which such entities report. [FRS 102.4.1, FRS 102.5.1]. The Note on legal requirements to FRS 103 observes that entities preparing financial statements within other legal frameworks will need to satisfy themselves that FRS 103 does not conflict with any relevant legal obligations. [FRS 103.A3.3]. The Regulations require that the individual accounts of an insurance company prepared under Section 396 of the CA 2006 must comply with Schedule 3 to the Regulations ('Schedule 3'). A parent company of an insurance group preparing Companies Act group accounts must do so in accordance with the provisions of Part 1 of Schedule 6 as modified by Part 3 of that Schedule (which, in summary, substitutes references to Schedule 1 of the Regulations for references to Schedule 3 to the Regulations).

There is no ability for an insurance entity or group to prepare financial statements using 'adapted formats' (see Chapter 6 at 3); the statutory format must be used. In addition, an insurance entity would not qualify as a small entity eligible to apply Section 1A *Small Entities* of FRS 102 as insurance companies and companies that carry on insurance market activities are excluded from the small companies regime (see Chapter 5 at 2.2.3).

A company that issues insurance contracts which is not an insurance company is not required to prepare its individual accounts in accordance with Schedule 3 to the Regulations. That entity will prepare its individual accounts in accordance with another applicable Schedule (usually Schedule 1 unless it is a banking company). A UK friendly society within the scope of the Friendly Societies Act 1992 and which elects to comply with FRS 102 and FRS 103 is required to prepare financial statements in accordance with The Friendly Societies (Accounts and Related Provisions) Regulations 1994 (SI 1994/1983). These regulations requires an income and expenditure account and balance sheet account format that is virtually identical to Schedule 3.

Insurance accounting practices under previous UK GAAP had separate recognition and measurement models for general insurance and life (long-term) insurance. Similarly, Schedule 3 to the Regulations requires separate income statements for general and long-term insurance business as well as separate balance sheet line items.

Schedule 3 to the Regulations does not address the presentation of either the statement of changes in equity or the statement of cash flows. Insurers must therefore follow the requirements of FRS 102 for these primary statements (see Chapter 6 at 6 and Chapter 7).

8.1.1 Definition of an insurance company in UK law

An insurance company is defined by the CA 2006 as: [s1165(3)]

- An authorised insurance company
- Or
- Any other person (whether incorporated or not) who:
 - Carries on insurance market activity
 - Or
 - May effect or carry out contracts of insurance under which the benefits provided by that person are exclusively or primarily benefits in kind in the event of accident to or breakdown of a vehicle

An authorised insurance company means a person (whether incorporated or not) who has permission under Part 4A of the Financial Services and Markets Act (2000) (c.8) to effect or carry out contracts of insurance. [s1165(2)]. Insurance market activity has the meaning given in section 316(3) of the Financial Services and Markets Act 2000, [s1165(7)], and refers to those engaging in insurance activity in the Lloyd's insurance market.

An insurance group is a group where the parent company is an insurance company, or where: [s1165(5)]

- The parent company's principal subsidiary undertakings are wholly or mainly insurance companies
And
- The parent company does not itself carry on any material business apart from the acquisition, management and disposal of interests in subsidiary undertakings

A parent company's principal subsidiary undertakings are the subsidiary undertakings of the company whose results or financial position would principally affect the figures shown in the group accounts and the management of interests in subsidiary undertakings includes the provision of services to such undertakings. [s1165(6)].

When a group contains a mixture of insurance subsidiaries and non-insurance subsidiaries, judgement may need to be exercised to determine which subsidiaries are those whose results or financial position principally affect the figures in the group financial statements and therefore whether the group is an insurance group preparing consolidated financial statements under Schedule 3 to the Regulations or a non-insurance group preparing financial statements under either Schedule 1 or Schedule 2 to the Regulations. The presentation and disclosure requirements of Schedule 1 are discussed in Chapter 6.

8.2 Statement of financial position under Schedule 3

As discussed at 8.1 above, an insurance entity is required by FRS 102 to prepare its individual balance sheet in accordance with Part 1 'General Rules and Formats' of Schedule 3 to the Regulations. An insurance group is required to prepare its consolidated balance sheet in accordance with the provisions of Part 1 of Schedule 6 to the Regulations as modified by Part 3 of that Schedule.

How we see it

This requirement means that an insurance entity that does not report under the Companies Act 2006 (e.g., a non-UK entity or a UK friendly society preparing financial statements under SI 1994/1983) must follow the formats, including the related notes to the formats, to the extent it does not conflict with its own statutory framework, but does not need to give the other disclosures in the notes to the accounts required by Schedule 3 to the Regulations.

As discussed at 8.1 above, insurance entities and groups are not permitted to use 'adapted' formats; the statutory format must be used.

All applicable items denoted by a letter or a Roman number in the statutory Schedule 3 balance sheet format must be shown on the face of the statement of financial position. All applicable items denoted by an Arabic number, except for items concerning technical provisions and the reinsurers' share thereof, may be shown either on the face of the statement of financial position or in the notes thereto. The minimum line items that must be presented on the face of the statement of financial position are illustrated in Figure 8-1 below:

Figure 8-1 Individual statement of financial position (UK insurance company)

ASSETS

- A** Called up share capital not paid
- B** Intangible assets
- C** Investments
 - I Land and buildings
 - II Investments in group undertakings and participating interests
 - III Other financial investments
 - IV Deposits with ceding undertakings
- D** Assets held to cover linked liabilities

- Da Reinsurers' share of technical provisions**
- E Debtors**
 - I Debtors arising out of direct insurance operations
 - II Debtors arising out of reinsurance operations
 - III Other debtors
 - IV Called up share capital not paid
- F Other assets**
 - I Tangible assets
 - II Stocks
 - III Cash at bank and in hand
 - IV Own shares
 - V Other
- G Prepayments and accrued income**
 - I Accrued interest and rent
 - II Deferred acquisition costs
 - III Other prepayments and accrued income

LIABILITIES

- A Capital and reserves**
 - I Called up share capital or equivalent funds
 - II Share premium account
 - III Revaluation reserve
 - IV Reserves
 - V Profit and loss account
- B Subordinated liabilities**
- Ba Fund for future appropriations**
- C Technical provisions**
- D Technical provision for linked liabilities**
- E Provisions for other risks**
- F Deposits received from reinsurers**
- G Creditors**
 - I Creditors arising out of direct insurance operations
 - II Creditors arising out of reinsurance operations
 - III Debenture loans
 - IV Amounts owed to credit institutions
 - V Other creditors including taxation and social security
- H Accruals and deferred income**

The following discussion relates to the Schedule 3 statement of financial position (or balance sheet) format only. The Schedule 3 balance sheet includes sub-headings, denoted with an Arabic number, which have not been shown in Figure 8-1 above. The main modifications required for the group balance sheet format are the identification of non-controlling interest and the replacement of the sub-heading 'Participating interests' (see 8.2.2 below) by 'Interests in associated undertakings' and 'Other participating interests'.

The individual line items in the balance sheet format are discussed at 8.2.1 to 8.2.15 below. The rest of this section addresses the general requirements of the Schedule 3 format.

Schedule 3 requires that every balance sheet of a company must show the items listed above in the balance sheet format adopted. The items must also be shown in the order and under the headings and sub-headings given in the particular format used, but the letters or numbers assigned to that item in the format do not need to be given (and are not in practice). The items listed in the formats need to be read together with the notes to the formats, which may also permit alternative positions for any particular items. [3 Sch 1]. The relevant notes to the balance sheet formats are discussed for each line item at 8.2.1 to 8.2.15 below. These notes must be presented in the order in which, where relevant, the items to which they relate are presented in the balance sheet and in the profit and loss account. [3 Sch 60(2)].

Where the special nature of the company's business requires it, the company's directors must adapt the arrangement, headings and sub-headings otherwise required in respect of items given an Arabic number in the balance sheet (or profit or loss account) format used. The directors may combine items to which Arabic numbers are given in the formats if their individual amounts are not material to assessing the state of affairs (or profit or loss) of the company for the financial year in question or the combination facilitates that assessment. In the latter case, the individual amounts of any items combined must be disclosed in a note to the accounts. [3 Sch 3, 3 Sch 4].

Schedule 3 allows any item to be shown in the company's balance sheet in greater detail than required by the particular format used. The balance sheet may include an item representing or covering the amount of any asset or liability not otherwise covered by any of the items listed in the format used, but preliminary expenses, the expenses of, and commission on, any issue of shares or debentures, and the costs of research must not be treated as assets in the balance sheet. [3 Sch 2]. FRS 102 requires additional line items, headings and subtotals to be added where relevant to an understanding of the entity's financial position. [FRS 102.4.3]. When additional detail is provided on the face of the balance sheet, it is usual to provide a subtotal for the heading.

For every item shown in the balance sheet, the corresponding amount for the immediately preceding financial year (i.e., the comparative) must also be shown. Where that corresponding amount is not comparable with the amount to be shown for the item in question in the current financial year, the corresponding amount may be adjusted, and particulars of the non-comparability and of any adjustment must be disclosed in a note to the accounts. [3 Sch 5].

Amounts in respect of items representing assets must not be set off against amounts in respect of items representing liabilities and *vice versa* subject to the provisions of Schedule 3. [3 Sch 6].

The company's directors must, in determining how amounts are presented within items in the balance sheet, have regard to the substance of the reported transaction or arrangement, in accordance with generally accepted accounting principles or practice. [3 Sch 8]. In addition, when an asset or liability relates to more than one item in the balance sheet, the relationship of such asset or liability to the relevant item must be disclosed either under those items or in the notes to the accounts. [3 Sch 8A].

The provisions of Schedule 3 which relate to long-term business apply, with necessary modifications, to business which consists of effecting or carrying out relevant contracts of general business which:

- Is transacted exclusively or principally according to the technical principles of long-term business.
- And
- Is a significant amount of the business of the company. [3 Sch 7(1)].

For this purpose, a contract of general insurance is a relevant contract if the risk insured against relates to accident or sickness (this must be read with certain sections and schedules of the Financial Services and Markets Act 2000). [3 Sch 7(2)].

8.2.1 Intangible assets

Figure 8-2 Analysis of intangible assets

B	Intangible assets
1	Development costs
2	Concessions, patents, licences, trade marks and similar rights and assets
3	Goodwill
4	Payments on account

Intangible assets are not defined in the CA 2006 but Note (2) to the Schedule 3 balance sheet format states that amounts are only included in the balance sheet as concessions, patents, licences, trademarks and similar rights and assets if either the assets were acquired for valuable consideration and are not required to be shown under goodwill, or the assets in question were created by the company itself. However, entities preparing FRS 102 financial statements must apply the more restrictive requirements of the standard. Note (3) to the Schedule 3 balance sheet format states that goodwill can only be included to the extent that the goodwill was acquired for valuable consideration.

Schedule 3 does not address the presentation of negative goodwill. However, FRS 102 requires that negative goodwill is disclosed immediately below positive goodwill, with a subtotal of the net amount of the positive goodwill and the negative goodwill. [FRS 102.19.24(b)].

8.2.2 Investments in group undertakings and participating interests

Figure 8-3 Analysis of investments in group undertakings and participating interests

C	Investments
II	Investments in group undertakings and participating interests
1	Shares in group undertakings
2	Debt securities issued by, and loans to, group undertakings
3	Participating interests†
4	Debt securities issued by, and loans to, undertakings in which the company has a participating interest

† In group accounts, this line item is replaced by two items: 'Interests in associated undertakings' and 'other participating interests'

A 'participating interest' means an interest held by, or on behalf of, an undertaking in the shares of another undertaking which it holds on a long-term basis for the purpose of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest. In the context of the balance sheet formats, 'participating interest' does not include an interest in a group undertaking. A holding of 20% or more of the shares of the undertaking is presumed to be a participating interest unless the contrary is shown. An interest in shares of another undertaking includes an interest which is convertible into an interest in shares and an option to acquire shares or any such interest, even if the shares are unissued until the conversion or exercise of the option. [10 Sch 11].

For investments in subsidiaries, associates and jointly controlled entities in separate and individual financial statements, neither the current accounting rules, fair value accounting rules nor the alternative accounting rules of Schedule 3 permit the use of cost less impairment. Consequently, an investor can account for these only at fair value with changes in fair value recognised in other comprehensive income (except for reversals of a revaluation decrease recognised in profit or loss or a revaluation decrease which exceeds accumulated revaluation gains recognised in equity which are recognised in profit or loss) or at fair value with changes in fair value recognised in profit or loss. [FRS 102.9.26].

8.2.3 Other financial investments

Figure 8-4 Analysis of other financial investments

C	Investments
III	Other financial investments
1	Shares and other variable-yield securities and units in unit trusts
2	Debt securities and other fixed-income securities
3	Participation in investment pools
4	Loans secured by mortgages
5	Other loans
6	Deposits with credit institutions
7	Other

Note (5) to the Schedule 3 balance sheet format states that debt-securities and other fixed-income securities is to comprise transferable debt securities and any other transferable fixed-income securities issued by credit institutions, other undertakings or public bodies, in so far as they are not covered within investments in group undertakings and participating interests.

Note (6) to the Schedule 3 balance sheet format states that participation in investment pools is to comprise shares held by the company in joint investments constituted by several undertakings or pension funds, the management of which has been entrusted to one of those undertakings or to one of those pension funds.

Note (7) to the Schedule 3 balance sheet format states that loans to policyholders for which the policy is the main security are to be included in 'other loans' and their amount must be disclosed in a note to the accounts. Loans secured by mortgage are to be shown as such even where they are also secured by insurance policies. Where the amount of 'other loans' not secured by policies is material, an appropriate breakdown must be given in the notes to the accounts.

Note (8) to the Schedule 3 balance sheet format states that deposits with credit institutions must comprise sums the withdrawal of which is subject to a time restriction. Sums deposited with no restriction must be shown under 'Cash at bank and in hand' even if they bear interest.

8.2.4 Reinsurers' share of technical provisions

Figure 8-5 Analysis of reinsurers' share of technical provisions

Da	Reinsurers' share of technical provisions
1	Provision for unearned premiums
2	Long-term business provision
3	Claims outstanding
4	Provisions for bonuses and rebates
5	Other technical provisions
6	Technical provisions for unit-linked liabilities

Note (12) to the Schedule 3 balance sheet format states that the reinsurance amounts are to comprise the actual or estimated amounts which, under contractual reinsurance arrangements, are deducted from the gross amount of technical provisions.

8.2.5 Debtors

Debtors arising out of direct insurance operations must be split between those due from policyholders and those due from intermediaries.

Note (13) to the Schedule 3 balance sheet format states that amounts owed by group undertakings and undertakings in which the company has a participating interest must be shown separately as sub-assets of the relevant asset class.

8.2.6 Other assets

Figure 8-6 Analysis of other assets

F	Other assets
I	Tangible fixed assets
1	Plant and machinery
2	Fittings, fixtures, tools and equipment
3	Payments on account (other than deposits paid on land and buildings) and assets (other than buildings) in the course of construction
II	Stocks
1	Raw materials and consumables
2	Work in progress
3	Finished goods and goods for resale

- 4 Payments on account
- III Cash at bank and in hand
- IV Own shares
- V Other

Tangible fixed assets would include property, plant and equipment, as defined in FRS 102.

The items reported under stocks will generally correspond with inventories under FRS 102.

[FRS 102 Appendix I].

The Regulations do not define cash at bank and in hand. This line item would include bank deposits with notice or maturity periods. Such bank deposits may or may not meet FRS 102's definition of 'cash' (i.e., cash on hand and demand deposits) or 'cash equivalents' (i.e., short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value). [FRS 102.7.2]. See Chapter 7 at 3.2 for the definition of cash and cash equivalents.

While 'own shares' have an asset line heading in the Schedule 3 balance sheet format, FRS 102 requires investments in own shares to be treated as treasury shares and deducted from equity. [FRS 102.22.16]. Consequently, this line item will not be used under FRS 102.

Note (15) to the Schedule 3 balance sheet format states that 'other' is to comprise assets which are not covered by the other items and where such assets are material, they must be disclosed in a note to the accounts.

8.2.7 Prepayments and accrued income (including deferred acquisition costs)

Note (17) to the Schedule 3 balance sheet format states that deferred acquisition costs arising in general business must be stated separately from those arising in long-term business. In the case of general business, the amount of any deferred acquisition costs must be established on a basis consistent with that used for unearned premiums. See 8.5.7 below.

8.2.8 Capital and reserves

Every balance sheet of a company which carries on long-term business must show separately as an additional item the aggregate of any amounts included in capital and reserves which are not required to be treated as realised profits under section 843 of the CA 2006. [3 Sch 11(1)].

Called up share capital in relation to a company means so much of its share capital as equals the aggregate amounts of the calls made on its shares (whether or not those calls have been paid) together with any share capital paid up without being called, and any share capital to be paid on a specified future date under the articles, the terms of allotment of the relevant shares or any other arrangements for payment of those shares. [s547].

The share premium account is a statutory reserve that arises on the issue of share capital. It is beyond the scope of this publication to explain the rules governing share premium in detail but a summary explaining how the share premium arises and can be applied or reduced is contained in Chapter 6 at 4.3.12.B.

The revaluation reserve arises where an asset is carried at valuation using the alternative accounting rules in the Regulations. [3 Sch 29].

Figure 8-7 below shows the analysis required in respect of reserves.

Figure 8-7 Analysis of reserves

A Capital and reserves	
IV	Reserves
1	Capital redemption reserve
2	Reserve for own shares
3	Reserves provided for by articles of association
4	Other reserves

The capital redemption reserve is a statutory reserve which is established when the shares of a limited company are redeemed or purchased wholly or partly out of the company's profits, or where treasury shares are cancelled. It is beyond the scope of this chapter to explain the rules governing redemptions/purchases of shares, treasury shares and the capital redemption reserve.

The reserve for own shares is used where the company purchases its own shares to be held by an employee share ownership plan ('ESOP') that is treated as an extension of the sponsoring entity or where shares are held as treasury shares. [FRS 102.9.33, FRS 102.9.33A, FRS 102.9.34, FRS 102.9.35, FRS 102.9.36, FRS 102.9.37, FRS 102.22.16].

Where the Articles of Association specifically provide for reserves to be established, the line item 'Reserves provided for by articles of association' is used.

8.2.9 Subordinated liabilities

Note (18) to the Schedule 3 balance sheet format states that subordinated liabilities comprise all liabilities in respect of which there is a contractual obligation that, in the event of winding up of bankruptcy, they are to be repaid only after the claims of other creditors have been met (whether or not they are represented by certificates).

8.2.10 Fund for future appropriations ('FFA')

Note (19) to the Schedule 3 balance sheet format states that the FFA is to comprise all funds the allocation of which either to policyholders or shareholders has not been determined by the end of the financial year. Transfers to and from the FFA must be shown in the profit and loss line item, 'Transfers to or from the fund for future appropriations'.

The Implementation Guidance to FRS 103 states that where there is reasonable certainty over the allocation to policyholders or owners of all items recognised in the technical account for long-term business, it is inappropriate to establish an FFA. However, certain long-term business funds of:

- Proprietary insurers are established in such a way that allocation between equity and policyholders' liabilities is not clear cut.

And

- Mutual insurers are established in such a way that allocation between disclosed surplus and policyholders' liabilities is not clear cut.

And

- Therefore, it is appropriate to establish an FFA. [FRS 103.IG2.50].

Where an FFA is established, the notes to the financial statements must indicate the reasons for its use and the nature of the funds involved (see 11.4 below). [FRS 103.IG2.51].

8.2.11 Technical provisions

Figure 8-8 Analysis of technical provisions

C	Technical provisions
1	Provision for unearned premiums
2	Long-term business provision
3	Claims outstanding
4	Provisions for bonuses and rebates
5	Equalisation provision
6	Other technical provisions

The Schedule 3 balance sheet format permits the reinsurers' share of technical provisions to be shown either separately within liabilities or under assets item Da. However, FRS 103 prohibits the offsetting of reinsurance assets against the related insurance liabilities (see 8.10 below) and therefore the reinsurers' share of technical provisions must be shown as an asset.

Note (20) to the Schedule 3 balance sheet format states that the provision for unearned premiums for long-term business may be included in the long-term business provision rather than within unearned premiums.

Note (21) to the Schedule 3 balance sheet format states that the long-term business provision is to comprise the actuarially estimated value of the company's liabilities including bonuses already declared and after deducting the actuarial value of future premiums. It must also include claims incurred but not reported plus the estimated costs of settling such claims.

Note (22) to the Schedule 3 balance sheet format states that claims outstanding is to comprise the estimated ultimate cost to the company of settling all claims arising from events which have occurred up to the end of the financial year (including, in the case of general business, claims incurred but not reported) less amounts already paid in respect of such claims.

Note (23) to the Schedule 3 balance sheet format states that provisions for bonuses and rebates is to comprise amounts intended for policyholders or contract beneficiaries by way of bonuses and rebates to the extent that such amounts have not been credited to policyholders or contract beneficiaries or included in liabilities item Ba or in liabilities item C2.

Note (24) to the Schedule 3 balance sheet format states that equalisation provisions are those required to be maintained in respect of general business by the company in accordance with the rules made by the Financial Conduct Authority or the Prudential Regulation Authority ('PRA') under Part 10 of the Financial Services and Markets Act 2000. They also comprise any amounts required to be set aside by a company to equalise fluctuations in loss ratios in future years or to provide for special risks in accordance with Council Directive 87/343/EEC. Since the implementation of the Solvency II Directive, effective from 1 January 2016, the UK (and EU) regulatory framework does not permit equalisation or catastrophe provisions.

Note (25) to the Schedule 3 balance sheet format states that other technical provisions are to include the provision for unexpired risks (see 8.5.5 below). Where the provision for unexpired risks is significant, it must be disclosed separately under the respective sections presenting the gross provision for unexpired risks and the reinsurers' share.

8.2.12 Technical provisions for linked liabilities

Note (26) to the Schedule 3 balance sheet format states that this comprises technical provisions constituted to cover liabilities relating to investment in the context of long-term policies under which the benefits payable to policyholders are wholly or partly determined by reference to the value of, or the income from, property of any description (whether or not specified in the contract), or by reference to fluctuations in, or in an index of, the value of property of any description (whether or not so specified). 'Property' in this context means any type of asset. Any additional technical provisions constituted to cover death risks, operating expenses or other risk (such as benefits payable at the maturity date or guarantee surrender values) must be included in the long-term business provision.

This item must also comprise technical provisions representing the obligations of a tontine's organiser in relation to its members.

The Implementation Guidance to FRS 103 states that the relevant provision for any contract must not be less than the element of any surrender or transfer value which is calculated by reference to the relevant fund or funds or index. [FRS 103.IG2.47]. The net assets held to cover linked liabilities at the reporting date may differ from the technical provisions for linked liabilities. However, the reasons for any significant mismatching must be disclosed. [FRS 103.IG2.48].

Where the technical provision for linked liabilities has regard to the timing of the tax obligation, the effect of this must be excluded from the determination of deferred tax. [FRS 103.IG2.49].

8.2.13 Provisions for other risks

Figure 8-9 Analysis of provisions for other risks

E	Provisions for other risks
1	Provisions for pensions and similar obligations
2	Provisions for taxation
3	Other provisions

8.2.14 Deposits received from reinsurers

Note (27) to the Schedule 3 balance sheet format states that this item is to comprise amounts deposited by or withheld from other insurance undertakings under reinsurance contracts. These amounts must not be merged with other amounts owed to or by those other undertakings. Where the company ceded insurance and has received, as a deposit, securities which have been transferred to its ownership, this item is to comprise the amount owned by the company by virtue of the deposit.

8.2.15 Creditors

Note (28) to the Schedule 3 balance sheet format states that amounts owed to group undertakings and undertakings in which the company has a participating interest must be shown separately as sub-items.

Note (29) to the Schedule 3 balance sheet format states that the amount of any convertible debenture loans must be shown separately.

8.3 Statement of comprehensive income under Schedule 3

FRS 102 requires an entity to present its total comprehensive income for a period either: *[FRS 102.5.2]*

- In a single statement of comprehensive income which presents all items of income and expense (and includes a subtotal for profit or loss).
- Or
- In two statements - an income statement (referred to as the profit and loss account in Schedule 3 to the Regulations) and a statement of comprehensive income, in which case the income statement presents all items of income and expense recognised in the period except those that are recognised in total comprehensive income outside of profit or loss as permitted or required by FRS 102.

These requirements apply both to consolidated and individual financial statements.

However, UK companies (and LLPs) preparing group accounts in accordance with the CA 2006 can take advantage of the exemption in section 408 of the CA 2006 (where the conditions are met) not to present the individual profit and loss account and certain related notes. *[s408, s472(2), Regulations 3(2)]*. See Chapter 1 at 5.3.2. This exemption does not extend to individual financial statements prepared under other statutory frameworks, unless permitted by these statutory frameworks.

A change from the single-statement approach to the two-statement approach, or *vice versa*, is a retrospective change in accounting policy to which Section 10 applies. *[FRS 102.5.3]*. See Chapter 9 at 3.3.

A Schedule 3 profit and loss account or income statement comprises both a technical account and a non-technical account. There are separate technical accounts for general business and long-term business. Therefore, composite insurers (i.e., those that underwrite both general and long-term business) will present a three-part profit and loss account comprising a technical account-general business, a technical account-long-term business and a non-technical account. As discussed at 8.1 above, insurance entities and groups are not permitted to use 'adapted' profit or loss formats; the statutory format must be used.

Extract from FRS 102

Appendix I

Glossary

other comprehensive income	Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by this FRS or by law.

Profit or loss is the default category; all comprehensive income is part of profit or loss unless FRS 102 permits or requires otherwise. Schedule 3 does not address the format or content of other comprehensive income which is discussed at 8.3.13 below.

Figure 8-10 Format of the Technical account - General business

I	Technical account - General business
1	Earned premiums, net of reinsurance
	(a) gross premiums written
	(b) outward reinsurance premiums
	(c) change in gross provision for unearned premiums
	(d) change in provision for unearned premiums, reinsurers' share
2	Allocated investment return transferred from the non-technical account
3	Investment income
	(a) income from participating interests, with a separate indication of that derived from group undertakings
	(b) income from other investments, with a separate indication of that derived from group undertakings
	(aa) income from land and buildings
	(bb) income from other investments
	(c) value re-adjustments on investments
	(d) gains on realisation of investments
4	Other technical income, net of reinsurance
5	Claims incurred, net of reinsurance
	(a) claims paid
	(aa) gross amount
	(bb) reinsurers' share
	(b) change in the provision for claims
	(aa) gross amount
	(bb) reinsurers' share
6	Changes in other technical provisions, net of reinsurance, not shown under other headings
7	Bonuses and rebates, net of reinsurance
8	Net operating expenses
	(a) acquisition costs
	(b) change in deferred acquisition costs
	(c) administrative expenses
	(d) reinsurance commissions and profit participation
9	Other technical charges, net of reinsurance
10	Investment expenses and charges
	(a) investment management expenses, including interest
	(b) value adjustments on investments
	(c) loss on the realisation of investments
11	Change in the equalisation provision
12	Balance on the technical account for general business

Figure 8-11 Format of the Technical account - Long-term business

II	Technical account - Long-term business
1	Earned premiums, net of reinsurance
	(a) gross premiums written
	(b) outward reinsurance premiums
	(c) change in the provision for unearned premiums, net of reinsurance
2	Investment income
	(a) income from participating interests, with a separate indication of that derived from group undertakings
	(b) income from other investments, with a separate indication of that derived from group undertakings
	(aa) income from land and buildings
	(bb) income from other investments
	(c) value re-adjustments on investments
	(d) gains on realisation of investments
3	Unrealised gains on investments
4	Other technical income, net of reinsurance
5	Claims incurred, net of reinsurance
	(a) claims paid
	(aa) gross amount
	(bb) reinsurers' share
	(b) change in provisions for claims
	(aa) gross amount
	(bb) reinsurers' share
6	Change in other technical provisions, net of reinsurance, not shown under other headings
	(a) long-term business provision, net of insurance
	(aa) gross amount
	(bb) reinsurers' share
	(b) other technical provisions, net of reinsurance
7	Bonuses and rebates, net of reinsurance
8	Net operating expenses
	(a) acquisition costs
	(b) change in deferred acquisition costs
	(c) administrative expenses
	(d) reinsurance commissions and profit participation
9	Investment expenses and charges
	(a) investment management expenses, including interest
	(b) value adjustments on investments
	(c) losses on the realisation of investments
10	Unrealised losses on investments
11	Other technical charges, net of reinsurance

- 11a Tax attributable to the long-term business
- 12 Allocated investment return transferred to the non-technical account
- 12a Transfers to or from the fund for future appropriations
- 13 Balance on the technical account for long-term business

Figure 8-12 Format of the Non-technical account

III	Non-technical account
1	Balance on the general business technical account
2	Balance on the long-term business technical account
2a	Tax credit attributable to balance on the long-term business technical account
3	Investment income
(a)	income from participating interests, with a separate indication of that derived from group undertakings
(b)	income from other investments, with a separate indication of that derived from group undertakings
(aa)	income from land and buildings
(bb)	income from other investments
(c)	value re-adjustments on investments
(d)	gains on realisation of investments
3a	Unrealised gains on investments
4	Allocated investment return transferred from the long-term business technical account
5	Investment expenses and charges
(a)	investment management expenses, including interest
(b)	value adjustments on investments
(c)	loss on the realisation of investments
5a	Unrealised losses on investments
6	Allocated investment return transferred to the general business technical account
7	Other income
8	Other charges, including value adjustments
8a	Profit or loss on ordinary activities before tax
9	Tax on profit or loss on ordinary activities
10	Profit or loss on ordinary activities after tax
11	Extraordinary income
12	Extraordinary charges
13	Extraordinary profit or loss
14	Tax on extraordinary profit or loss
15	Other taxes not shown under the preceding items
16	Profit or loss for the financial year

8.3.1 Gross written premiums

Note (1) to the Schedule 3 profit and loss format states that gross premiums written is to comprise all amounts during the financial year in respect of insurance contracts entered into regardless of the fact that such amounts may relate in whole or in part to a later financial year and must include:

- Premiums yet to be determined, where the premium calculation can be done only at the end of the year.
- Single premiums, including annuity premiums, and in long-term business, single premiums resulting from bonus and rebate provisions in so far as they must be considered as premiums under the terms of the contract.

- Additional premiums in the case of half-yearly, quarterly or monthly payments and additional payments from policyholders for expenses borne by the company.
- In the case of co-insurance, the company's portion of total premiums.
- Reinsurance premiums due from ceding and retroceding undertakings, including portfolio entries.

The above must be shown after deductions of cancellations and portfolio withdrawals credited to ceding and retroceding undertakings.

In addition, gross premiums written must not include the amounts of taxes or duties levied with premiums.

8.3.2 Outwards reinsurance premiums

Note (2) to the Schedule 3 profit and loss format states that outwards reinsurance premiums must comprise all premiums paid or payable in respect of outwards reinsurance contracts entered into by the company. Portfolio entries payable on the conclusion or amendment of outwards reinsurance contracts must be added. Portfolio withdrawals receivables must be deducted.

8.3.3 Changes in the provision for unearned premiums, net of reinsurance

Note (3) to the Schedule 3 profit and loss format states that in the case of long-term business, the change in unearned premiums may be included either in this line item or within changes in other technical provisions.

8.3.4 Claims incurred, net of reinsurance

Note (4) to the Schedule 3 profit and loss format states that this is to comprise all payments made in the financial year with the addition of the provision for claims (but after deducting the provision for claims for the preceding financial year).

The amounts must include annuities, surrenders, entries and withdrawals of loss provisions to and from ceding insurance undertakings and reinsurers and external and internal claims management costs and charges for claims incurred but not reported. Sums recoverable on the basis of salvage and subrogation must be deducted.

Where the difference between the loss provision at the beginning of the year and the payments made during the year on account of claims incurred in previous years and the loss provision shown at the end of the year for such outstanding claims is material, it must be shown in the notes to the accounts, broken down by category and amount.

8.3.5 Bonuses and rebates, net of reinsurance

Note (5) to the Schedule 3 profit and loss format states that bonuses comprise all amounts chargeable for the financial year which are paid or payable to policyholders and other insured parties or provided for their benefit, including amounts used to increase technical provisions or applied to the reduction of future premiums, to the extent that such amounts represent an allocation of surplus or profit arising on business as a whole or a section of business, after deduction of amounts provided in previous years which are no longer required. Rebates are to comprise such amounts to the extent that they represent a partial refund of premiums resulting from the experience of individual contracts.

Where material, the amount charged for bonuses and that charged for rebates must be disclosed separately in the notes to the accounts.

8.3.6 Acquisition costs

Note (6) to the Schedule 3 profit and loss format states that acquisition costs comprise costs arising from the conclusion of insurance contracts. They must cover both direct costs, such as acquisition commissions or the cost of drawing up the insurance document or including the insurance contract in the portfolio, and indirect costs, such as the advertising costs or the administrative expenses connected with the processing of proposals and the issuing of policies. In the case of long-term business, policy renewal commissions must be included within administrative expenses.

8.3.7 Administrative expenses

Note (7) to the Schedule 3 profit and loss format states that administrative expenses must include the costs arising from premium collection, portfolio administration, handling of bonuses and rebates and inward and outward reinsurance. In particular, they must include staff costs and depreciation provisions in respect of office furniture and equipment in so far as these need not be shown under acquisition costs, claims incurred or investment charges.

8.3.8 Investment income, expenses and charges

Note (8) to the Schedule 3 profit and loss format states that investment income, expenses and charges must, to the extent that they arise in the long-term technical fund, be disclosed in the long-term technical account. Other investment income, expenses and charges must either be disclosed in the non-technical account or attributed between the appropriate technical and non-technical accounts. Where the company makes such an attribution it must disclose the basis for it in the notes to the accounts. See 8.7 below.

8.3.9 Unrealised gains and losses on investments

Note (9) to the Schedule 3 profit and loss format states that in the case of investments attributed to the long-term fund, the difference between the valuation of the investments and their purchase price or, if they have previously been valued, their valuation as at the last balance sheet date, may be disclosed (in whole or in part) under either item 3 (unrealised gains on investments) or item 10 (unrealised losses on investments), as the case may be, of the long-term technical account, and in the case of investments shown as assets held to cover linked liabilities must also be disclosed.

In the case of other investments, the difference between the valuation of investments and their purchase price or, if they have previously been valued, their valuation as at the last balance sheet date, may be disclosed (in whole or in part) under items 3a (unrealised gains on investments) or 5a (unrealised losses on investments), as the case may require, of the non-technical account.

8.3.10 Allocated investment return

Note (10) to the Schedule 3 profit and loss format states that the investment return allocated initially to one part of the profit and loss account (see 8.3.8 above) may be transferred to another part of the profit and loss account. See 8.7 below.

One reason that such a transfer might be made is so that, for example, a long-term insurer could recognise investment return in the life technical account on a longer-term rate of return basis.

Where part of the investment return allocated initially to the non-technical account is transferred to the general business technical account, any transfer must be deducted from item 6 in the non-technical account and added to item 2 of the technical account - general business.

Where part of the investment return allocated initially to the long-term business account is transferred to the non-technical account, the transfer to the non-technical account must be deducted from item 12 of the long-term business account and added to item 4 of the non-technical account.

The reasons for such transfers (which may consist of a reference to any relevant statutory requirement) and the basis on which they are made must be disclosed in the notes to the accounts. See 11.7 below.

8.3.11 Exchange gains or losses

Exchange differences required to be included within profit or loss under Section 30 *Foreign Currency Translation* of FRS 102 must be dealt with through the non-technical account except for long-term insurance business where exchange differences must be recognised in the technical account for long-term business. Exchange differences taken to other comprehensive income arising from translating results and financial position into a different presentational currency, [FRS 102.30.18(c)], can, where appropriate, in the case of long-term business, be recognised in the FFA. [FRS 103.2.32].

8.3.12 Employee benefits

The net interest on the net defined benefit liability during the reporting period, [FRS 102.28.23(b)], must be recognised, as appropriate, in the technical account for long-term business or the non-technical account. [FRS 103.2.33].

As an exception to the requirement in paragraph 28.23(d) of FRS 102 to remeasure the net defined benefit liability in other comprehensive income, the remeasurement of the net defined benefit liability which is not attributable to owners must be treated as an amount, the allocation of which, either to policyholders or to owners, has not been determined by the reporting date (i.e., reported within the FFA). It must be included as a separate line in the technical account for long-term insurance business immediately above the line for transfer to or from the FFA and reflected in that transfer. The impact must be disclosed separately in the notes to the financial statements. [FRS 103.2.34].

8.3.13 Other comprehensive income

As discussed at 8.3 above, Schedule 3 to the Regulations does not address the presentation of other comprehensive income. Illustrative examples of the presentation of other comprehensive income are in Chapter 6 at 5.5.2.

Other comprehensive income means items of income and expense (including reclassification adjustments), that are not recognised in profit or loss as required or permitted by FRS 102. [FRS 102 Appendix I]. Therefore, profit or loss is the default category; all comprehensive income is part of profit or loss unless FRS 102 permits or requires otherwise.

FRS 102 requires the following items to be included in other comprehensive income:

- Changes in revaluation surplus relating to property, plant and equipment, [FRS 102.17.15E, FRS 102.17.15F], and intangible assets. [FRS 102.18.18G, FRS 102.18.18H]. See Chapter 15 at 3.7.3 and Chapter 16 at 3.3.2.C
 - Actuarial gains and losses, and the return on plan assets excluding amounts included in net interest on the net defined benefit liability (known collectively as 'remeasurements' of the net defined benefit liability) on defined benefit plans. [FRS 102.28.23(d), FRS 102.28.25]. See Chapter 30 at 3.5.10.B
 - Exchange gains and losses arising from translating the financial statements of a foreign operation (including in consolidated financial statements, exchange differences on a monetary item that forms part of the net investment in the foreign operation). However, under FRS 102, cumulative exchange differences accumulated in equity are not reclassified to profit and loss on disposal of a net investment in a foreign operation. [FRS 102.9.18A, FRS 102.30.13].
 - The effective portion of fair value gains and losses on hedging instruments in a cash flow hedge or a hedge of the foreign exchange risk in a net investment in a foreign operation. The amounts taken to equity in respect of the hedge of the foreign exchange risk in a net investment in a foreign operation are not reclassified to profit or loss on disposal or partial disposal of the foreign operation. [FRS 102.12.23, FRS 102.12.24, FRS 102.12.25A]. See Chapter 13 at 6 and Chapter 13 at 7
 - Fair value gains and losses through other comprehensive income for an investor that is not a parent measuring its interests in jointly controlled entities, [FRS 102.15.9(c), FRS 102.15.14, FRS 102.15.15, FRS 102.15.15A], and investments in associates in its individual financial statements. [FRS 102.14.4(c), FRS 102.14.9, FRS 102.14.10, FRS 102.14.10A]. See Chapter 18 at 3.5.2 and Chapter 17 at 3.2.4
 - Fair value gains and losses through other comprehensive income for investments in subsidiaries, associates and jointly controlled entities used by the parent in its separate financial statements or in consolidated financial statements for certain excluded subsidiaries. [FRS 102.9.26(b), FRS 102.9.26A, FRS 102.9.9, FRS 102.9.9A, FRS 102.9.9B, FRS 102.9.9C(b)]. See Chapter 8 at 3.4 and Chapter 8 at 4.2
- And
- Any unrealised gain arising on an exchange of business or non-monetary assets for an interest in a subsidiary, jointly controlled entity or associate. [FRS 102.9.31(c)]. See Chapter 8 at 3.8.

Of the above items, only the amounts taken to other comprehensive income in relation to cash flow hedges may be reclassified to profit or loss in a subsequent period under FRS 102.

Where the entity applies the recognition and measurement requirements of IAS 39 or IFRS 9 to financial instruments, further items are reported in other comprehensive income (see Chapter 13).

In addition, Schedule 3 to the Regulations restricts when unrealised profits can be reported in the profit and loss account. [3 Sch 18(a)]. Consequently, certain unrealised profits may be required to be reported in other comprehensive income rather than in profit or loss. Whether profits are available for distribution must be determined in accordance with applicable law. Technical Release 02/17BL *Guidance on realised and distributable profits under the Companies Act 2006* ('TECH 02/17BL') provides guidance on the determination of the profits available for distribution (under the CA 2006). [FRS 102.A3.29].

8.4 Recognition and measurement requirements for long-term insurance business

Extract from FRS 103

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long-term insurance business	Insurance contracts (including reinsurance) falling within one of the classes of insurance specified in Part II of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

Section 3 of FRS 103 contains recognition and measurement requirements for entities applying FRS 103 that are carrying out long-term insurance business. These requirements are set out as follows:

- Paragraphs 3.3 to 3.9 and 3.16 to 3.18 apply to all long-term insurance business.
- And
- Paragraphs 3.10 to 3.15 apply to with-profits business and with-profits funds, to which the PRA realistic capital regime (as set out in section 1.3 of the Prudential sourcebook for insurers ('INSPRU') as at 31 December 2015) was being applied, either voluntarily or compulsorily, prior to 1 January 2016. *[FRS 103.3.1].*

The requirements set out in Section 3 provide the benchmark for setting accounting policies for long-term insurance business as at 1 January 2015 (i.e., the date from which FRS 103 replaced previous UK GAAP). Entities are permitted to change their accounting policies in accordance with paragraph 2.3 of FRS 103 (see 9 below). Entities that are setting accounting policies for the first time may apply this benchmark or are permitted to set alternative policies (see 1.3 above). *[FRS 103.3.1A].*

The requirements in Section 3 are based on those contained previously in FRS 27 and the ABI SORP. FRS 103 does not explain why the FRC felt that these requirements needed to be embedded into the standard, when no general insurance accounting requirements are embedded into the standard, but the reason seems to be to ensure that life insurers are directed towards continuing to comply with the requirements of FRS 27 in respect of with-profits business.

Notwithstanding these requirements, an entity is permitted to change its accounting policies away from the requirements if certain criteria are satisfied (see 9 below). When an entity's new accounting policies are not consistent with these requirements, those requirements that are not consistent with the entity's accounting policies need not be applied. *[FRS 103.3.2].*

The recognition and measurement requirements are discussed below as follows:

- Gross premiums written (see 8.4.1 below)
- Claims recognition (see 8.4.2 below)
- Deferred acquisition costs (see 8.4.3 below)
- Measurement of insurance liabilities and related assets (see 8.4.4 below)
- And
- Value of in-force life assurance business held by parents that are not insurers (see 8.4.5 below)

8.4.1 Gross premiums written and reinsurance outwards premiums

Premiums, including those for inwards reinsurance, must be recognised when due for payment. When the amount due is not known, for example with certain pensions business, estimates must be used. *[FRS 103.3.3].* An insurer must not accrue for future premiums receivable under a contract. This is because such premiums are included within the calculation of the insurance liability (see 8.4.4 below). FRS 103 does not elaborate as to how estimates must be made when the amount due is not known.

For linked business (i.e., business where the benefits payable to policyholders are wholly or partly to be determined by reference to the value of, or the income from, property of any description or by reference to fluctuations in, or an index of, the value of property of any description), the due date for payment may be taken as the date when the liability is established. *[FRS 103.3.3].*

Reinsurance outwards premiums must be recognised when paid or payable. *[FRS 103.3.4].*

8.4.2 Claims recognition

Claims payable on maturity must be recognised when the claims become due for payment and claims payable on death must be recognised on notification. *[FRS 103.3.5]*.

Where a claim is payable and the policy or contract remains in force, the relevant instalments must be recognised when due for payment. The recognition of the claim in the technical account for long-term business and the calculation of the long-term business provision and/or the provision for linked liabilities, must be treated consistently, as appropriate. *[FRS 103.3.5]*.

Surrenders must be included within claims incurred and recognised either when paid or at the earlier date on which, following notification, the policy ceases to be included within the calculation of the long-term business provision and/or the provision for linked liabilities. *[FRS 103.3.6]*.

8.4.3 Deferred acquisition costs

Extract from FRS 103

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acquisition costs

Costs arising from the conclusion of insurance contracts including direct costs and indirect costs connected with the processing of proposals and the issuing of policies.

Further details are set out in note 6 of the Notes on the Profit and Loss Account format in Schedule 3 to the Regulations.

Direct costs from the conclusion of insurance contracts include acquisition commissions or the cost of drawing up the insurance document or including the insurance contract in the portfolio. Indirect costs include advertising costs or the administrative expenses connected with the processing of proposals and the issuing of policies. *[3 Sch P&L Note 6]*.

FRS 103 does not permit acquisition costs to be deferred for with-profit funds. *[FRS 103.3.10]*. This prohibition applies to with-profits business and with-profit funds to which the PRA realistic capital regime (as set out in section 1.3 of INSPRU as at 31 December 2015) was being applied, either voluntarily or compulsorily, prior to 1 January 2016. *[FRS 103.3.1(b)]*.

For other long-term insurance business, acquisition costs can be deferred except to the extent that: *[FRS 103.3.7]*

- The costs in question have already been recovered (for example where the design of the policy provides for the recovery of costs as incurred).
 - The net present value of margins within insurance contracts is not expected to be sufficient to cover deferred acquisition costs after providing for contractual liabilities to policyholders and expenses.
- And
- The receipt of future premiums or the achievement of future margins is insufficiently certain based on estimates of future expected discontinuance rates or other experience.

Advertising costs can only be deferred where they are directly attributable to the acquisition of new business. *[FRS 103.3.8]*.

FRS 103 does not specify a particular method for the amortisation of deferred acquisition costs. However, the costs that are carried forward must be amortised over a period no longer than the one in which, net of any related deferred tax provision, they are expected to be recoverable out of margins on related insurance contracts in force at the reporting date, and in a similar profile to those margins. *[FRS 103.3.9]*.

How we see it

The amortisation of deferred acquisition costs based on profit margins arising from the related insurance business is an appropriate amortisation methodology.

8.4.4 Measurement of insurance liabilities and related assets

Schedule 3 requires that technical provisions must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen. [3 Sch 49].

Schedule 3 requires that the long-term business provision must in principle be computed separately for each long-term contract, save that statistical or mathematical methods may be used where they may be expected to give approximately the same results as individual calculations. [3 Sch 52(1)].

There is also a requirement that the computation of the long-term business provision must be made annually by a Fellow of the Institute or Faculty of Actuaries with due regard to generally accepted actuarial principles and on the basis of recognised actuarial methods. [3 Sch 52(3)].

8.4.4.A Measurement of non-profit insurance liabilities

FRS 103 states that the established accounting treatment for long-term insurance business is to measure liabilities for policyholder benefits under the modified statutory solvency basis ('MSSB'). [FRS 103.3.11].

The MSSB is the basis for determining insurance liabilities which is the statutory solvency basis adjusted:

- To defer new business acquisition costs incurred where the benefit of such costs will be obtained in subsequent reporting periods (see 8.4.3 above).

And

- To treat investment, resilience and similar reserves, or reserves held in respect of general contingencies or the specific contingency that the fund will be closed to new business, where such items are held in respect of long-term insurance business, as reserves rather than provisions. These are included, as appropriate, within shareholders' capital and reserves or the FFA. [FRS 103 Appendix I].

The statutory solvency basis is the basis of determination of insurance liabilities in accordance with rule 1 of the Prudential Sourcebook for Insurers ('INSPRU') as at 31 December 2015. [FRS 103 Appendix I].

The Implementation Guidance to FRS 103 provides guidance in relation to the requirement of the Regulations (see 8.4.4 above) to compute insurance liabilities. The Implementation Guidance states that the gross premium method must be used for every class of insurance business except those for which the net premium method is used in the related regulatory returns, but policyholder liabilities of overseas subsidiaries may be computed on a local basis, subject to Part 3 of Schedule 6 to the Regulations. Where the valuation is performed using a net premium method, bonuses must be included in the long-term business provision only if they have vested or have been declared as a result of the current valuation. [FRS 103.IG2.39, FRS 103.IG2.40].

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gross premium method

A form of actuarial valuation of liabilities arising under long-term insurance contracts where the premiums brought into account are the full amounts receivable under the contract. The method includes explicit estimates of cash flows for:

- (a) premiums, adjusted for renewals and lapses;
- (b) expected claims and for with-profits business future regular but not occasional or terminal bonuses;
- (c) costs of maintaining contracts; and
- (d) future renewal expenses.

Cash flows are discounted at the valuation interest rate. The methodology may be set out in the relevant regulatory framework. The discount rate is based on the expected return on the assets deemed to back the liabilities. This will be adjusted to reflect any further risks although, under this method, most of the key risks will be reflected in the modelling of the cash flows. For linked business, allowance may be made for the purchase of future units required by the contract terms and credit is taken for future charges permitted under those terms.

net premium method

An actuarial valuation of liabilities arising under long-term insurance contracts where the premium brought into account at any valuation date is that which, on the valuation assumptions regarding interest, mortality and disability, will exactly provide for the benefits guaranteed. A variation of the net premium method involves zillmerisation. The detailed methodology for UK companies is included in regulations contained in the PRA Rulebook as at 31 December 2015.

The Implementation Guidance to FRS 103 states that, in determining the long-term business provision, and the technical provision for linked liabilities, no policy must have an overall negative provision except as allowed by PRA rules, or a provision which is less than any guaranteed surrender or transfer value.

[FRS 103.IG2.41].

The Implementation Guidance also states that the long-term business provision may be calculated on a basis used for regulatory reporting subject to appropriate adjustments including the reversal of any reduction in policyholder liabilities where these liabilities already implicitly take account of a pension fund surplus through future expense assumptions which reflect lower expected contributions. [FRS 103.IG2.42].

Investment reserves (realised and unrealised investment gains and exchange gains), surpluses carried forward, resilience and similar reserves, contingency and closed fund reserves which may be included in the statutory liabilities for solvency purposes under the PRA rules, must be considered to assess the extent to which they must be included in the long-term business provision. [FRS 103.IG2.52].

The Implementation Guidance clarifies that, where the long-term business provision has been determined on an actuarial basis that, in assessing the future net cash flows, having regard to the timing of tax relief where assumed expenses exceed attributable income, such tax relief must be excluded from the determination of deferred tax. [FRS 103.IG2.44].

8.4.4.B Measurement of with-profits-liabilities and related assets

FRS 103 requires that (unless an entity has changed its accounting policies) with-profit-funds are required to use the realistic value of liabilities as the basis for the estimated value of the liabilities to be included in the financial statements. [FRS 103.3.11].

The realistic values of liabilities is that element of the amount defined by rule 1.3.40 of INSPRU as at 31 December 2015, excluding current liabilities falling within the definition set out in rule 1.3.190 of INSPRU as at 31 December 2015 that are recognised separately in the statement of financial position.

[FRS 103 Appendix I].

Extract from FRS 103

Measurement of with-profits liabilities and related assets**3.12** For with-profits funds:

- (a) liabilities to policyholders arising from with-profits business shall be stated at the amount of the realistic value of liabilities adjusted to exclude the shareholders' share of projected future bonuses;
- (b) reinsurance recoveries that are recognised shall be measured on a basis that is consistent with the value of the policyholder liabilities to which the reinsurance applies;
- (c) an amount may be recognised for the present value of future profits on non-participating business written in a with-profits fund if the determination of the realistic value of liabilities in that with-profits fund takes account, directly or indirectly, of this value;
- (d) where a with-profits life fund has an interest in a subsidiary or associate and the determination of the realistic value of liabilities to with-profits policyholders takes account of a value of that interest at an amount in excess of the net amounts included in the entity's consolidated accounts, an amount may be recognised representing this excess; and
- (e) adjustments to reflect the consequential tax effects of (a) to (d) above shall be made.

Adjustments from the MSSB necessary to meet the above requirements, including the recognition of an amount in accordance with paragraph 3.12(c) or 3.12(d), shall be included in profit or loss. An amount equal and opposite to the net amount of these adjustments shall be transferred to or from the fund for future appropriations (FFA) and also included in profit or loss.

[FRS 103.3.12]

According to the Implementation Guidance, the shareholder's share of projected future bonuses excluded in accordance with (a) above must be calculated as the value of future transfers to shareholders using market consistent financial assumptions and assuming that transfers take place at a level consistent with those assumptions used to calculate the realistic value of liabilities. When an explicit assumption is not required in order to calculate the liabilities then continuation of the current profit-sharing arrangements must be assumed unless the entity has plans to change this approach. Non-economic assumptions must be consistent with those used in determining the realistic value of liabilities. The amount deducted for the shareholder's share of project future bonuses must be taken to the FFA. If shareholders' transfers have been included as part of the realistic value of liabilities (or otherwise included in liabilities) then the amount of such transfers must be taken out of liabilities and included in the FFA, together with any related tax liability. If shareholder transfers have not been set up as part of the realistic value of liabilities or elsewhere, no adjustment is required. [FRS 103.IG1.2].

In determining the realistic value of liabilities, a with-profits fund may take account of the value of future profits expected to arise from any non-participating business that forms part of the with profits fund - sometimes referred to as the value of in-force life assurance business ('VIF'). An entity is permitted to recognise the VIF if that business has been taken into account in measuring the liability because excluding it whilst recognising the realistic value of liabilities in full and valuing the non-statutory participating liabilities on a statutory basis would give rise to an inconsistency in the fund's net assets. The VIF can be recognised even though there is not a direct link between the value of the assets and the amount of the liabilities. Where there is not a direct link between the value of the business and the amount of the realistic liabilities, but the value is taken into account in determining these liabilities, it is appropriate to recognise the total value of the business. Although not separately identifiable, any excess amount over the realistic liabilities will be taken to the FFA. [FRS 103.IG1.3].

The amount recognised under (c) and (d) above may be regarded either as an additional asset, representing the value of future cash flows from the related insurance business or as an adjustment to the measurement of liabilities and the FFA, being the deduction from these items of the obligation to transfer an unrecognised asset or other source of value. FRS 103 requires entities to present this as an adjustment to liabilities, unless this would not be in compliance with the statutory requirements that apply to the entity, in which case the amount is permitted to be recognised as an asset. [FRS 103.IG1.5].

The VIF recognised within assets as described above is determined as the discounted value of future profits expected to arise from the policies, taking into account liabilities relating to the policies measured on the statutory solvency basis. This includes adjustments made onto an MSSB for the purposes of the financial statements (for example, to adjust liabilities to exclude certain additional reserves included in the liabilities when measured on the statutory solvency basis, or where future income needed in the VIF covers deferred acquisition costs included in the statement of financial position). A corresponding adjustment to the value of in-force policies will need to be made in order to ensure a consistent valuation. *[FRS 103.IG1.6]*.

Where with-profits policyholders are entitled to a share of the profits on non-participating business it would generally be expected that the determination of the realistic liabilities would take account directly or indirectly, of the value of future profits on this business. *[FRS 103.IG1.4]*. FRS 103 permits recognition of a VIF asset when the determination of the realistic value of liabilities takes account of this value. It would not be appropriate to recognise this release of capital requirements within the VIF asset presented in the accounts because the MSSB liabilities do not include an allowance for capital. Therefore, the amount of the VIF asset must be adjusted accordingly. *[FRS 103.IG1.7]*. Some contracts written within a with-profits fund may not satisfy FRS 103's definition of an insurance contract or contain a discretionary participation feature. These contracts are therefore accounted within the appropriate section of FRS 102. The VIF recognised for such contracts must be adjusted to reflect the difference in profit recognition bases between the basis used to determine the VIF taken into account in determining the realistic value of liabilities and the profit recognition profile determined by the appropriate section of FRS 102. *[FRS 103.IG1.8]*.

In the case of a mutual, an FFA or retained surplus account is maintained that represents amounts that have not yet been allocated to specific policyholders. For such entities, the adjustments required above will be offset within profit or loss by a transfer directly to or from this FFA or retained surplus account, with the result that overall profit or loss for the year will be unchanged. *[FRS 103.3.13]*.

The realistic value of liabilities must exclude the amount which represents the shareholders' share of future bonuses. Similar adjustments must be made if other amounts due to shareholders would otherwise be included in the realistic value of liabilities. *[FRS 103.3.14]*.

An entity is permitted to recognise the excess of the market value of a subsidiary over the net amounts included in the consolidated financial statements as a deduction from the sub-total of the FFA and liabilities to policyholders in the same way as the VIF described in paragraph IG1.3 of the Implementation Guidance. *[FRS 103.3.15]*. The Implementation Guidance explains that this situation could arise where the subsidiary or associate writes non-participating business and the value of the subsidiary or associate recognised incorporates the VIF of non-participating business written in the subsidiary or associate. The value of the subsidiary or associate is reduced by the subsidiary's or associate's capital requirement as noted in rule 1.3.33(3) of INSPRU as at 31 December 2015. When preparing both consolidated and non-consolidated accounts, the excess value that may be recognised must therefore be taken as the excess before the deduction of the subsidiary or associate's capital requirement. *[FRS 103.IG1.9]*.

Where the amounts on a 'realistic' basis are different from the amounts on the MSSB, a corresponding amount is transferred to or from the FFA, so that there is no effect on equity. The potential shareholders' share corresponding to additional bonuses to policyholders that have been included in the policyholders' liability must be accounted for in the FFA. Since the FFA is presented as a liability, there will generally be no change in the profit for the reporting period except where the adjustments result in a negative balance on the FFA and the entity determines that this negative balance must result in a deduction from equity through profit or loss. *[FRS 103.IG1.10]*.

Where there are options and guarantees relating to policyholders these are required to be measured either at fair value or at an amount estimated using a market-consistent stochastic model. *[FRS 103.IG1.11]*. The Implementation Guidance states that for all entities with long-term business, the best basis for measuring policyholders' options and guarantees is one that includes their time value. Any deterministic approach to valuation of a policy with a guarantee or optionality feature will generally fail to deal appropriately with the time value of an option. Therefore, stochastic modelling techniques must be used to evaluate the range of potential outcomes unless a market value for the option is available. The regulatory framework includes a requirement to value options and guarantees on this basis. For liabilities of businesses not falling within the scope of paragraph 3.1(b) of FRS 103, entities are encouraged, but not required, to adopt these valuation techniques. Where options are not valued on this basis additional disclosures are required (see 11.5.2 below). *[FRS 103.IG1.12]*.

The Implementation Guidance further states that in determining the value of guarantees and options under the regulatory framework, the entity must take into account, under each scenario in the market-consistent stochastic modelling, management actions it anticipates would be taken in response to variations in market variables. Such actions must be realistically capable of being implemented within the timescale assumed in the scenario analysis and be consistent with the entity's published principles and practices of financial

managements ('PPFM'). Examples of such management actions include changing the balance of the investment portfolio between debt instruments and equity, varying the amount charged to policyholders or varying its bonus policy. [FRS 103.IG1.13].

8.4.5 Value of in-force life assurance business held by parents that are not insurers

Banking and other non-insurance entities with insurance subsidiaries sometimes account for the insurance business in their consolidated financial statements on an embedded value or similar basis under which, in addition to the value of the retained surplus in the insurance subsidiary, an asset is recognised for the VIF. The continuation of such a practice is permitted only if the valuation policy is amended, if necessary, to exclude from the measurement of the value of the future profit to shareholders any value attributable to future investment margins. [FRS 103.3.16].

No value must be attributed to in-force long-term insurance business other than:

- In accordance with the requirements above and at 8.4.4.B
- Or
- Amounts recognised as an intangible asset as part of the allocation of fair values under acquisition accounting as discussed at 10 below [FRS 103.3.17]

When the value attributable to a VIF asset recognised by a banking or other non-insurance entity in respect of its insurance subsidiaries in the consolidated financial statements includes an amount in relation to non-participating business written in a with-profits fund or an interest of a with-profits fund in a subsidiary or associate an adjustment must be made to eliminate any double-counting of the same VIF. [FRS 103.3.18].

8.5 Recognition and measurement requirements for general insurance business

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general insurance business

Insurance contracts (including reinsurance) falling within one of the classes of insurance specified in Part I of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

Unlike for long-term business, FRS 103 does not contain any recognition and measurement requirements for general business. However, the Implementation Guidance provides guidance on applying the principles of FRS 102 and FRS 103, as well as guidance on implementing certain requirements of Schedule 3 to the Regulations (e.g., in respect of discounting) to general insurance business as follows:

- Gross written premiums (see 8.5.1 below)
- Portfolio premiums and claims (see 8.5.2 below)
- Claims provisions (see 8.5.3 below)
- Discounting of claims provisions (see 8.5.4 below)
- Unexpired risks provision (see 8.5.5 below)
- Equalisation reserves (see 8.5.6 below)
- And
- Deferred acquisition costs (see 8.5.7 below)

8.5.1 Written and earned premiums

The Implementation Guidance states that underwriting results must be determined on an annual basis, notwithstanding that this will normally require some estimation to be made at the reporting date, particularly with regard to outstanding claims. [FRS 103.IG2.1].

Written premiums must comprise the total premiums receivable for the whole period of cover provided by the contracts entered into during the reporting period, regardless of whether these are wholly due for payment in the reporting period, together with any adjustments arising in the reporting period to such premiums receivable in respect of business written in prior reporting periods. [FRS 103.IG2.2].

The Implementation guidance further states that regardless of the method by which commission is remitted (e.g., by an intermediary), premiums must be grossed up for the commission, if necessary, on an estimated basis, as this correctly reflects the contractual arrangements in force. This also applies where the premiums are determined by an intermediary. Where, however, policies are issued to intermediaries on a wholesale basis and the intermediaries are themselves responsible for setting the final amount payable by the insured without reference to the insurer, the written premium will normally comprise the premium payable to the insurer and grossing up will be inappropriate unless it reflects the contractual position. [FRS 103.IG2.3].

Written premiums must include an estimate for pipeline premiums (i.e., premiums written but not reported to the undertaking by the reporting date) relating only to those underlying contracts of insurance where the period of cover has commenced prior to the reporting date. [FRS 103.IG2.4]. Under some policies written premiums may be adjusted retrospectively in the light of claims experience or where the risk covered cannot be assessed accurately at the commencement of cover. Where written premiums are subject to an increase retrospectively, recognition of potential increases must be deferred until the additional amount can be ascertained with reasonable certainty. Where written premiums are subject to a reduction, a remeasurement taking account of such a reduction must be made as soon as the entity has an obligation to the policyholder. [FRS 103.IG2.6].

Where an insurer has offered renewal and is therefore contractually liable to pay claims if renewal is subsequently confirmed by the policyholder, it must recognise the renewal premium in income, subject to making a provision for anticipated lapses and the necessary proportion of unearned premiums.

[FRS 103.IG2.5].

Additional or return premiums must be treated as a remeasurement of the initial premium. Where a claims event causes a reinstatement premium to be paid, the recognition of the reinstatement premium and the effect on the initial premium must reflect the respective incidence of risk attaching to those premiums in determining under the annual accounting basis that proportion earned and unearned at the reporting date.

[FRS 103.IG2.7].

Written premiums must be recognised as earned premiums over the period of the policy having regard to the incidence of risk. Time apportionment of the premium is normally appropriate if the incidence of risk is the same throughout the period of cover. If there is a marked unevenness in the incidence of risk over the period of cover, a basis which reflects the profile of risk must be used. The proportion of the written premiums relating to the unexpired period of these policies must be carried forward as an unearned premiums provision at the reporting date. [FRS 103.IG2.8].

Schedule 3 requires that the provision for unearned premiums must in principle be calculated separately for each insurance contract, save that statistical methods (and in particular proportional and flat rate methods) may be used where they may be expected to give approximately the same results as individual calculations. Where the pattern of risk varies over the life of a contract, this must be taken into account in calculation methods. [3 Sch 50].

8.5.2 Portfolio premiums and claims

Extract from FRS 103

Appendix I

Glossary

portfolio premiums	Amounts payable by one insurer to another in consideration for a contract whereby the latter agrees to assume responsibility for the claims arising on a portfolio of in-force business written by the former from a future date until the expiry of the policies.
portfolio claims	Amounts payable by one insurer to another in consideration for a contract whereby the latter agrees to assume responsibility for the unpaid claims incurred by the former prior to a date specified in the contract.

A portfolio transfer is different from reinsurance where the reinsurer agrees to pay losses suffered by the reinsured rather than assuming responsibility for the losses.

The Implementation Guidance states that portfolio premiums payable must be included within premiums for reinsurance outwards in the transferor's financial statements but deferred to subsequent reporting periods as appropriate in respect of any unexpired period of risk at the reporting date. In the transferee's financial statements, they must be included within written premiums with any amount unearned at the reporting date being carried forward in the unearned premiums provision. [FRS 103.IG2.29].

Portfolio claims transfers must be recognised in the transferor's financial statements as payments in settlement of the claims transferred in accordance with the requirements of (note 4) to the profit and loss account (see 8.3.4 above). [FRS 103.IG2.30]. Similarly, the consideration receivable by the transferee undertaking must be credited to claims payable in the statement of financial position. [FRS 103.IG2.31]. Any claims portfolio transfers, which materially affect the transferee undertaking's exposure to risk, must be disclosed in the notes to the financial statements. [FRS 103.IG2.32].

8.5.3 Claims provisions

Schedule 3 requires that technical provisions must at all times be sufficient to cover any liabilities arising out of insurance contracts as far as can reasonably be foreseen. [3 Sch 49].

A provision must in principle be computed separately for each claim on the basis of the costs still expected to arise, although statistical methods may be used if they result in an adequate provision having regard to the nature of the risks. The provision must also allow for claims incurred but not reported by the balance sheet date, the amount of the allowance being determined having regard to past experience as to the number and magnitude of claims reported after previous balance sheet dates. All claims settlement costs (whether direct or indirect) must be included in the calculation of the provision. [3 Sch 53(1), 3 Sch 53(2), 3 Sch 53(3), FRS 103.IG2.9].

Recoverable amounts arising out of salvage or subrogation must be estimated on a prudent basis and either deducted from the provision for claims outstanding (in which case if the amounts are material they must be shown in the notes to the accounts) or shown as assets. [3 Sch 53(4)]. Once potential recoveries qualify for recognition as separate assets (e.g., property, plant and equipment) they must be accounted for as such under the appropriate section of FRS 102.

In determining the estimate of the amount required to settle the obligation at the reporting date, the Implementation Guidance states that, in relation to an entity's existing accounting policies, the level of claims provisions must continue to be set such that no adverse run-off deviation is anticipated. When estimating the amount required to settle the obligation at the reporting date, consideration must be given to the probability and magnitude of future experience being more adverse than previously assumed. An entity must not introduce this practice when changing its existing accounting policies or developing a new accounting policy. [FRS 103.IG2.10].

The Implementation Guidance further states that provision must be made at the reporting date for all claims handling expenses to cover the anticipated future costs of negotiating and settling incurred claims, whether reported or not, up to the reporting date. Separate provisions must be assessed for each category of business. [FRS 103.IG2.11]. When determining the provision for claims handling expenses, unless clear evidence is available to the contrary, it must be assumed that the activity of the claims handling department will remain at its current level and therefore that the contribution to its costs from future new business will remain at the same level. [FRS 103.IG2.12]. The provision for claims handling expenses must be included within the provision for claims outstanding but do not need separate disclosure. Claims handling expenses incurred must be included within claims incurred in the technical account for general business. [FRS 103.IG2.13].

8.5.4 Discounting of claims provisions

Schedule 3 prohibits implicit discounting or deductions from general insurance claims provisions. [3 Sch 53(7)].

Schedule 3 permits explicit discounting of general insurance claims subject to conditions. These conditions are: [3 Sch 54]

- The expected average interval between the date for settlement of the claims being discounted and the accounting date must be at least four years.
- The discounting or deductions must be effected on a recognised prudential basis.
- When calculating the total cost of settling claims, the company must take account of all factors that could cause increases in that cost.

- The company must have adequate data at its disposal to construct a reliable model of the rate of claims settlements.
And
- The rate of interest used for discounting must not exceed a rate prudently estimated to be earned by assets of the company which are appropriate in magnitude and nature to cover the provisions for claims being discounted during the period necessary for the payment of such claims and must not exceed either a rate justified by the performance of such assets over the preceding five years or a rate justified by the performance of such assets during the year preceding the balance sheet date.

The Implementation Guidance to FRS 103 states that the four-year test described above must be applied by reference to the end of each reporting period in respect of all claims outstanding at that date, and not just once in the accounting period in which the claims were incurred. [FRS 103.IG2.14]. The calculation of the average interval must be weighted on the basis of expected claims before any deduction for reinsurance. [FRS 103.IG2.16].

When applied, explicit discounting must typically be adopted by reference to categories of claims (with similar characteristics but not solely by length of settlement pattern), rather than to individual claims. [FRS 103.IG2.15].

In considering if there is adequate data available to construct a reliable model of the rate of claims settlement, the principal factors to be considered are the amount of future claims settlements, the timing of future cash flows and the discount rate. Procedures must be undertaken to assess the accuracy of the claims settlement pattern predicted by the model in prior periods. Adjustments must be made to the current model, as appropriate, to reflect the out-turn and conclusions of analyses in the previous period. Cash flows must be modelled gross and net of reinsurance as reinsurance recoveries may arise later than the related claims payments. [FRS 103.IG2.17].

To determine an appropriate discount rate, an entity must consider the returns achieved over the period in question to the extent that this is relevant to the future. [FRS 103.IG2.18].

The effect of the unwinding of discounted claims provisions during a reporting period must be disregarded when determining if material adverse run-off deviations have occurred that require disclosure under (Note 4) of the Notes to the Profit and Loss Account format in Schedule 3 to the Regulations (see 8.3.4 above). [FRS 103.IG2.19].

Any unwinding of the discount on general insurance business claims provisions in a reporting period must be recorded under the investment income or gains headings in the corresponding sections of the income statement (referred to as the profit and loss account in the CA 2006). Where material, a separate disclosure must then be provided to indicate the amount of the investment return associated with the unwinding of the discount. [FRS 103.IG2.20].

8.5.5 Unexpired risks provision

The Regulations require that the provision for unexpired risks must be computed on the basis of claims and administrative expenses likely to arise after the end of the financial year from contracts concluded before that date, in so far as their estimate value exceeds the provision for unearned premiums and any premiums receivable under those contracts. [3 Sch 51].

The Implementation Guidance below helps apply the requirements of paragraphs 2.14 to 2.19 of FRS 103 and the principles of FRS 102 Section 21 and Section 32 *Events after the End of the Reporting Period* to general insurance contracts.

When the estimated value of claims and expenses attributable to the unexpired periods of policies in force at the reporting date exceeds the unearned premiums provision in relation to such policies after deduction of any deferred acquisition costs, an unexpired risks provision must be established. If material, this provision must be disclosed separately either in the statement of financial position or in the notes to the financial statements. [FRS 103.IG2.21].

The assessment of whether an unexpired risks provision is necessary must be made for each grouping of business which is managed together. Any unexpired risks surpluses and deficits within that grouping must be offset in that assessment. [FRS 103.IG2.22]. For this purpose, business must only be regarded as 'managed together' where no constraints exist on the ability to use assets in relation to such business to meet any of the associated liabilities and either:

- There are significant common characteristics, which are relevant to the assessment of risk and setting of premiums for the business lines in question.
Or

- The lines of business are written together as separate parts of the same insurance contracts.

[FRS 103.IG2.23].

For delegated authorities (i.e., where the insurer is unable to influence the terms on which policies are issued) a provision must be established at the reporting date for any anticipated losses arising on policies issued in the period after the reporting date which the delegated authority entered into before that date.

[FRS 103.IG2.24].

The determination of whether an unexpired risks provision is required, and if so its amount, must be based on information available at the reporting date. This assessment may include evidence of relevant previous claims experience on similar contracts adjusted for known differences, events not expected to recur and, where appropriate, the normal level of seasonal claims if the previous reporting period was not typical in this respect. However, the assessment must not take into account any new claims events occurring after the reporting date, as these are non-adjusting events. In accordance with paragraph 32.10 of FRS 102, exceptional claims events occurring subsequent to the end of the reporting period but before the financial statements are authorised for issue must be disclosed in the notes to the financial statements along with an estimate of their financial effect. Where there is uncertainty regarding future events, in accordance with paragraph 2.9 of FRS 102, an insurer must apply a degree of caution in the exercise of the judgements needed in making the estimates required such that liabilities are not understated. [FRS 103.IG2.25].

When calculating the best estimate of the amount required to settle future claims related to the unexpired periods of risk on policies in force at the reporting date, the future investment return arising on investments supporting the unearned premiums provision and the unexpired risks provision may be taken into account. For this calculation, the deferred acquisition costs must be deducted from the unearned premiums provision. The investment return will be based on the expected earnings from the investments held until the future claims are settled. [FRS 103.IG2.26].

Deferred acquisition costs must not be written off, either fully or partially, to profit or loss as being irrecoverable for the purpose of reducing or eliminating the need for an unexpired risks provision.

[FRS 103.IG2.27].

In accordance with the Schedule 3 balance sheet format, the gross amount for unexpired risk provisions must be presented under the liabilities item C.6. 'Other technical provisions', with the reinsurers' share presented under the assets item Da.5. 'Other technical provisions'.

8.5.6 Equalisation and catastrophe provisions

An entity is allowed to recognise a liability for possible future claims only if permitted by the regulatory framework that applies to the entity. However, following the implementation of the Solvency II Directive, with effect from 1 January 2016 the UK regulatory framework does not permit equalisation or catastrophe provisions.

Where an entity has equalisation or catastrophe provisions (e.g., in an overseas subsidiary where these are permitted by the local regulatory framework) the presentation of such liabilities must follow the requirements of the legal framework that applies to the entity. [FRS 103.2.13(a)]. For disclosure requirements see 11.2.1.A below.

8.5.7 Deferred acquisition costs

The Implementation Guidance for applying the requirements of Note (17) to the balance sheet (see 8.2.7 above) states that acquisition costs must be deferred in line with the unearned premiums provision. The proportion of acquisition costs to be deferred will be the same proportion of the total acquisition costs as the ratio of unearned premiums to gross written premiums for the class of business in question. For this purpose, acquisition expenses must be allocated to classes of business. Where this is not possible for reinsurance business inwards an estimate must be made. [FRS 103.IG2.34].

Advertising costs must not be deferred unless they are directly attributable to the acquisition of new business. [FRS 103.IG2.35].

Related reinsurance commissions deferred must not be netted against deferred acquisition costs but must be shown as liabilities in the statement of financial position. [FRS 103.IG2.36].

8.6 Insurance business in run-off

Where a decision has been made to cease underwriting the whole, or a material category, of the insurance business, that business does not constitute a discontinued operation under Section 5 of FRS 102.

[FRS 103.IG2.37].

Notwithstanding the above, a decision to cease underwriting the whole, or a material category, of insurance business may be a restructuring to which Section 21 of FRS 102 applies.

8.7 Allocation of investment return between technical and non-technical accounts

As required by note 10 to the profit and loss account (see 8.3.10 above) for long-term business, the investment return (which includes movements in realised and unrealised investment gains and losses) and related tax charges on assets representing reserves which are held within the long-term fund for solvency purposes under the PRA rules, must first be allocated to the long-term business technical account.

[FRS 103.IG2.53]. General business investment return must either be presented in the non-technical account or allocated between the technical and non-technical account. [FRS 103.IG2.53].

FRS 103 allows, but does not mandate, a presentation format that helps users of the financial statements identify operating profit or loss based on the longer-term rate of investment return. This return may be recorded within the general business and long-term business technical accounts and may also be disclosed separately as part of the total operating profit. [FRS 103.IG2.64].

When investment return is allocated, it must be on one of the following bases:

- The longer-term rate of return basis (see 8.7.1 to 8.7.3 below).
- Or
- An allocation of the actual investment return on investments supporting the general insurance technical provisions and associated equity must be made from the non-technical account to the technical account for general business. [FRS 103.IG2.65].

The allocation of investment return from the technical account for long-term business to the non-technical account must be such that the investment return remaining in the technical account for long-term business on investments directly attributable to owners reflects the longer-term rate of return on these investments. [FRS 103.IG2.67]. The allocation may be of a negative amount which increases rather than decreases the amount of investment return included in the long-term business technical account. [FRS 103.IG2.69]. The allocation must be included in the long-term business technical account and the non-technical account before any attributable tax. The tax attributable to the allocated investment return must be deducted from the tax attributable to long-term business and added to the tax on profit or loss on ordinary activities.

[FRS 103.IG2.70].

The allocation from the non-technical account to the technical account for general business must be based on the longer-term rate of investment return on investments that supports the general insurance technical provisions and all the relevant equity. [FRS 103.IG2.68]. Where it is necessary for the purpose of reflecting the longer-term rate of investment return in the technical account for general business, the allocation to the technical account may exceed the actual investment return of the reporting period on the corresponding investments. [FRS 103.IG2.69].

To ensure consistent treatment for an entity transacting both general and long-term insurance business:

- Where the longer-term rate of return basis is used, it must be applied to both the general and long-term insurance business.
- And
- Where an allocation of the actual investment return on investments supporting the general business technical provisions and associated equity is made from the non-technical account to the technical account for general business, no allocation of investment return must be made from the technical account for long-term business to the non-technical account. [FRS 103.IG2.66].

Guidance is provided on applying the requirements above as follows:

- Equities and property (see 8.7.1 below)
- Fixed-income securities (see 8.7.2 below)
- Derivatives (see 8.7.3 below)
- And
- Attributing tax to the transfer to the non-technical account (see 8.7.4 below)

8.7.1 The longer-term rate of return for equities and properties

The longer-term investment return on equities and properties must be determined using one of the following methods: [FRS 103.IG2.72]

- Grossing-up actual income earned for each asset class by a factor representing the longer term rate of investment return divided by an assumed long-term dividend or rental yield (based on the assumption that income will reflect the mix of assets held during the reporting period). Adjustments will be required for special factors which may distort the underlying yields of the portfolio such as (in the case of equities), special or stock dividends and share buy-backs.

Or

- Applying the longer-term rate of return to investible assets held during the period (taking account of new money invested and changes in portfolio mix) by reference to the quarterly or monthly weighted average of each group of assets after excluding the effect of short-term market movements.

The longer-term rate of return must be determined separately for equities and property and for each material currency in which relevant investments are held. [FRS 103.IG2.73]. Considering the entity's investment policy, the longer-term rate of investment return must reflect a combination of historical experience and current market expectations for each geographical area and each category of investments. The selected rates must be best estimates based on historical market real rates of return and current inflation expectations, taking into account to the following factors, where appropriate: [FRS 103.IG2.74]

- Comparison of the business's actual returns and market returns over the previous five years or such longer period as may be appropriate.
- Longer term rates of return currently used in the business for other purposes, for example, product pricing, with-profits bonus policy, and pensions funding.
- The rate used for the purpose of achieved profits method reporting.
- Consensus economic and investment market forecasts of investment returns.

And

- Any political and economic factors which may influence current returns.

Rates of return must be set with a view to ensuring that longer term returns credited to operating results do not consistently exceed or fall below actual returns being earned. Any decline in the longer-term return expectations must be recognised immediately by reducing the assumed rate of return. Rates used must be reviewed at least on an annual basis although frequent changes are not anticipated. [FRS 103.IG2.75].

8.7.2 The longer-term rate of return for fixed income securities

The longer-term investment return on fixed income securities may be determined using one of the following methods: [FRS 103.IG2.76]

- A redemption yield calculated so that any excess of the purchase price over the amount repayable on maturity is recognised in profit or loss by instalments so that it is written off by the time that the security is redeemed.

Or

- Amortised cost with realised gains and losses subject to continuing amortisation over the remaining period to the maturity date.

The Implementation Guidance explains that the longer-term return may be based on interest earned where the net effect of amortisation would be immaterial. In the case of irredeemable fixed interest securities and short-term assets, the allocated longer-term rate of investment return must be the interest income receivable in respect of the reporting period. [FRS 103.IG2.76].

8.7.3 The longer-term rate of return for derivatives

The Implementation Guidance states that where derivatives have a material effect and are used to adjust exposure to the various classes of instruments, the calculation of the longer-term rate of return for equities and properties must be adjusted to reflect the underlying economic exposure. [FRS 103.IG2.77].

8.7.4 Attributing tax to the transfer to the non-technical account

The Implementation Guidance notes that taxable profits for UK entities with long-term insurance business are derived from pre-tax profits reported in the financial statements. The tax expense (income) must be allocated to the same account (technical or non-technical) as the transaction or other event that resulted in the tax expense (income) making the transfer from (to) the long-term business technical account net of tax. There is therefore a requirement for the tax attributable to the transfer to be brought into account in arriving at profit before tax in the non-technical account. [FRS 103.IG2.79].

Entities must determine the amount to be brought into account in the non-technical account in respect of the transfer from (to) the long-term business technical account using a method which is consistent with the approach in paragraph 29.22 of FRS 102 which requires tax to be presented in the same component of total comprehensive income as the transaction or other event that resulted in the tax expense or income. This must fairly represent that part of the tax expense (income) in the long-term business technical account which is based on pre-tax accounting profits or on timing differences in the recognition of such profits for accounting and tax purposes. [FRS 103.IG2.80].

The reconciliation of the tax expense included in profit or loss to the profit or loss on ordinary activities before tax multiplied by the applicable tax rate required by paragraph 29.27(b) of FRS 102 applies only to the tax expense (income) that appears in the non-technical account. [FRS 103.IG2.81].

8.8 Liability adequacy testing

FRS 103 requires an insurer to assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those acquired in a business combination or portfolio transfer and discussed at 10 below) is inadequate in the light of the estimated future cash flows, the entire deficiency must be recognised in profit or loss. [FRS 103.2.13(b), FRS 103.2.14].

The purpose of this requirement is to prevent material liabilities being unrecorded.

8.8.1 Using a liability adequacy test under existing accounting policies

FRS 103 does not impose additional requirements if the insurer's liability adequacy test meets the specified minimum requirements. The minimum requirements are the following: [FRS 103.2.15]

- The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.

And

- If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

If the insurer's liability adequacy test meets these requirements, then the test must be applied at the level of aggregation specified in that test. [FRS 103.2.17].

The standard does not specify:

- What criteria in the liability adequacy test determine when existing contracts end and future contracts start.
- At what level of aggregation the test must be performed.
- Whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty.
- Whether the test considers both the time value and intrinsic value of embedded options and guarantees.
- Whether additional losses recognised because of the test are recognised by reducing the carrying amount of deferred acquisition costs or by increasing the carrying amount of the related insurance liabilities.

Or

- Whether the liability adequacy test can be performed net of expected related reinsurance recoveries.

How we see it

For UK general business, applying the requirements for the unexpired risks provision (see 8.5.5 above) would normally satisfy the criteria above. For UK long-term business, the measurement requirements described at 8.4.4 above would normally satisfy the criteria above.

8.8.2 Using the liability adequacy test specified in FRS 103

If an insurer's accounting policies do not require a liability adequacy test that meets the minimum criteria discussed in 8.8.1 above, it must: *[FRS 103.2.16]*

- (a) Determine the carrying amount of the relevant insurance liabilities less the carrying amount of:
 - (i) Any related deferred acquisition costs.
 - And
 - (ii) Any related intangible assets such as those acquired in a business combination or portfolio transfer. However, related reinsurance assets are not considered because an insurer assesses impairment for them separately (see 8.11 below).
- (b) Determine whether the carrying amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of Section 21 of FRS 102. If it is less, the entire difference must be recognised in profit or loss and the carrying amount of the related deferred acquisition costs or related intangible assets must be reduced or the carrying amount of the relevant insurance liabilities must be increased.

This test must be performed at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio. *[FRS 103.2.17]*. Future investment margins must be reflected in the calculation if, and only if, the carrying amounts of the liabilities and any related deferred acquisition costs and intangible assets also reflect those margins. *[FRS 103.2.18]*.

Section 21 of FRS 102 requires an amount to be recognised as a provision that is the best estimate of the expenditure required to settle the present obligation. This is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or transfer it to a third party at that time. *[FRS 102.21.7]*.

Section 21's requirements are potentially more prescriptive and onerous than those applying if an insurer has an existing liability adequacy test which meets the minimum FRS 103 criteria discussed at 8.8.1 above.

8.8.3 Interaction between the liability adequacy test and shadow accounting

FRS 103 does not address the interaction between the liability adequacy test (LAT) and shadow accounting (discussed at 9.5 below). The liability adequacy test requires all deficiencies to be recognised in profit or loss whereas shadow accounting permits certain losses to be recognised in other comprehensive income if they are directly affected by movements in assets which were recognised in other comprehensive income.

How we see it

An entity can apply shadow accounting to offset an increase in insurance liabilities to the extent that the increase is caused directly by market interest rate movements that lead to changes in the value of investments that are recognised directly in other comprehensive income. Although FRS 103 does not specify the priority of shadow accounting over the LAT, because the LAT is to be applied as a final test to the amount recognised under the insurer's accounting policies, it follows that shadow accounting has to be applied first.

8.9 Insurance liability derecognition

An insurance liability, or a part of such a liability, can be removed from the balance sheet (derecognised) when, and only when, it is extinguished i.e., when the obligation specified in the contract is discharged, cancelled or expires. *[FRS 103.2.13(c)]*. This requirement is identical to that contained in Section 11 of FRS 102 for the derecognition of financial liabilities. *[FRS 102.11.36]*.

Accordingly, insurance liabilities must not normally be derecognised as a result of entering into a reinsurance contract because this does not usually discharge the insurer's liability to the policyholder. This applies even if the insurer has delegated all claims settlement authority to the reinsurer or if a claim has been fully reinsured.

In respect of a structured settlement arrangement falling within one of the cases referred to in sections 731 to 734 of the Income Tax (Trading and Other Income) Act 2005 where either; (a) an annuity is purchased by a general insurance undertaking under which the structured settlement beneficiary is the annuitant; or (b) an annuity previously purchased by a general insurance undertaking for its own account to fund the periodic payments under a structured settlement agreement is assigned to the structured settlement beneficiary, the general insurance company will normally remain liable to the policyholder should the annuity provider fail. An annuity, paid by an annuity provider, which exactly matches the amount and timing of this liability must be recognised as an asset and measured at the same amount as the related obligation. *[FRS 103.IG2.33]*.

Derecognition must be distinguished from remeasurement. The carrying amounts of many insurance liabilities are estimates and an insurer must re-estimate its claims liabilities, and hence change their carrying amounts, if that is required by its accounting policies. However, in certain situations, the distinction between the two concepts can be blurred, for example where there is a dispute or other uncertainty over the contractual terms of an insurance policy.

How we see it

FRS 103 contains no guidance on when or whether a modification of an insurance contract might cause derecognition of that contract. This will be a matter of judgement based on facts and circumstances. However, under the GAAP hierarchy in paragraph 10.5 of FRS 102, insurers must consider the applicability of guidance elsewhere in FRS 102, such as guidance on circumstances when a modification of a financial liability might cause that liability to be derecognised.

8.10 Offsetting of insurance and related reinsurance contracts

FRS 103 prohibits offsetting of: *[FRS 103.2.13(d)]*

- Reinsurance assets against the related insurance liabilities.
- Or
- Income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

Offsetting of insurance and related reinsurance contracts is prohibited because a cedant normally has no legal right to offset amounts due from a reinsurer against amounts due to the related underlying policyholder. As a result, balances due from reinsurers must be shown as assets in the balance sheet, whereas the related insurance liabilities must be shown as liabilities. Because of the relationship between the two, some insurers provide linked disclosures in the notes to their financial statements.

This prohibition broadly aligns the offsetting criteria for insurance assets and liabilities with those required for financial assets and financial liabilities under FRS 102, which requires that financial assets and financial liabilities can only be offset where an entity: *[FRS 102.11.38A]*

- Has a legally enforceable right to set-off the recognised amounts.
- And
- Intends to settle on a net basis, or to realise both the asset and settle the liability simultaneously.

The FRS 103 requirements, however, appear to be less flexible than those in Section 11 of FRS 102 in that they provide no circumstances in which offsetting can be acceptable. So, for example, 'pass through' contracts that provide for reinsurers to pay claims direct to the underlying policyholder would still have to be shown gross in the balance sheet. Section 11 of FRS 102 also does not address offsetting in the income statement.

8.11 Impairment of reinsurance assets

A reinsurance asset is impaired if, and only if:

- There is objective evidence, as a result of an event that occurred after initial recognition of the asset, that the cedant may not receive all amounts due to it under the terms of the contract.
- And
- That event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Where a reinsurance asset is impaired, its carrying amount must be reduced accordingly and the impairment loss recognised in profit or loss. *[FRS 102.2.13(e), FRS 103.2.19]*.

FRS 103 does not provide any specific indicators of impairment relating to reinsurance assets. However, both Section 11 of FRS 102 and IAS 39 use an incurred loss impairment model for financial assets, and both provide various indicators of impairment for financial assets, such as the significant financial difficulty of the obligor and a breach of contract, such as a default in interest or principal payments. *[FRS 102.11.22, IAS 39.59]*.

How we see it

In the absence of impairment indicators in FRS 103, an insurer could refer to Section 10 of FRS 102 and use the hierarchy to refer to impairment indicators for financial instruments as a guide to determining whether reinsurance assets are impaired.

IFRS 9 (as permitted by paragraphs 11.2(b) and 12.2(b) of FRS 102) uses an expected loss model rather than an incurred loss model. However, adoption of IFRS 9 does not result in any consequential amendments to FRS 103 in respect of impairment of reinsurance assets. Therefore, even if IFRS 9 is applied for recognition and measurement of financial assets, insurers must continue to use an incurred loss impairment model for reinsurance assets notwithstanding the fact that an expected loss model will be used for financial assets within the scope of IFRS 9.

8.12 Reporting foreign exchange transactions in the functional currency

Paragraph 30.9 of FRS 102 states that, at the end of each reporting period, an entity must translate foreign currency monetary items using the closing rate and non-monetary items using the exchange rate at the date of the transaction or the date when fair value was determined (for non-monetary items measured at fair value). For the purposes of applying the requirements of Section 30 of FRS 102 an entity must treat all assets and liabilities arising from an insurance contract as monetary items. [FRS 103.2.26].

The Basis for Conclusions states that the purpose of this requirement is to avoid accounting mismatches caused in the income statement. This mismatch would have arisen because some foreign currency assets and liabilities related to insurance contracts which are not monetary items (e.g., deferred acquisition costs and unearned premiums) would otherwise have been recognised at historic exchange rates whereas insurance assets and liabilities that are monetary items (e.g., claims liabilities) are retranslated at each reporting date. [FRS 103.BC24, FRS 103.BC25].

8.13 Accounting policy matters not specifically addressed by FRS 103

8.13.1 Derecognition of insurance and reinsurance assets

FRS 103 does not address the derecognition of insurance or reinsurance assets. Although not carried over to FRS 103, the Basis of Conclusions of IFRS 4 states that the IASB could identify no reason why the derecognition criteria for insurance assets must differ from those for financial assets accounted for under IAS 39 (IFRS 9). [IFRS 4.BC105].

How we see it

It would seem reasonable under Section 10 of FRS 102 for insurers to use the hierarchy to apply the derecognition criteria for financial assets in Section 11 of FRS 102 (or IAS 39 or IFRS 9 if applied) to insurance and reinsurance assets.

8.13.2 Impairment of insurance assets

FRS 103 does not specify the impairment model to be used for receivables arising under insurance contracts that are not reinsurance assets (discussed at 8.11 above). An example of these would be premium receivables from policyholders. Insurers must therefore apply their existing accounting policies for determining impairment provisions for these assets, although an impairment model similar to that required by the applicable model being applied for financial assets (depending on accounting policy choice for recognition and measurement) would appear to be appropriate. As FRS 103 does not mandate an impairment model for insurance assets, there is no prohibition on an entity applying the recognition and measurement criteria of IFRS 9 (as permitted by Sections 11 and 12 of FRS 102) from using an expected loss impairment model for insurance assets.

8.13.3 Gains and losses on buying reinsurance

FRS 103 does not restrict the recognition of gains on entering into reinsurance contracts but instead requires specific disclosure of the gains and losses that arise (see 11.2.2 below).

Insurers are therefore permitted to continue applying their existing accounting policies to gains and losses on the purchase of reinsurance contracts and are also permitted to change those accounting policies according to the criteria discussed at 9 below.

8.13.4 Policy loans

Some insurance contracts permit the policyholder to obtain a loan from the insurer with the insurance contract acting as collateral for the loan. FRS 103 is silent on whether an insurer must treat such loans as a prepayment of the insurance liability or as a separate financial asset. Consequently, insurers can either present these loans either as separate assets or as a reduction of the related insurance liability depending on previous GAAP requirements.

8.13.5 Investments held in a fiduciary capacity

Insurers often make investments on behalf of policyholders as well as on behalf of shareholders. In some cases, this can result in the insurer holding an interest in an entity which, either on its own, or when combined with the interest of the policyholder, gives the insurer control of that entity (as defined by Section 9 of FRS 102).

9 Changes in accounting policies

As discussed at 3.3 above, an entity is permitted by FRS 103 to change its existing accounting policies upon adoption of FRS 103. In addition, an insurer may change its accounting policies at any time and there is no requirement for an insurer to continue to use the recognition and measurement requirements for long-term insurance business (see 8.4 above) or the implementation guidance contained in respect of recognition and measurement of general insurance business (see 8.5 above).

However, an insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer must judge relevance and reliability by the criteria in paragraph 10.4 of FRS 102 (see Chapter 9 at 3.3) and the qualitative characteristics of information in financial statements set out in Section 2 *Concepts and Pervasive Principles* of FRS 102. [FRS 103.2.3].

FRS 103 observes that one basis for changing accounting policies might be to enable them to be more consistent with the rules for the recognition and measurement of technical provisions in the PRA Rulebook, which transposes the Solvency II Directive. In doing so an entity must make appropriate adjustments to the rules to meet the requirements of paragraph 2.3 of FRS 103. [FRS 103.2.3A]. This is consistent with the requirements of the Regulations for the computation of the long-term business provision to have due regard to generally accepted actuarial principles (see 8.4.4 above).

These conditions for changing accounting policies described above apply both to changes made by an insurer that already applies FRS 103 and to changes made by an insurer adopting FRS 103 for the first time. [FRS 103.2.2].

FRS 103 exempts an insurer from applying paragraphs 10.4 to 10.6 of FRS 102, which explain how management uses its judgement in developing an accounting policy if no FRS applies specifically to a transaction, other event or condition, to insurance contracts issued and reinsurance contracts held, including related acquisition costs and intangible assets. [FRS 103.2.12]. However, to justify changing its accounting policies for insurance contracts, an insurer must show that the change brings its financial statements closer to meeting the criteria in paragraph 10.4 of FRS 102, but the change need not achieve full compliance with those criteria. [FRS 103.2.4]. The following specific issues are discussed below:

- Continuation of existing practices (see 9.1 below)
 - Current market interest rates (see 9.2 below)
 - Prudence (see 9.3 below)
 - Future investment margins (see 9.4 below)
 - Shadow accounting (see 9.5 below)
- And
- Redesignation of financial assets (see 9.6 below)

There is often a fine line between changing an accounting policy and changing an accounting estimate and insurers must refer to the guidance in Section 10 (see Chapter 9 at 3.4) on this matter. When it is difficult to distinguish a change in accounting policy from a change in accounting estimate, the change is treated as a change in accounting estimate. [FRS 102.10.15].

9.1 Continuation of existing practices

An insurer may continue the following practices but the introduction of any of them after FRS 103 has been adopted is not permitted because it does not satisfy paragraph 10.8(b) of FRS 102 (i.e., it does not provide reliable and more relevant information). [FRS 103.2.6].

9.1.1 Measuring insurance liabilities on an undiscounted basis

An insurer is only permitted to change its accounting policies to measure insurance liabilities on an undiscounted basis if otherwise required by Schedule 3 to the Regulations (or other legal framework that applies to the entity). [FRS 103.2.6(a)].

Schedule 3 to Regulations permits explicit discounting for general insurance business only subject to certain conditions (see 8.5.4 above).

9.1.2 Measuring contractual rights to future investment management fees in excess of their fair value

It is not uncommon to find insurance contracts that give the insurer an entitlement to receive a periodic investment management fee. In the FRC's opinion, these rights must not be measured at an amount that exceeds fair value as implied by a comparison with current fees charged by other market participants for similar services. The assumption is that the fair value at inception of such contractual rights will equal the origination costs paid to acquire the contract, unless future investment management fees and related costs are out of line with market comparables. [FRS 103.2.6(b)].

9.1.3 Introducing non-uniform accounting policies for the insurance contracts of subsidiaries

FRS 102 requires consolidated financial statements to be prepared using uniform accounting policies for like transactions. [FRS 102.9.17]. However, under previous UK GAAP, some insurers consolidated subsidiaries using accounting policies for the measurement of the subsidiaries' insurance contracts (and related deferred acquisition costs and intangible assets) which were different from those of the parent and were, instead, in accordance with the relevant local GAAP applying in each jurisdiction.

The use of non-uniform accounting policies in consolidated financial statements reduces the relevance and reliability of financial statements and is not permitted by FRS 102. However, prohibiting this practice in FRS 103 would have made FRS 103 more onerous than IFRS 4, the standard on which FRS 103 is largely based. Therefore, an insurer is permitted to continue using non-uniform accounting policies for insurance contracts (and related deferred acquisition costs and intangible assets, if any) and change those policies only if the change does not make the accounting policies more diverse and also satisfies any other requirements in FRS 103. [FRS 103.2.6(c)].

There is one exception to this requirement which is discussed at 9.2 below.

9.2 Current market interest rates

An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities (including related deferred acquisition costs and related intangible assets) to reflect current market interest rates. Any changes in these rates would need to be recognised in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. An insurer may change its accounting policies for designated liabilities without applying those policies consistently to all similar liabilities as Section 10 of FRS 102 would otherwise require. If an insurer designates liabilities for this election, it must apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all those liabilities until they are extinguished. [FRS 103.2.5].

This concession was included in IFRS 4 to allow insurance contracts measured at locked-in interest rates to move, in whole or in part, towards the use of current interest rates. For UK life insurers, the concession is largely irrelevant because existing accounting practices already require the use of current interest rates. However, the concession may be useful if an insurer wants to change its accounting policies for overseas contracts that may be valued using local accounting practices that do not require the use of current market interest rates (see 9.1.3 above).

9.3 Prudence

Extract from FRS 102

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prudence	The exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.

Under previous UK GAAP, insurers sometimes measured insurance liabilities on what was intended to be a highly prudent basis required for regulatory purposes. FRS 103 does not define how much prudence is 'sufficient' and therefore does not require the elimination of 'excessive prudence'. As a result, insurers are not required under FRS 103 to change their accounting policies to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it must not introduce additional prudence. [FRS 103.2.7].

The liability adequacy test requirements discussed at 8.8 above address the converse issue of understated insurance liabilities.

9.4 Future investment margins

An insurer need not change its accounting policies for insurance contracts to eliminate the recognition of future investment margins (which may occur under some forms of embedded value accounting). However, FRS 103 imposes a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts, unless those margins directly affect the contractual payments.

Two examples of accounting policies that reflect those margins are:

- Using a discount rate that reflects the estimated return on the insurer's assets.
- And
- Projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the rate in the measurement of the liability. [FRS 103.2.8].

Such accounting policies are used in US GAAP and in embedded value methodologies. The European Insurance CFO Forum European Embedded Value (EEV) Principles state that the value of future cash flows from in-force covered business is the present value of future shareholder cash flows projected to emerge from the assets backing the liabilities of the in-force covered business reduced by the value of financial options and guarantees.²⁵⁴ The EEV methodology is considered to be an indirect method of measuring the insurance liability because the measurement of the liability is derived from the related asset. In contrast, direct methods measure the liability by discounting future cash flows arising from the book of insurance contracts only. If the same assumptions are made in both direct and indirect methods, they can produce the same results.

By replicating this requirement from IFRS 4, the FRC repeats the concern of the IASB that insurers might take advantage of the lack of specific accounting guidance for insurance contracts in FRS 103 as an opportunity to change their accounting policies to an embedded value basis on the grounds that this was more relevant and no less reliable, or more reliable and no less relevant than their existing accounting policies (possibly prepared on an 'excessively prudent' regulatory basis). The IASB's view is that the cash flows arising from an asset are irrelevant for the measurement of a liability unless those cash flows affect (a) the cash flows arising from the liability or (b) the credit characteristics of the liability. [IFRS 4.BC141, IFRS 4.BC142, IFRS 4.BC143, IFRS 4.BC144].

²⁵⁴ European Embedded Value Principles, European Insurance CFO Forum, May 2004, p.3.

It is possible for insurers to introduce accounting policies that involve the use of asset-based discount rates for liabilities if they can overcome the rebuttable presumption described above. The rebuttable presumption can be overcome, provided it is permitted by the Regulations, if, and only if, the other components of a change in accounting policies increase the relevance and reliability of its financial statements sufficiently to outweigh the decrease in relevance and reliability caused by the inclusion of future investment margins. This is likely to be most relevant for a non-UK insurer using, for example, existing accounting policies for insurance contracts that include excessively prudent assumptions set at inception, a discount rate prescribed by a regulator without direct reference to market conditions, and which ignore some embedded options and guarantees. In that situation, the insurer might make its financial statements more relevant and no less reliable by switching to a comprehensive investor-oriented basis of accounting that is widely used and involves:

- Current estimates and assumptions.
 - A reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty.
 - Measurements that reflect both the intrinsic value and time value of embedded options and guarantees.
- And
- A current market discount rate, even if that discount rate reflects the estimated return on the insurer's assets. [FRS 103.2.9].

In some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. In those approaches, the discount rate affects the measurement of the liability only indirectly. In particular, the use of a less appropriate discount rate has a limited or no effect on the measurement of the liability at inception. Conversely, in other approaches, the discount rate determines the measurement of the liability directly. In the latter case, because the introduction of an asset-based discount rate has a more significant effect, it is considered to be highly unlikely that an insurer could overcome the rebuttable presumption described above. [FRS 103.2.10].

Wording in the Basis for Conclusion to IFRS 4 (not carried forward into FRS 103) states that the IASB believes that in most applications of embedded value the discount rate determines the measurement of the liability directly and therefore it is highly unlikely that an insurer could overcome the rebuttable presumption described above if it wanted to change its accounting policies for insurance contracts to an embedded value basis. [IFRS 4.BC144].

9.5 Shadow accounting

FRS 103 permits, but does not require, an insurer to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects the related insurance liabilities in the same way that a realised gain or loss does. In other words, a measurement adjustment to an insurance liability (or deferred acquisition cost or intangible asset) arising from the remeasurement of an asset would be recognised in other comprehensive income if, and only if, the unrealised gains or losses on the asset are also recognised in other comprehensive income. This relief is known as 'shadow accounting'. Application of shadow accounting is always voluntary and in practice it is also applied selectively. [FRS 103.2.11].

'Shadow accounting', ensures that all gains and losses on investments affect the measurement of the insurance assets and liabilities in the same way, regardless of whether they are realised or unrealised and regardless of whether the unrealised investment gains and losses are recognised in profit or loss or in other comprehensive income using a revaluation reserve. In particular, the relief permits certain gains or losses arising from remeasuring insurance contracts to be recognised in other comprehensive income whereas FRS 103 otherwise requires all gains and losses arising from insurance contracts to be recognised in profit or loss. Normally, this change in accounting policy would be adopted upon transition to FRS 103.

Recognition of movements in insurance liabilities (or deferred acquisition costs or intangible assets) in other comprehensive income only applies when unrealised gains on assets are recognised in other comprehensive income such as for available-for-sale investments accounted for under IAS 39 (when the IAS 39 recognition and measurement option is applied as permitted by paragraphs 11.2(b) and 12.2(b) respectively of FRS 102) or fair value through other comprehensive income for debt instruments under IFRS 9 or property, plant and equipment accounted for using the revaluation model under Section 17 of FRS 102.

Shadow accounting is not applicable for liabilities arising from investment contracts accounted for under Sections 11 and 12 of FRS 102. Further, shadow accounting must not be used if the measurement of an insurance liability is not driven by realised gains and losses on assets held, for example if the insurance liabilities are measured using a discount rate that reflects a current market rate but that measurement does not depend directly on the carrying amount of any assets held.

FRS 103 does not specifically address the interaction between shadow accounting and the liability adequacy test.

How we see it

In our view, shadow accounting is applied before the liability adequacy test and the implications of this are discussed at 8.8.3 above.

9.6 Redesignation of financial assets

When an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its financial assets at fair value through profit or loss provided those assets meet the criteria in paragraph 11.14(b) of FRS 102 (or if the entity has made the accounting policy choice under paragraphs 11.2(b) or (c), or paragraphs 12.2(b) or (c) of FRS 102 to apply the recognition and measurement provisions of either IAS 39 or IFRS 9, as applicable) at the reporting date. [FRS 103.6.4].

This reclassification is permitted if an insurer changes its accounting policies when it first applies FRS 103 and also if it makes a subsequent policy change for accounting for insurance contracts permitted by FRS 103. This reclassification is a change in accounting policy and the requirements of Section 10 of FRS 102 apply i.e., it must be performed retrospectively unless impracticable. [FRS 103.6.4].

This concession cannot be used to reclassify financial assets out of the fair value through profit or loss category.

10 Insurance contracts acquired in business combinations and portfolio transfers

10.1 Expanded presentation of insurance contracts

Section 19 of FRS 102 requires assets and liabilities acquired or assumed in a business combination to be measured at fair value. [FRS 102.19.14]. Insurance contracts are not exempt from these requirements and FRS 103 explicitly confirms that insurance liabilities assumed and insurance assets acquired in a business combination must be measured at fair value at the acquisition date. [FRS 103.2.27].

However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) A liability measured in accordance with the acquirer's accounting policies for insurance contracts that it issues.
- And
- (b) An intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). As an exception to Section 18 of FRS 102, the subsequent measurement of this asset must be consistent with the measurement of the related insurance liabilities. [FRS 103.2.27(a), FRS 103.2.27(b)].

Technically, this FRS 103 intangible asset has no intrinsic value that can be actuarially calculated. It is no more than the balancing number between the purchase price allocated to the insurance liability and the amount recorded for the insurance liability by the purchaser under the purchaser's existing GAAP. The more prudent (higher) the basis of liability measurement, the higher the value of the intangible.

Life insurers have variously described this intangible asset as the 'present value of in-force business' (PVIF), 'present value of future profits' (PVFP or PVP) or 'value of business acquired' (VOBA). Similar principles apply in non-life insurance, for example if claims liabilities are not discounted.

An insurer acquiring a portfolio of insurance contracts (separate from a business combination) may also use the expanded presentation described above. [FRS 103.2.28].

An illustration of how a business combination might be accounted for using the expanded presentation is given below.

Illustration 10-1: Business combination under FRS 103

Insurance entity A purchases an insurance business owned by Entity B for £10 million. Under A's existing accounting policies for insurance contracts the carrying value of the insurance contract liabilities held by B is £8 million. Entity A estimates the fair value of the insurance contract liabilities to be £6 million. The fair value of other net assets acquired, including intangible assets, after recognising any additional deferred tax, is £13 million. The tax rate is 25%.

This gives rise to the following journal entry to record the acquisition of B in A's consolidated financial statements:

	DR	CR
	£m	£m
Cash		10.0
Present value of in-force business (PVIF) intangible (£8m less £6m)	2.0	
Carrying value of insurance liabilities (A's existing accounting policies)		8.0
Goodwill	3.5	
Other net assets acquired	13.0	
Deferred taxation on PVIF (25% × £2m)		0.5

The intangible asset described at (b) above is excluded from the scope of both Section 18 and Section 27 *Impairment of Assets* of FRS 102. Instead, FRS 103 requires its subsequent measurement to be consistent with the measurement of the related insurance liabilities. [FRS 103.2.27(a), FRS 103.2.27(b)]. As a result, it is generally amortised over the estimated life of the acquired insurance contracts. This intangible asset is included within the scope of the liability adequacy test discussed at 8.8 above which acts as a quasi-impairment test on its carrying amount.

Although the VIF asset is outside the scope of Section 18 of FRS 102 for measurement purposes, an entity underwriting long-term insurance business is still required to provide the disclosures set out in paragraphs 18.27 and 18.28(a) of FRS 102 in relation to the VIF asset. [FRS 103.IG2.54].

The Implementation Guidance states that, in respect of long-term business, when a group reconstruction occurs and the new group carries on substantially the same insurance business as the group which it replaces (for example where a demutualisation is effected through the establishment of a proprietary company to acquire the business of an existing mutual insurer), any VIF which would be regarded as internally-generated under the former group structure must continue to be treated as such in the new group. [FRS 103.IG2.55].

Investment contracts within the scope of Sections 11 and 12 of FRS 102 are required to be measured at fair value when acquired in a business combination.

Section 19 of FRS 102 is silent as to whether there must be a reassessment of the classification of contracts previously classified as insurance contracts under FRS 103 which are acquired as part of a business combination. In contrast, IFRS 3 *Business Combinations* requires a group of insurance contracts acquired in a business combination to be measured at the acquisition date under IFRS 17. [IFRS 3.31A]. IFRS 17 requires contracts acquired in a business combination within the scope of IFRS 3 to be treated as if the entity had entered into the contracts on the date of the transaction and not the date the acquiree entered into the contracts (i.e., insurance risk for acquired contracts is reassessed as at the date of the business combination). [IFRS 17.B93].

How we see it

In our view, since neither FRS 102 or FRS 103 provide specific guidance as to whether there must be a reassessment of insurance risk for contracts acquired in a business combination, an insurer must develop an accounting policy in accordance with Section 10 of FRS 102 (see Chapter 9) to determine whether there must be a reassessment of the classification of insurance contracts acquired in a business combination at the acquisition date.

10.1.1 Practical issues

10.1.1.A The difference between a business combination and a portfolio transfer

Extract from FRS 102

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business

An integrated set of activities and assets conducted and managed for the purpose of providing:

- (a) a return to investors; or
- (b) lower costs or other economic benefits directly and proportionately to policyholders or participants.

A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.

When an entity acquires a portfolio of insurance contracts it must determine whether that acquisition meets the definition of a business. When it is considered that a business is acquired, goodwill may need to be recognised as may deferred tax liabilities in respect of any acquired intangible assets. For a portfolio transfer that does not represent a business combination, neither goodwill nor deferred tax must be recognised.

The determination of whether a portfolio of contracts or a business has been acquired will be a matter of judgement based on the facts and circumstances. Acquisitions of contracts that also include the acquisition of underwriting systems and/or the related organised workforce are more likely to meet the definition of a business than merely the acquisition of individual or multiple contracts.

Rights to issue or renew contracts in the future (as opposed to existing insurance contracts) are separate intangible assets and the accounting for the acquisition of such rights is discussed at 10.2 below.

10.1.1.B Fair value of an insurer's liabilities

FRS 103 does not prescribe a method for determining the fair value of insurance liabilities. However, the definition of fair value in FRS 103 is the same as that of FRS 102 and therefore any calculation of fair value must be consistent with FRS 102's valuation principles.

Deferred acquisition costs (DAC) are generally considered to have no value in a business combination and are usually subsumed into the PVIF intangible. The fair value of any unearned premium reserve will include any unearned profit element as well as the present value of the claims obligation in respect of the unexpired policy period at the acquisition date which is likely to be different from the value under existing accounting policies.

10.1.1.C Deferred taxation

Section 29 *Income Tax* of FRS 102 requires deferred tax to be recognised in respect of timing differences arising in business combinations, for example if the amount that can be assessed for tax of the asset or liability is based on cost when the carrying amount is fair value. FRS 103 contains no exemption from these requirements. Therefore, deferred tax will often arise on timing differences created by the recognition of insurance contracts at their fair value or on the related intangible asset. The deferred tax adjusts the amount of goodwill recognised as illustrated in Illustration 10-1 at 10.1 above. [FRS 102.29.11].

10.1.1.D Negative intangible assets

There are situations where the presentation described at 10.1 above will result in the creation of a negative intangible asset. This could arise, for example, where the acquirer's existing accounting policies are such that the contractual liabilities acquired are measured at an amount less than their fair value although this is likely to raise questions about whether the carrying value of the liabilities is adequate (see 8.8 above). FRS 102 and FRS 103 are silent on the subject of negative intangible assets but there appears to be no prohibition on their recognition.

10.2 Customer lists and relationships not connected to contractual insurance rights and obligations

The requirements discussed at 10.1 above do not apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations existing at the date of the business combination or portfolio transfer. [FRS 103.2.29]. Sections 18 and 27 of FRS 102 apply to such assets.

11 Disclosure

FRS 103 requires that an entity whose financial statements comply with FRS 103 must, in addition to the statement of compliance made in accordance with FRS 102, make an explicit and unreserved statement of compliance with FRS 103 in the notes to the financial statements. [FRS 103.1.12].

The disclosure principles outlined in FRS 103 require entities to disclose the amounts recognised in the financial statements, and the risks and uncertainties related with those balances. These provisions are complementary to the disclosure requirements of Section 11 and the Financial Institutions sub-section of Section 34 of FRS 102. [FRS 103.BC30].

The disclosures are set out in Section 4 *Disclosure* and Section 5 *Disclosure: Additional requirements for with-profits business* of FRS 103 with additional guidance on Companies Act and capital disclosures contained in the Implementation Guidance. Additionally, Schedule 3 to the Regulations contains other disclosures required by insurance entities that are not mentioned by FRS 103. The disclosures required by FRS 103 are in addition to the disclosure requirements of FRS 102. [FRS 103.4.1]. Disclosures required by FRS 102 and the Regulations in respect of non-insurance balances and transactions are discussed in the relevant chapters of this publication.

Section 4 of FRS 103 repeats the disclosure requirements of IFRS 4. These requirements are relatively high-level and contain little specific detail. For example, reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs are required but no details about the line items those reconciliations must contain are specified. By comparison, sections of FRS 102 such as Section 17, provide details of items required to be included in similar reconciliations for other balance sheet amounts.

The equivalent disclosure requirements of IFRS 4 were supplemented by seventy-one paragraphs of related implementation guidance which explained how insurers may or might apply the standard. None of this IFRS 4 implementation guidance is included in FRS 103. However, insurers are recommended to refer to the IFRS 4 Implementation Guidance in considering how best to apply the disclosures required by Section 4 of FRS 103. According to this guidance, an insurer must decide in the light of its circumstances how much emphasis to place on different aspects of the requirements and how information must be aggregated to display the overall picture without combining information that has materially different characteristics. Insurers must strike a balance so that important information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have materially different characteristics. To satisfy the requirements of the standard an insurer would not typically need to disclose all the information suggested in the guidance. [IFRS 4.IG12].

Section 5 of FRS 103 contains additional disclosure requirements for with-profits business. These requirements are not in IFRS 4.

The Implementation Guidance to FRS 103 contains guidance explaining how to apply disclosures required by Schedule 3 to the Regulations as well as suggested disclosures for entities with long-term business necessary for providing capital disclosures in accordance with paragraph 34.31 of FRS 102. The Implementation Guidance does not carry the authority of an accounting standard and is not regarded as mandatory.

11.1 Disclosure of significant accounting policies

In accordance with paragraph 8.5 of FRS 102, an entity must disclose, in the summary of significant accounting policies, in relation to both insurance contracts and financial instruments that it issues with a discretionary participation feature: [FRS 103.4.2]

- The measurement basis (or bases) used.
- And
- The other accounting policies used that are relevant to an understanding of the financial statements.

Schedule 3 to the Regulations also requires disclosure of the accounting policies adopted in determining the amounts included in the balance sheet and profit and loss account (including such policies with respect to the depreciation and diminution in value of assets). [3 Sch 61].

The IFRS 4 Implementation Guidance suggested that an insurer might need to address the treatment of some or all of the following accounting policies: [IFRS 4.IG17]

- Premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not passed on and premium taxes or other levies on premiums).
- Fees or other charges made to policyholders.

- Acquisition costs (including a description of their nature).
- Claims incurred (both reported and unreported), claims handling costs (including a description of their nature) and liability adequacy tests (including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in those tests. Disclosure of whether insurance liabilities are discounted might be given together with an explanation of the methodology used.
- The objective of methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models, and the source of information used in those models.
- Embedded options and guarantees including a description of whether:
 - The measurement of insurance liabilities reflects the intrinsic value and time value of these items.
 - And
 - Their measurement is consistent with observed current market prices.
- Discretionary participation features (including an explanation of how the insurer classifies those features between liabilities and components of equity) and other features that permit policyholders to share in investment performance.
- Salvage, subrogation or other recoveries from third parties.
- Reinsurance held.
- Underwriting pools, coinsurance and guarantee fund arrangements.
- Insurance contracts acquired in business combinations and portfolio transfers, and the treatment of related intangible assets.
- And
- The judgements, apart from those involving estimations, management has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. The classification of a DPF is an example of an accounting policy that might have a significant effect.

If the financial statements disclose supplementary information, for example embedded value information, that is not prepared on the basis used for other measurements in the financial statements, it would be appropriate to explain the basis of preparation. Disclosures about embedded value methodology might include information similar to that described above, as well as disclosure of whether, and how, embedded values are affected by estimated returns from assets and by locked-in capital and how those effects are estimated. [IFRS 4.IG18].

If non-uniform accounting policies for the insurance liabilities of subsidiaries are adopted, it might be necessary to disaggregate the disclosures about the amounts reported to give meaningful information about amounts determined using different accounting policies.

11.2 Explanation of recognised amounts from insurance contracts

An insurer must identify and explain the amounts in its financial statements arising from insurance contracts. [FRS 103.4.4].

To comply with this principle an insurer must disclose: [FRS 103.4.5]

- (a) The recognised assets, liabilities, income and expense (and cash flows if its statement of cash flows is presented using the direct method) arising from insurance contracts. Furthermore, if the insurer is a cedant, it must disclose:
 - (i) gains or losses recognised in profit or loss on buying reinsurance.
 - And
 - (ii) if gains and losses on buying reinsurance are deferred and amortised, the amortisation for the period and the amounts remaining unamortised at the beginning and the end of the period.
 - (b) The process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described in (a). When practicable, quantified disclosure of these assumptions must be given.
 - (c) The effect of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.
- And

- (d) Reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisitions costs.

Each of these requirements is discussed in turn at 11.2.1 to 11.2.5 below.

11.2.1 Recognised assets, liabilities, income and expense

As discussed at 8 above, the presentation of the balance sheet and profit and loss account for insurance entities is mandated by Schedule 3 to the Regulations. Details of the presentation requirements are discussed at 8.2 and 8.3 above.

Those UK entities that underwrite insurance contracts that are not insurance entities will usually prepare financial statements under Schedule 1 to the Regulations. The Schedule 1 formats do not cater for insurance balances and therefore those entities will have to use judgement in deciding how to sub-analyse the Schedule 1 line items in order to provide separate disclosure of insurance assets, liabilities, income and expense, if material.

Schedule 3 to the Regulations requires the disclosure of the total amount of commissions for direct business which includes acquisition, renewal, collection and portfolio management. For this purpose, commission must exclude payments made to employees of the undertaking. [FRS 103.4.6].

In respect of deferred acquisition costs, Schedule 3 to the Regulations requires disclosure of: [3 Sch BS Note 17(c)-(e)]

- How the deferral of acquisition costs has been treated (unless otherwise expressly stated in the accounts).
And
- Where such costs are included as a deduction from the provision for unearned premiums, the amount of such deduction.
Or
- Where the actuarial method used in the calculation of the provisions within the long-term business provision has made allowance for explicit recognition of such costs, the amount of the cost so recognised.

Section 11 of FRS 102 requires an entity to disclose the carrying amount of financial assets pledged as collateral for liabilities or contingent liabilities and any terms and conditions relating to assets pledged as collateral. [FRS 102.11.46]. In complying with this requirement, it might be necessary to disclose segregation requirements that are intended to protect policyholders by restricting the use of some of the insurer's assets.

11.2.1.A Equalisation provisions

The Implementation guidance to FRS 103 states that, as guidance for applying the requirements of note 24 of the Notes to the balance sheet format in Schedule 3, disclosure must be made when an equalisation reserve has been established in accordance with the PRA Rulebook. When equalisation reserves are established, an entity must disclose the following in the notes to the financial statements: [FRS 103.IG2.28]

- That the amounts provided are not liabilities because they are in addition to the provisions required to meet the anticipated ultimate cost of settlement of outstanding claims at the reporting date.
- Notwithstanding this, they are required by Schedule 3 to the Regulations to be included within technical provisions.
And
- The impact of the equalisation reserves on equity and the effect of movements in the reserves on the profit or loss for the reporting period.

As discussed at 8.5.6 above, following the implementation of the Solvency II Directive the UK regulatory framework does not permit equalisation or catastrophe provisions.

11.2.1.B Discounting of general insurance provisions

When general insurance provisions are discounted, the Regulations require the following disclosures: [3 Sch 54(2)]

- The total amount of gross provisions before discounting or deductions.
- The categories of claims which are discounted or from which deductions have been made.
And

- For each category of claims, the methods used, in particular the discount rates used and the criteria adopted for estimating the period that will elapse before the claims are settled.

In addition, the Implementation Guidance suggests that separate disclosure must be made, where material, of the amount of any investment return that corresponds to the unwinding of the discount. [FRS 103.IG2.20].

11.2.2 Gains or losses on buying reinsurance

A cedant is required to provide specific disclosure about gains or losses on buying reinsurance as discussed at 8.13.3 and 11.2 above. In addition, if gains and losses on buying reinsurance are deferred and amortised, disclosure is required of the amortisation for the period and the amounts remaining unamortised at the beginning and end of the period. [FRS 103.4.5(a)(i), FRS 103.4.5(a)(ii)].

11.2.3 Processes used to determine significant assumptions

As noted at 11.2 above, FRS 103 requires disclosure of the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts. Where practicable, quantified disclosure of these assumptions must also be given. [FRS 103.4.5(b)].

FRS 103 does not prescribe specific assumptions that must be disclosed. However, the Regulations require disclosure of the principal assumptions used in making the long-term business provision. [3 Sch 52(2)]. In order to comply with that requirement, the Implementation Guidance to FRS 103 states that an entity must disclose for each principal category of business the more significant assumptions relating to the following: [FRS 103.IG2.43]

- Premiums
- Persistency
- Mortality and morbidity
- Interest rates
- The discount rates used with, if relevant, an explanation of the basis of reflecting risk margins
- And
- If applicable, any other significant factors

The Implementation Guidance to IFRS 4 stated that the description of the process used to describe assumptions might include a summary of the most significant of the following: [IFRS 4.IG32]

- The objective of the assumptions, for example, whether the assumptions are intended to be neutral estimates of the most likely or expected outcome ('best estimates') or to provide a given level of assurance or level of sufficiency. If they are intended to provide a quantitative or qualitative level of assurance that level could be disclosed.
- The source of data used as inputs for the assumptions that have the greatest effect, for example, whether the inputs are internal, external or a mixture of the two. For data derived from detailed studies that are not carried out annually, the criteria used to determine when the studies are updated and the date of the latest update could be disclosed.
- The extent to which the assumptions are consistent with observable market prices or other published information.
- A description of how past experience, current conditions and other relevant benchmarks are taken into account in developing estimates and assumptions. If a relationship would normally be expected between past experience and future results, the reasons for using assumptions that differ from past experience and an indication of the extent of the difference could be explained.
- A description of how assumptions about future trends, such as changes in mortality, healthcare costs or litigation awards were developed.
- An explanation of how correlations between different assumptions are identified.
- The policy in making allocations or distributions for contracts with discretionary participation features. In addition, the related assumptions that are reflected in the financial statements, the nature and extent of any significant uncertainty about the relative interests of policyholders and shareholders in the unallocated surplus associated with those contracts, and the effect on the financial statements of any changes during the period in that policy or those assumptions could be disclosed.
- And
- The nature and extent of uncertainties affecting specific assumptions.

11.2.4 The effects of changes in assumptions

As noted at 11.2 above, FRS 103 requires disclosure of the effects of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material impact on the financial statements. [FRS 103.4.5(c)]. This requirement is consistent with Section 10 of FRS 102 which requires disclosure of the nature and amount of a change in an accounting estimate. [FRS 102.10.18].

Additionally, the Regulations specifically require that, where the difference between the loss provision made at the beginning of the year for outstanding claims incurred in previous years and the payments made during the year on account of claims incurred in previous years and the loss provision shown at the end of the year for outstanding claims is material, it must be shown in the notes to the accounts broken down by category and amount. [3 Sch P&L Note 4]. The effect of unwinding discounted claims provisions must be disregarded in considering whether material adverse run-off deviations have occurred. [FRS 103.IG2.19].

Assumptions are often interdependent. When this is the case, any analysis of changes by assumption may depend on the order in which the analysis is performed and may be arbitrary to some extent. Not surprisingly, FRS 103 does not specify a rigid format or content for this analysis. This allows insurers to analyse the changes in a way that meets the objective of the disclosure requirement and is appropriate for their particular circumstances. If practicable, the impact of changes in different assumptions might be disclosed separately, particularly if changes in those assumptions have an adverse effect and others have a beneficial effect. The impact of interdependencies between assumptions and the resulting limitations of any analysis of the effect of changes in assumption might also be described.

The Implementation Guidance to IFRS 4 stated that the effects of changes in assumptions both before and after reinsurance held might be disclosed, especially if a significant change in the nature or extent of an entity's reinsurance programme is expected or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held. [IFRS 4.IG36].

11.2.5 Reconciliations of changes in insurance assets and liabilities

As noted at 11.2 above, FRS 103 requires reconciliations of changes in insurance liabilities, reinsurance assets and, if any, related deferred acquisition costs, although it does not prescribe the line items that must appear in the reconciliations. [FRS 103.4.5(d)].

The Implementation Guidance to IFRS 4 stated that for insurance liabilities the changes might include: [IFRS 4.IG37]

- The carrying amount at the beginning and end of the period
- Additional insurance liabilities arising during the period
- Cash paid
- Income and expense included in profit or loss
- Liabilities acquired from, or transferred to, other insurers
- And
- Net exchange differences arising on the translation of the financial statements into a different presentation currency, and on the translation of a foreign operation into the presentation currency of the reporting entity

A reconciliation of deferred acquisition costs might include: [IFRS 4.IG39]

- The carrying amount at the beginning and end of the period
- The amounts incurred during the period
- The amortisation for the period
- Impairment losses recognised during the period
- And
- Other changes categorised by cause and type

An insurer may have intangible assets related to insurance contracts acquired in a business combination or portfolio transfer. FRS 103 does not require any disclosures for intangible assets in addition to those required by Section 18 of FRS 102.

11.3 Nature and extent of risks arising from insurance contracts

FRS 103 requires that an insurer disclose information to enable the users of the financial statements to evaluate the nature and extent of risks arising from insurance contracts. [FRS 103.4.7].

To comply with this principle, an insurer must disclose: [FRS 103.4.8]

- Its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.
- Information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
 - Sensitivity to insurance risk.
 - Concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each concentration (e.g., type of insured event, geographical area or currency).

And

 - Actual claims compared with previous estimates (i.e., claims development). This disclosure has to go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and timing of the claims payments, but need not go back more than ten years. Information about claims for which uncertainty about the amount and timing of claims payments is typically resolved within one year need not be disclosed.
- Information about credit risk, liquidity risk and market risk that, as a financial institution, Section 34 of FRS 102 would require if insurance contracts were within the scope of Sections 11 and 12 of FRS 102. However:
 - An insurer need not provide the maturity analyses required by paragraph 34.28 of FRS 102 if it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities instead. This may take the form of an analysis, by estimated timing, of the amounts recognised in the statement of financial position rather than gross undiscounted cash flows.

And

 - If an alternative method to manage sensitivity to market conditions, such as an embedded value analysis is used, an insurer may use that sensitivity analysis to meet the requirement in paragraph 34.39 of FRS 102. Such an insurer must also provide the disclosure required by paragraph 34.30 of FRS 102.

And

- Information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

The Implementation Guidance to IFRS 4 stated that these disclosure requirements are based on two foundations: [IFRS 4.IG41]

- There must be a balance between quantitative and qualitative disclosures, enabling users to understand the nature of risk exposures and their potential impact.
- And
- Disclosures must be consistent with how management perceives its activities and risks, and the objectives, policies and processes that management uses to manage those risks so that they:
 - Generate information that has more predictive value than information based on assumptions and methods that management does not use, for example, in considering the insurer's ability to react to adverse situations.

And

 - Are more effective in adapting to the continuing change in risk measurement and management techniques and developments in the external environment over time.

In developing disclosures to satisfy the requirements, the Implementation guidance to IFRS 4 stated that it might be useful to group insurance contracts into broad classes appropriate for the nature of the information to be disclosed, taking into account matters such as the risks covered, the characteristics of the contracts and the measurement basis applied. These broad classes may correspond to classes established for legal or regulatory purposes, but IFRS 4 did not require this. [IFRS 4.IG42].

In identifying broad classes for separate disclosure, it is useful to consider how best to indicate the level of uncertainty associated with the risks underwritten, so as to inform users whether outcomes are likely to be within a wider or a narrower range. For example, an insurer might disclose information about exposures where there are significant amounts of provisions for claims incurred but not reported (IBNR) or where outcomes and risks are unusually difficult to assess, e.g., for asbestos-related claims. [IFRS 4.IG45].

The disclosures required are discussed in more detail below.

11.3.1 Objectives, policies and processes for managing insurance contract risks

As noted at 11.3 above, FRS 103 requires an insurer to disclose its objectives, policies and processes for managing risks arising from insurance contracts and the methods used to manage those risks.

[FRS 103.4.8(a)].

No further guidance is provided by FRS 103. However, the Implementation Guidance to IFRS 4 suggested that such disclosure provides an additional perspective that complements information about contracts outstanding at a particular time and might include information about: [IFRS 4.IG48]

- The structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability.
- The scope and nature of its risk reporting or measurement systems, such as internal risk measurement models, sensitivity analyses, scenario analysis, and stress testing, and how these are integrated into the entity's operating activities. Useful disclosure might include a summary description of the approach used, associated assumptions and parameters (including confidence intervals, computation frequencies and historical observation periods) and strengths and limitations of the approach.
- The processes for accepting, measuring, monitoring and controlling insurance risks and the entity's underwriting strategy to ensure that there are appropriate risk classification and premium levels.
- The extent to which insurance risks are assessed and managed on an entity-wide basis.
- The methods employed to limit or transfer insurance risk exposures and avoid undue concentrations of risk, such as retention limits, inclusion of options in contracts, and reinsurance.
- Asset and liability management (ALM) techniques.

And

- The processes for managing, monitoring and controlling commitments received (or given) to accept (or contribute) additional debt or equity capital when specified events occur.

It might be useful to provide disclosures both for individual types of risks insured and overall. They might include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the contracts and their relative significance to the insurer.

11.3.2 Insurance risk - general matters

As noted at 11.3 above, FRS 103 requires disclosure about insurance risk (both before and after risk mitigation by reinsurance). [FRS 103.4.8(b)].

The Implementation Guidance to IFRS 4 suggested that disclosures made to satisfy this requirement might build on the following foundations: [IFRS 4.IG51]

- Information about insurance risk might be consistent with (though less detailed than) the information provided internally to the entity's key management personnel so that users can assess the entity's financial position, performance and cash flows 'through the eyes of management'.
- Information about risk exposures might report exposures both gross and net of reinsurance (or other risk mitigating elements, such as catastrophe bonds issued or policyholder participation features). This is especially relevant if a significant change in the nature or extent of an entity's reinsurance programme is expected or if an analysis before reinsurance is relevant for an analysis of the credit risk arising from reinsurance held.
- In reporting quantitative information about insurance risk, disclosure of the methods used, the strengths and limitations of those methods, the assumptions made, and the effect of reinsurance, policyholder participation and other mitigating elements might be useful.
- Risk might be classified according to more than one dimension. For example, life insurers might classify contracts by both the level of mortality risk and the level of investment risk. It may sometimes be useful to display this information in a matrix format.

And

- If risk exposures at the reporting date are unrepresentative of exposures during the period, it might be useful to disclose that fact.

The following disclosures required by FRS 103 might also be relevant:

- The sensitivity of profit or loss and equity to changes in variables that have a material effect on them (see 11.3.3 below)
 - Concentrations of insurance risk (see 11.3.4 below)
- And
- The development of prior year insurance liabilities (see 11.3.5 below)

The Implementation Guidance to IFRS 4 also suggested that disclosures about insurance risk might also include: *[IFRS 4.IG51A]*

- Information about the nature of the risk covered, with a brief summary description of the class (such as annuities, pensions, other life insurance, motor, property and liability).
 - information about the general nature of participation features whereby policyholders share in the performance (and related risks) of individual contracts or pools of contracts or entities. This might include the general nature of any formula for the participation and the extent of any discretion held by the insurer.
- And
- Information about the terms of any obligation or contingent obligation for the insurer to contribute to government or other guarantee funds established by law.

11.3.3 Insurance risk - sensitivity information

As noted at 11.3 above, IFRS 4 required disclosures about sensitivity to insurance risk. *[FRS 103.4.8(b)(xi)]*.

To comply with this requirement, disclosure is required of either: *[FRS 103.4.9]*

- A sensitivity analysis that shows how profit or loss and equity would have been affected had changes in the relevant risk variable that were reasonably possible at the end of the reporting period occurred; the methods and assumptions used in preparing that sensitivity analysis; and any changes from the previous period in the methods and assumptions used. However, if an alternative method is used to manage sensitivity to market conditions, such as an embedded value analysis, it may meet this requirement by disclosing that alternative sensitivity analysis and the disclosures required by paragraph 34.30 of FRS 102.
- Or
- Qualitative information about sensitivity, and information about those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of future cash flows.

Quantitative disclosures may be provided for some insurance risks and qualitative information about sensitivity and information about terms and conditions for other insurance risks.

The Implementation Guidance to IFRS 4 stated that insurers must avoid giving a misleading sensitivity analysis if there are significant non-linearities in sensitivities to variables that have a material effect. For example, if a change of 1% in a variable has a negligible effect, but a change of 1.1% has a material effect, it might be misleading to disclose the effect of a 1% change without further explanation. *[IFRS 4.IG53]*. Further, if a quantitative sensitivity analysis is disclosed and that sensitivity analysis does not reflect significant correlations between key variables, the effect of those correlations may need to be explained. *[IFRS 4.IG53A]*.

11.3.4 Insurance risk - concentrations of risk

As noted at 11.3 above, FRS 103 requires disclosure of concentrations of insurance risk, including a description of how management determines concentrations and a description of the shared characteristic that identifies each type of concentration (e.g., type of insured event, geographical area, or currency). *[FRS 103.4.8(b)(xii)]*.

The Implementation guidance to IFRS 4 stated that such concentrations could arise from, for example: *[IFRS 4.IG55]*

- A single insurance contract, or a small number of related contracts, for example when an insurance contract covers low-frequency, high-severity risks such as earthquakes.
- Single incidents that expose an insurer to risk under several different types of insurance contract. For example, a major terrorist incident could create exposure under life insurance contracts, property insurance contracts, business interruption and civil liability.
- Exposure to unexpected changes in trends, for example unexpected changes in human mortality or in policyholder behaviour.

- Exposure to possible major changes in financial market conditions that could cause options held by policyholders to come into the money. For example, when interest rates decline significantly, interest rate and annuity guarantees may result in significant losses.
- Significant litigation or legislative risks that could cause a large single loss, or have a pervasive effect on many contracts.
- Correlations and interdependencies between different risks.
- Significant non-linearities, such as stop-loss or excess of loss features, especially if a key variable is close to a level that triggers a material change in future cash flows.

And

- Geographical and sectoral concentrations.

Disclosure of concentrations of insurance risk might include a description of the shared characteristic that identifies each concentration and an indication of the possible exposure, both before and after reinsurance held, associated with all insurance liabilities sharing that characteristic. [IFRS 4.IG56].

Disclosure about the historical performance of low-frequency, high-severity risks might be one way to help users assess cash flow uncertainty associated with those risks. For example, an insurance contract may cover an earthquake that is expected to happen, on average, once every 50 years. If the earthquake occurs during the current reporting period the insurer will report a large loss. If the earthquake does not occur during the current reporting period the insurer will report a profit. Without adequate disclosure of long-term historical performance, it could be misleading to report 49 years of large profits, followed by one large loss, because users may misinterpret the insurer's long-term ability to generate cash flows over the complete cycle of 50 years. Therefore, describing the extent of the exposure to risks of this kind and the estimated frequency of losses might be useful. If circumstances have not changed significantly, disclosure of the insurer's experience with this exposure may be one way to convey information about estimated frequencies. [IFRS 4.IG57]. However, there is no specific requirement to disclose a probable maximum loss (PML) in the event of a catastrophe because there is no widely agreed definition of PML. [IFRS 4.BC222].

11.3.5 Insurance risk - claims development information

As noted at 11.3 above, FRS 103 requires disclosure of actual claims compared with previous estimates (i.e., claims development). The disclosure about claims development must go back to the period when the earliest material claim arose for which there is still uncertainty about the amount and the timing of the claims payments but need not go back more than ten years. Disclosure need not be provided for claims for which uncertainty about claims payments is typically resolved within one year. [FRS 103.4.8(b)(iii)].

As discussed at 3.3 above, transitional relief is available for this disclosure requirement.

The requirement applies to all insurers, not only to property and casualty insurers. In practice, however, life insurers have not made these disclosures under FRS 103. This is because the Implementation Guidance to IFRS 4 suggested that, because insurers need not disclose the information for claims for which uncertainty about the amount and timing of payments is typically resolved within a year, it is unlikely that many life insurers will need to give the disclosure. Additionally, the claims development disclosure must not normally be needed for annuity contracts because each periodic payment is regarded as a separate claim about which there is no uncertainty. [IFRS 4.BC220, IFRS 4.IG60].

The Implementation Guidance to IFRS 4 suggested that it might also be informative to reconcile the claims development information to amounts reported in the balance sheet and disclose unusual claims expenses or developments separately, allowing users to identify the underlying trends in performance. [IFRS 4.IG59].

FRS 103, like IFRS 4, is silent as to whether development information must be provided on both a gross basis and a net basis. If the effect of reinsurance is significant it would seem appropriate to provide such information both gross and net of reinsurance.

FRS 103 (and IFRS 4) is also silent as to the presentation of:

- Exchange differences associated with insurance liabilities arising on retranslation
 - Claims liabilities acquired in a business combination or portfolio transfer
- And
- Claims liabilities disposed of in a business combination or portfolio transfer

As FRS 103 is silent on these matters, a variety of treatments would appear to be permissible provided they are adequately explained to the users of the financial statements and consistently applied in each reporting period. For example, exchange rates could be fixed at the date the claims are incurred, the original reporting period dates or amounts could be retranslated at each reporting date. Claims liabilities acquired in a business combination or portfolio transfer could be reallocated to the prior reporting periods in which they were originally incurred by the acquiree or all liabilities could be allocated to the reporting period in which the acquisition/portfolio transfer occurred.

An illustrative example of one possible format for presenting claims development is reproduced below. This example presents claims development information by accident year. Other formats are permitted, including for example, presenting information by underwriting year or reporting period rather than underwriting year. In the interests of brevity, this illustrative example provides only five years of data although the standard itself requires ten (subject to the transitional relief upon first-time adoption). The effect of reinsurance is ignored. Given the long tail nature of many non-life insurance claims liabilities, it is likely that many non-life insurers will still have claims outstanding at the reporting date that are more than ten years old and which will need to be included in a reconciliation of the development table to the balance sheet.

Illustration 11-1: Illustrative disclosure of claims development

This example illustrates a possible format for a claims development table for a general insurer. The top half of the table shows how the insurer's estimates of total claims for each accident year develop over time. For example, at the end of 2X22, the insurer estimated that it would pay claims of £680 for insured events relating to insurance contracts underwritten in 2X22. By the end of 2X23, the insurer had revised the estimate of cumulative claims (both those paid and those still to be paid) to £673.

The lower half of the table reconciles the cumulative claims to the amount appearing in the balance sheet. First, the cumulative payments are deducted to give the cumulative unpaid claims for each year on an undiscounted basis. Second, if the claims liabilities are discounted, the effect of discounting is deducted to give the carrying amount in the balance sheet.

Accident year	2X22	2X23	2X24	2X25	2X26	Total
	£	£	£	£	£	£
Estimate of cumulative claims:						
At end of underwriting year	680	790	823	920	968	
One year later	673	785	840	903		
Two years later	692	776	845			
Three years later	697	771				
Four years later	702					
Estimate of cumulative claims	702	771	845	903	968	
Cumulative payments	(702)	(689)	(570)	(350)	(217)	
Balance recognised in the balance sheet	-	82	275	553	751	1,661

11.3.6 Credit risk, liquidity risk and market risk disclosures

As noted at 11.3 above, FRS 103 requires disclosure of information about credit risk, liquidity risk and market risk that, as a financial institution, Section 34 of FRS 102 would require if insurance contracts were within the scope of Sections 11 and 12 of FRS 102. [FRS 103.4.8(c)].

Such disclosure must include: [FRS 102.34.24]

- The exposures to risk and how they arise
- The objectives, policies and processes for managing the risk and the methods used to measure the risk
- And
- Any changes in risk exposures, objectives, policies and processes from the previous period

The Implementation Guidance to IFRS 4 suggested that, to be informative, the disclosure about credit risk, liquidity risk and market risk might include: [IFRS 4.IG64]

- Information about the extent to which features such as policyholder participation features might mitigate or compound those risks.
 - A summary of significant guarantees, and of the levels at which guarantees of market prices or interest rates are likely to alter cash flows.
- And
- The basis for determining investment returns credited to policyholders, such as whether the returns are fixed, based contractually on the return of specified assets or partly or wholly subject to the insurer's discretion.

11.3.6.A Credit risk disclosures

Extract from FRS 102

Appendix I

Glossary

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

For a reinsurance contract, credit risk includes the risk that the insurer incurs a financial loss because a reinsurer defaults on its obligations under the contract. Furthermore, disputes with reinsurers could lead to impairments of the cedant's reinsurance assets. The risk of such disputes may have an effect similar to credit risk. Thus, similar disclosure might be relevant. Balances due from agents or brokers may also be subject to credit risk.

The specific disclosure requirements about credit risk in Section 34 of FRS 102 are: [FRS 102.34.25, FRS 102.34.26, FRS 102.34.27]

- (a) The amount representing the maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements. Disclosure is not required for instruments whose carrying amount best represents the maximum exposure to credit risk.
- (b) In respect of the amount above, a description of the collateral held as security and other credit enhancements and the extent to which these mitigate credit risk.
- (c) The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to risk.
- (d) Information about the credit quality of financial assets that are neither past due nor impaired.
- (e) For each class of financial assets:
 - (i) An analysis of the age of those that are past due at the reporting date but not impaired.

And

 - (ii) An analysis of those that are individually determined to be impaired as at the reporting date, including the factors considered in determining that they are impaired.
- (f) When a financial institution obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g., guarantees) and such assets meet the recognition criteria in other sections of FRS 102, disclosure is required of:
 - (i) The nature and carrying amount of the assets obtained.

And

 - (ii) When the assets are not readily convertible into cash, the entity's policies for disposing of such assets or for using them in its operations.

The disclosures in (a) to (e) above are to be given by class of financial instrument. [FRS 102.34.25-26].

11.3.6.B Liquidity risk disclosures

Extract from FRS 102

Appendix I

Glossary

liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The specific disclosure requirement about liquidity risk in Section 34 of FRS 102 is for a maturity analysis for financial liabilities that shows the remaining contractual maturities at undiscounted amounts separated between derivative and non-derivative liabilities. *[FRS 102.34.28]*.

Although the maturity analysis is required of undiscounted contractual maturities, an insurer need not present this analysis if, instead, it discloses information about the estimated timing of the net cash outflows resulting from recognised insurance liabilities. This may take the form of an analysis, by estimated timing, of the amounts recognised in the balance sheet. *[FRS 103.4.8(c)(i)]*.

The reason for this concession is to avoid insurers having to disclose detailed cash flow estimates for insurance liabilities that are not required for measurement purposes.

This concession is not available for investment contracts that do not contain a DPF. These contracts are within the scope of Section 34 of FRS 102 and not FRS 103. Consequently, a maturity analysis of contractual undiscounted amounts is required for these liabilities.

The Implementation Guidance to IFRS 4 suggests that an insurer might need to disclose a summary narrative description of how the cash flows in the maturity analysis (or analysis by estimated timing) could change if policyholders exercised lapse or surrender options in different ways. If lapse behaviour is likely to be sensitive to interest rates, that fact might be disclosed as well as whether the disclosures about market risk (see 11.3.6.C below) reflect that interdependence. *[IFRS 4.IG65C]*.

11.3.6.C Market risk disclosures

Extract from FRS 102

Appendix I

Glossary

market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. Interest rate risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Currency risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Other price risk - the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

The specific disclosure requirements about market risk in Section 34 of FRS 102 are: *[FRS 102.34.29]*

- A sensitivity analysis for each type of market risk (e.g., interest rate risk, currency risk, other price risk) to which there is exposure at the reporting date, showing the impact on profit or loss and equity.
- And
- Details of the methods and assumptions used in preparing that sensitivity analysis.

If a financial institution prepares a sensitivity analysis, such as value-at risk, that reflects interdependencies between risk variables (e.g., interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis instead. *[FRS 102.34.30]*. Similarly, if an insurer uses an alternative method to manage sensitivity to market conditions, such as an embedded value analysis, it may use that sensitivity analysis to meet the requirements of paragraph 34.29 of FRS 102. *[FRS 103.4.8(c)(ii)]*.

Because two approaches are permitted, an insurer might wish to use different approaches for different classes of business.

Where the sensitivity analysis disclosed is not representative of the risk inherent in the instrument (for example because the year-end exposure does not reflect the exposure during the year), it would be informative to disclose that fact together with the reasons the sensitivity analyses are unrepresentative.

An insurer might be able to take action to reduce the effect of changes in market conditions. For example, it may have discretion to change surrender values or maturity benefits, or to vary the amount or timing of policyholder benefits arising from discretionary participation features. There is no requirement for entities to consider the potential effect of future management actions that may offset the effect of the disclosed changes in any relevant risk variable. However, disclosure is required of the methods and assumptions used to prepare any sensitivity analysis. To comply with this requirement, disclosure of the extent of available management actions and their effect on the sensitivity analysis might be useful to readers of the financial statements.

Many life insurance contract liabilities are backed by matching assets. In these circumstances giving isolated disclosures about the variability of, say, interest rates on the valuation of the liabilities without linking this to the impact on the assets could be misleading to users of the financial statements. In these circumstances it may be useful to provide information as to the linkage of market risk sensitivities.

11.3.7 Exposures to market risk from embedded derivatives

As noted at 11.3 above, disclosure is required if there are exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value. [FRS 103.4.8(d)].

Fair value measurement is not required for derivatives embedded in an insurance contract if the embedded derivative is itself an insurance contract (see 5 above). Examples of these include guaranteed annuity options and guaranteed minimum death benefits as illustrated below.

Illustration 11-2: Contract containing a guaranteed annuity option

An insurer issues a contract under which the policyholder pays a fixed monthly premium for thirty years. At maturity, the policyholder can elect to take either (a) a lump sum equal to the accumulated investment value or (b) a lifetime annuity at a rate guaranteed at inception (i.e., when the contract started). This is an example of a contract containing a guaranteed annuity option.

For policyholders electing to receive the annuity, the insurer could suffer a significant loss if interest rates decline substantially or if the policyholder lives much longer than the average. The insurer is exposed to both market risk and significant insurance risk (mortality risk) and the transfer of insurance risk occurs at inception of the contract because the insurer fixed the price for mortality risk at that date. Therefore, the contract is an insurance contract from inception. Moreover, the embedded guaranteed annuity option itself meets the definition of an insurance contract, and so separation is not required.

Illustration 11-3: Contract containing minimum guaranteed death benefits

An insurer issues a contract under which the policyholder pays a monthly premium for 30 years. Most of the premiums are invested in a mutual fund. The rest is used to buy life cover and to cover expenses. On maturity or surrender, the insurer pays the value of the mutual fund units at that date. On death before final maturity, the insurer pays the greater of (a) the current unit value and (b) a fixed amount. This is an example of a contract containing minimum guaranteed death benefits. It is an insurance contract because the insurer is exposed to significant insurance risk as the fixed amount payable on death before maturity could be greater than the unit value.

It could be viewed as a hybrid contract comprising (a) a mutual fund investment and (b) an embedded life insurance contract that pays a death benefit equal to the fixed amount less the current unit value (but zero if the current unit value is more than the fixed amount).

Both of the examples of embedded derivatives above meet the definition of an insurance contract where the insurance risk is deemed significant. However, in both cases, market risk or interest rate risk may be much more significant than the mortality risk. So, if interest rates or equity markets fall substantially, these guarantees would have significant value. Given the long-term nature of the guarantees and the size of the exposures, an insurer might face extremely large losses in certain scenarios. Therefore, particular emphasis on disclosures about such exposures might be required.

The Implementation Guidance to IFRS 4 stated that, to be informative, disclosures about such exposures may include: [IFRS 4.IG70]

- The sensitivity analysis discussed at 11.3.6.C above.
 - Information about the levels where these exposures start to have a material effect on the insurer's cash flows.
- And
- The fair value of the embedded derivative, although this is not a required disclosure.

11.4 Additional disclosures required by FRS 103 for with-profits business

Section 5 of FRS 103 requires additional disclosures for with-profits business written by life insurers. These replicate disclosures required under previous UK GAAP by FRS 27. However, when an entity has changed in accounting policies (see 9 above) and the new accounting policies are no longer consistent with policies on which the disclosure requirements of Section 5 are based, those requirements that are no longer consistent with the entity's accounting policies need not be applied. [FRS 103.5.2].

The following presentation and disclosure requirements apply:

- The FFA must be disclosed separately in the statement of financial position and not combined with technical provisions or other liabilities. Entities that consolidate interests in an entity carrying on long-term insurance business on a basis that combines the FFA and technical provisions into a single amount of liabilities to policyholders are required to show those elements separately. [FRS 103.5.4].
- And
- Where the balance on the FFA of a with-profits fund is negative, for whatever reason, disclosure is required explaining the nature of the negative balance, the circumstances in which it arose, and why no action to eliminate it has been considered necessary. [FRS 103.5.5].

In addition, amounts recognised for the present value of future profits on non-participating business written in a with-profits fund or for the excess of the realistic value of an interest in a subsidiary or associate over the net amounts included in the entity's consolidated accounts must be presented in one of the following ways: [FRS 103.5.3]

- Where it is possible to apportion the amount recognised between an amount relating to liabilities to policyholders and amount relating to the FFA, these portions must be presented in the statement of financial position as a deduction in arriving at the amount of the liabilities to policyholders and FFA respectively.
- Or
- Where it is not possible to make a reasonably approximate apportionment of the amount recognised, the amount must be presented in the statement of financial position as a separate item deducted from a sub-total of liabilities to policyholders and the FFA.
- Or
- Where the presentation above does not comply with the statutory requirements for balance sheet presentation applying to the entity, the amount recognised must be recognised as an asset.

Additionally, the Implementation Guidance to FRS 103 states that:

- Where an FFA is established, the notes to the financial statements must indicate the reasons for its use and the nature of the funds involved. *[FRS 103.IG2.51]*.
- For each significant class of with-profits insurance business, the insurer must disclose the extent to which the basis of preparation of the long-term business provision incorporates allowance for future bonuses. For example, it must be stated (if it is the case) that explicit provision is made only for vested bonuses (including those vesting following the current valuation) and that no provision is made for future regular or terminal bonuses. If practical, insurers must disclose the amount that has been included explicitly in the long-term business provision in relation to future bonuses provided this can be done without undue cost or effort. If the valuation method makes implicit allowance for future bonuses by adjusting the discount rate used or by another methods, this fact must be stated together with a broad description of the means by which such allowance is made. *[FRS 103.IG2.45]*.

And

- The aggregate of the bonuses added to policies in the reporting period must be disclosed in the notes to the financial statements. *[FRS 103.IG2.46]*.

11.5 Capital disclosures for entities with long-term insurance business

As financial institutions, insurers are required to make capital disclosures in accordance with paragraphs 34.31 to 34.32 of FRS 102.

The non-mandatory Implementation Guidance to FRS 103 contains best practice guidance for providing capital disclosures for entities with long-term insurance business. The suggested disclosures are those required previously under UK GAAP by FRS 27. They go far beyond the minimum requirements of paragraphs 34.31 to 34.32 of FRS 102. It is stated in the Basis for Conclusions that the disclosures provide entities with some flexibility over how to meet the requirements of FRS 102 but does not anticipate a reduction in the usefulness of the information disclosed compared to FRS 27. *[FRS 103.BC36]*.

No best practice guidance on capital disclosures is provided for entities with general insurance business on the grounds that this was not required under previous UK GAAP and therefore its introduction would be unduly onerous in the context of an accounting standard that consolidates existing practice, pending future developments relating to the accounting and regulatory environment for insurers. *[FRS 103.BC37]*.

The non-mandatory implementation guidance is analysed as follows:

- Capital statement (see 11.5.1 below)
- Disclosures relating to liabilities and capital (see 11.5.2 below)

And

- Movements in capital (see 11.5.3 below)

11.5.1 Capital statement

An entity must present a statement detailing its total regulatory capital resources relating to long-term insurance business. The statement must show, for each section of that business as defined below:

[FRS 103.IG3.1]

- Equity (or in the case of a mutual, the equivalent, often described as disclosed surplus)
- Adjustments to restate these amounts in accordance with regulatory requirements
- Each additional component of capital included for regulatory purposes, including capital retained within a life fund whether attributable to shareholders, policyholders or not yet allocated between shareholders and policyholders

And

- The total capital available to meet regulatory capital requirements

Available capital will consist of several distinct elements, each disclosed individually, including:

[FRS 103.IG3.2]

- Equity as included in the published statement of financial position, represented by surplus held within a life fund or by assets held separately from those of the fund itself.
- Amounts that are wholly attributable to owners, but held within a life fund and where the distribution out of the fund is restricted by regulatory or other considerations.

- Surplus held in life funds that has yet to be attributed or allocated between owners and policyholders (in the case of a mutual all such surplus is attributable to policyholders but is not treated as a liability).
And
- Qualifying debt capital, whether issued by the life entity itself or by another entity within the group.

The capital statement must show as separate sections: *[FRS 103.IG3.3]*

- Each UK with-profits life fund that is material to the group.
And
- The entity's other long-term insurance business, showing the extent to which the various components of capital are subject to constraints such that they are available to meet requirements in only part of the entity's business, or are available to meet risks and regulatory capital requirements in all parts of the business.

The Implementation Guidance observes that the capital statement aims to detail the entity's the financial strength and analyse the nature of its capital, and constraints over the availability of the capital to meet risks and regulatory requirements. It is important that sources of capital are shown separately and the extent to which the capital in each section is subject to constraint in its availability to meet requirements in other parts of the entity. Such constraints can arise for any of the following reasons: *[FRS 103.IG3.4]*

- Ownership - the capital may be subject to specific ownership considerations (for example, the FFA of a UK (or Republic of Ireland) with-profits fund, for which the allocation between policyholders and shareholders has not been determined).
- Regulatory - local regulatory limitations may require the maintenance of solvency margins in particular funds or countries.

Or

- Financial - the availability of capital in certain cases can be restricted due to the imposition of taxes or other financial penalty in the event of the capital being required to be redeployed across the group.

The aggregate amount of regulatory capital resources included in the capital statement must be reconciled to equity, FFA and other amounts shown in the entity's statement of financial position. Each component of capital must show the amount related to the entity's business separate from long-term insurance business. If such other business is significant, an explanation must be provided regarding how this capital can be used to meet the requirements of the life assurance business. *[FRS 103.IG3.5]*.

While the detailed requirements apply to long-term insurance business, entities must include information on other parts of the business, along with consolidation adjustments, in order to demonstrate how the aggregated capital attributed to the long-term insurance business reconciles to the total shown in the consolidated statement of financial position, and the extent to which capital outside the long-term insurance business may be made available to meet the capital requirements of the long-term insurance business. This reconciliation applies to each different type of capital shown in the capital statement. *[FRS 103.IG3.6]*.

Where the entity is a subsidiary, narrative supporting the capital statement must explain the extent to which the subsidiary's capital can be transferred to a parent or fellow subsidiaries, or the extent to which it is required to be retained within the subsidiary. *[FRS 103.IG3.7]*.

Entities with life assurance liabilities must reconcile their regulatory capital resources to their shareholders' funds. Adjustments to reconcile the capital shown in the statement of financial position to the amount for regulatory purposes may include the following: *[FRS 103.IG3.8]*

- The difference between provisions measured on the realistic basis and the regulatory basis.
- The inclusion in capital of the FFA.
- The exclusion from capital of the shareholders' share of accrued bonus.
- The exclusion of goodwill and other intangible assets, such as an amount attributed to the acquired value of in-force life assurance business (VIF).

And

- Changes to the valuation of assets and the exclusion of certain non-admissible assets for regulatory purposes, for example any regulatory adjustment to a pension fund deficit that is recognised as a liability.

Disclosure of these adjustments must clearly depict the capital position from a regulatory perspective and its relationship to the equity shown in the consolidated statement of financial position.

Where the amount of a capital instrument that qualifies for inclusion as regulatory capital is restricted (e.g., when only a limited percentage of total regulatory capital may be composed of debt) the entire amount of the instrument must be included, with a separate deduction for the amount in excess of the restriction.

[FRS 103.IG3.9].

Any formal intra-group arrangements to provide capital to particular funds or business units, including intra-group loans and contingent arrangements, must be disclosed. Where the entity is a subsidiary, similar arrangements between the entity and a parent or fellow subsidiary, must also be disclosed. [FRS 103.IG3.10].

Separate disclosing each class of capital is important for understanding the business's funding and how future losses would be absorbed or new business financed. Regulatory capital can include both equity and a surplus within the fund. Such surplus may either be entirely attributable to owners, or remain unallocated as part of the FFA. In a mutual fund, all surplus is attributable to policyholders. Debt instruments qualifying as capital may also be issued from the fund itself, or may form part of the owners' equity outside the life fund; a debt instrument issued by the fund to the owners may effectively transfer capital from the owners to the fund. [FRS 103.IG3.11].

Intra-group arrangements must be included in the regulatory capital of a section only where they are subject to formal arrangements. [FRS 103.IG3.12].

11.5.2 Disclosures relating to liabilities and capital

The capital statement must be supported by the following disclosures: [FRS 103.IG3.13]

- Narrative or quantified information on the regulatory capital requirements applying to each section of the business shown in the capital statement, and on the capital targets set by management for that section.
 - Narrative disclosure of the basis of determining regulatory capital and the corresponding regulatory capital requirements, and any major inconsistencies in this basis between the different sections of the business.
 - Narrative disclosure showing the sensitivity of regulatory liabilities (including options and guarantees), and the components of total capital, to changes in market conditions, key assumptions and other variables, as well as future management actions in response to changes in market conditions.
- And
- Narrative disclosure of the entity's capital management policies and objectives, and its approach to managing the risks that would affect the capital position.

The Implementation Guidance considers that these disclosures are important to the user's ability to understand the management of capital by the entity, its financial adaptability in changing circumstances, and the resources available to each group of policyholders.

In relation to liabilities arising from long-term insurance business, the entity must include the following additional information: [FRS 103.IG3.14]

- The process used to determine the assumptions that have the greatest effect on the measurement of liabilities including options and guarantees and, where practicable, quantified disclosure of those assumptions.
 - Those terms and conditions of options and guarantees relating to long-term insurance contracts that could in aggregate have a material effect on the amount, timing and uncertainty of the entity's future cash flows.
- And
- Information about exposures to interest rate risk or market risk under options and guarantees if the entity does not measure these at fair value or at an amount estimated using a market-consistent stochastic model.

To comply with the last bullet point above, an insurer must disclose: [FRS 103.IG3.18]

- (a) A description of the nature and extent of the options and guarantees.
 - (b) The basis of measurement for the amount at which these options and guarantees are stated, and the amount included, if any, for the additional payment that may arise in excess of the amounts expected to be paid if the policies did not include the option or guarantee feature.
 - (c) The main variables that determine the amount payable under the option or guarantee.
- And
- (d) Information on the potential effects of adverse changes in those market conditions that affect the entity's obligations under options and guarantees.

The requirement of paragraph (d) above may be met by disclosing: *[FRS 103.IG3.19]*

- For options and guarantees that would result in additional payments to policyholders if current asset values and market rates continued unchanged (i.e., those that are 'in the money' for the policyholder), an indication of the change in these amounts if the variables moved adversely by a stated amount.

And

- For options and guarantees that would result in additional payments to policyholders only if there was an adverse change in current asset values and market rates (i.e., those that are 'out of the money' for the policyholder):

- An indication of the change in these variables, from current levels, which would cause material amounts to become payable under the options and guarantees.

And

- An indication of the amount that would result from a specified adverse change in these variables from the levels at which amounts first become payable under the options and guarantees.

The above disclosures may be made in aggregate for classes of options and guarantees that do not differ materially, or which are not individually material.

The Implementation Guidance states that although it is important to explain all movements in liabilities and capital during the period that are material to the group, this does not imply that the impact of each change in assumption needs to be shown separately. Where there is a common cause for the change of assumption the impacts can be grouped together. As an example, the impact of changes in investment return attributable to changing market circumstances does not need to be broken down between the various classes of investment. *[FRS 103.IG3.15]*.

The description of the process would include the objective (whether a best-estimate or a given level of assurance is intended); the sources of data; whether assumptions are consistent with observable market data or other published information; how past experience, current conditions and future trends are taken into account; correlations between different assumptions; management's policy for future bonuses; and the nature and extent of uncertainties affecting the assumptions. *[FRS 103.IG3.16]*.

Options and guarantees are features of life assurance contracts that: (a) confer potentially valuable guarantees underlying the level or nature of policyholder benefits; or (b) are options to change these benefits exercisable at the discretion of the policyholder. For the purposes of FRS 103, the term is used to refer only to those options and guarantees whose potential value is affected by the behaviour of financial variables, and not to potential changes in policyholder benefits arising solely from insurance risk (including mortality and morbidity), or from changes in the entity's creditworthiness. It includes a financial guarantee or option that applies if a policy lapses, but does not include the option to surrender or allow a policy to lapse. *[FRS 103.IG3.17]*.

The capital statement must show the amount of policyholder liabilities attributed to each section of the business shown in the statement, analysed between: *[FRS 103.IG3.20]*

- With-profits business
- Linked business
- Other long-term insurance business

And

- Insurance business accounted for as financial instruments in accordance with the requirements of Sections 11 and 12 of FRS 102

The total of these policyholder liabilities must be the amounts shown in the entity's statement of financial position.

11.5.3 Movements in capital

An entity must include a reconciliation of the movements in the total amount of available capital for long-term insurance business shown in the capital statement from the comparative amounts at the end of the previous reporting period. This disclosure must cover individually each UK (or Republic of Ireland) life fund that is separately shown in the capital statement required under 11.5.1 above, and other long-term insurance business in aggregate. *[FRS 103.IG3.21]*.

This disclosure must set out in tabular form the effect of changes resulting from: *[FRS 103.IG3.22]*

- Changes in assumptions used to measure liabilities from long-term insurance business, showing separately the effect of each change in an assumption that has had a material effect on the group
- Changes in management policy
- Changes in regulatory requirements and similar external developments

And

- New business and other factors (for example changing market prices affecting assets and liabilities, surrenders, lapses and maturities), describing any material items

Changes in management policy above refers to significant changes in the management of the fund such as changes in investment policy or changes in the use of the inherited estate. Where management actions are clearly directly related to changes in assumptions or other factors it will be appropriate to show the net impact, but the narrative must discuss the constituent factors. An example might be the combined effect of a reduced level of bonuses assumed as a result of a reduction in the assumed level of future investment return and a reduction in investment returns earned in the period. *[FRS 103.IG3.23]*.

11.6 Segmental disclosures required by Schedule 3

FRS 102 does not require segmental disclosures except for entities whose debt and equity instruments are publicly traded, or those in the process of filing financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market. Those entities (as well as any entities choosing to provide segmental information voluntarily) must apply IFRS 8 *Operating Segments*. *[FRS 102.1.5]*.

However, UK insurance entities preparing individual financial and separate statements under Schedule 3 to the Regulations must make the segmental disclosures required by the Regulations.

Separate disclosures are required for general and long-term business as shown at 11.6.1 and 11.6.2 below. Entities preparing consolidated financial statements are not required to give the disclosures required by 11.6.1 and 11.6.2 below in respect of the group profit and loss account. *[6 Sch 40(6)]*.

11.6.1 Segmental disclosures for general business required in individual and separate financial statements

A company must disclose: *[3 Sch 85(1)]*

- Gross premiums written
- Gross premiums earned
- Gross claims incurred
- Gross operating expenses

And

- The reinsurance balance

The 'reinsurance balance' means the aggregate total of all those items included in the technical account for general business which relate to reinsurance outwards transactions including items recorded as reinsurance commissions and profit participation. *[FRS 103.IG2.62]*.

These amounts must be broken down between: *[3 Sch 85(2)]*

- Direct insurance
- And
- Reinsurance acceptances (if reinsurance acceptances amount to 10% or more of the gross premiums written)

Where the amount of gross premiums written in direct insurance for each group exceeds €10 million, the amounts in respect of direct insurance must be further broken down into the following groups of classes: *[3 Sch 85(3)]*

- Accident and health
- Motor (third party liability)
- Motor (other classes)
- Marine, aviation and transport
- Fire and other damage to property

- Third-party liability
- Credit and suretyship
- Legal expenses
- Assistance
- And
- Miscellaneous

The entity must, in any event, disclose the amounts relating to the three largest groups of classes in its business. [3 Sch 85(4)].

Total gross direct insurance premiums must also be split by the following categories if any one exceeds 5% of total gross premiums resulting from contracts concluded by the company in: [3 Sch 87]

- In the country in which its head office is located
- And
- In other countries

There must also be disclosed the total amount of commissions for direct insurance business accounted for in the financial year, including acquisition, renewal collection and portfolio management commissions.

[3 Sch 88].

11.6.2 Segmental disclosures for long-term business required in individual and separate financial statements

A company must disclose: [3 Sch 86]

- Gross premiums written, broken down between those written by way of direct insurance and those written by reinsurance
- And
- The reinsurance balance

Gross premiums written by way of direct insurance must be further broken down, when it exceeds 10% of the gross premiums written or (as the case may be) of the gross premiums written by way of direct insurance, between:

- Individual premiums and premiums under group contracts
- Periodic premiums and single premiums
- And
- Premiums from non-participating contracts, premiums from participating contracts and premiums from contracts where the investment risk is borne by policyholder

The 'reinsurance balance' means the aggregate total of all those items included in the technical account for long-term which relate to reinsurance outwards transactions including items recorded as reinsurance commissions and profit participation. [FRS 103.IG2.62].

Single premium contracts are those contracts under which there is no expectation of continuing premiums being paid at regular intervals. Additional single premiums paid in respect of existing individual contracts must be included. Regular premium contracts must include those contracts under which the premiums are payable at regular intervals during the policy year, including repeated or recurrent single premiums where the level of premiums is defined. [FRS 103.IG2.56].

The Implementation Guidance to FRS 103 states that new annual and single premiums must be disclosed separately in the financial statements together with an explanation of the basis adopted for recognising premiums as either annual or single premiums. New annual premiums must be shown as the premiums payable in a full year (i.e., annual premium equivalent). Department for Work and Pensions rebates received on certain pensions contracts must be treated as single premiums. [FRS 103.IG2.57]. Internal transfers between products where open market options are available must be counted as new business. If no open market exists, the transfer must not be treated as new business. [FRS 103.IG2.58].

Total gross direct insurance premiums must also be split by the following categories if any one exceeds 5% of total gross premiums resulting from contracts concluded by the company in: [3 Sch 87]

- In the country in which its head office is located
- And
- In other countries

There must also be disclosed the total amount of commissions for direct insurance business accounted for in the financial year, including acquisition, renewal collection and portfolio management commissions.

[3 Sch 88].

11.7 Disclosures in respect of the allocated investment return

Schedule 3 to the Regulations requires that, when an entity makes a transfer of investment return from one part of the profit and loss account to another (e.g., non-technical account to technical account), the reasons for such a transfer and the bases on which it is made must be disclosed in the notes to the financial statements. [3 Sch P&L Note 8, 3 Sch P&L Note10].

The Implementation Guidance to FRS 103 recommends the following disclosures where the technical results show a longer term rate of investment return: [FRS 103.IG2.71]

- The methodology used to determine the longer-term rate of return for each investment category.
 - For each investment category and material currency, both the longer-term rates of return and, if applicable, the long-term dividend and rental yields used to calculate the grossing-up factor for equities and property.
 - A comparison over a longer-term (at least five years) of the actual return achieved with the return allocated using the longer-term rate of return analysed between returns relating to general business, long-term business and other.
- And
- The sensitivity of the longer-term rate of return to a 1% decrease and a 1% increase in the longer-term rate of investment return.

11.8 Disclosure of distributable profits by life insurers

Schedule 3 to the Regulations requires that every balance sheet of a company which carries on long-term business must show separately as an additional item the aggregate of any capital and reserves which are not required to be treated as realised profits under section 843 of the CA 2006. [3 Sch 11(1)].

For companies authorised to carry on long-term insurance business in accordance with Article 14 of the Solvency II Directive, the realised profit or loss of the company in respect of which its relevant accounts are prepared is the amount calculated by a given formula. [s833A]. It is beyond the scope of this chapter to discuss the formula in detail but, in summary, it is the company's net assets as calculated by the Solvency II Directive less various deductions which include:

- Any defined benefit pension surplus (net of related deferred tax)
 - The value of shares in a qualifying investment subsidiary which exceeds the consideration paid (net of related deferred tax)
 - Excess assets held in a ring-fenced fund (net of related deferred tax)
 - The excess of the value of any portfolio of assets assigned to cover the best estimate of life insurance or reinsurance obligations where the company has permission to disapply or modify its rules on accordance with section 138BA of the Financial Services and Markets Act 2000, to apply a matching adjustment to a relevant risk-free interest rate term structure to calculate the best estimate of a portfolio of life insurance or reinsurance obligations
 - Paid-in ordinary share capital together with any related share premium account
 - Paid in preference shares which are not liabilities together with any related share premium account
 - Any capital redemption reserve
- And
- Any other reserve that the company is prohibited from distributing

For companies that are not required to comply with the Solvency II Directive, realised profits or losses are determined using the normal UK common law and statutory requirements (see Chapter 1 at 5.8).

In addition, a company which carries on long-term business must show separately, in the balance sheet or in the notes, the total amount of assets representing the long-term fund valued in accordance with the provisions of Schedule 3. [3 Sch 11(2)].

Appendix A - Defined terms

Extract from FRS 103

Appendix I

Glossary

This appendix is an integral part of this FRS.

acquisition costs	Costs arising from the conclusion of insurance contracts including direct costs and indirect costs connected with the processing of proposals and the issuing of policies. Further details are set out in note 6 of the Notes on the Profit and Loss Account format in Schedule 3 to the Regulations.
adopted IFRS	IFRS Accounting Standards that have been adopted in the relevant jurisdiction. In the UK, this refers to UK-adopted international accounting standards. In the Republic of Ireland, this refers to EU-adopted IFRS.
bonuses	Amounts allocated to policyholders under with-profits contracts whose existence but not size is specified in the contract. Bonuses may be regular, occasional or terminal
catastrophe provision	Amount recognised over reporting periods between catastrophe events to provide contingency against future catastrophe claims
category of business	Groupings of general insurance business with similar characteristics (such as patterns of risk, claims incurrence and settlement patterns, and setting of premiums).
cedant	The policyholder under a reinsurance contract.
claim	The amount payable under an insurance contract arising from the occurrence of an insured event.
claims incurred	A claim is incurred when the event giving rise to the claim occurs. Claims incurred include paid claims and movements in outstanding claims.
claims outstanding	In relation to general insurance business: The amounts provided to cover the estimated ultimate cost of settling claims arising out of events which have occurred by the reporting date, including incurred but not reported (IBNR) claims and claims handling expenses, less amounts already paid in respect of those claims. In relation to long-term insurance business: The amounts provided to cover the estimated ultimate cost of settling claims arising out of events, which have been notified by the reporting date being the sums due to beneficiaries together with claims handling expenses, less amounts already paid in respect of those claims.
deferred acquisition costs	Costs arising from the conclusion of insurance contracts that are incurred during a reporting period but which relate to a subsequent reporting period and are carried forward to subsequent reporting periods. In relation to general insurance business: Costs relating to the unexpired period of risk of contracts in force at the reporting date. In relation to long-term insurance business: Costs relating to contracts in-force at the reporting date in the expectation that they will be recoverable out of future margins within insurance contracts after providing for contractual liabilities.
deposit component	A contractual component that is not accounted for as a derivative under Sections 11 <i>Basic Financial Instruments</i> and 12 <i>Other Financial Instrument Issues</i> of FRS 102 and would be within the scope of FRS 102 if it were a separate instrument.
derivative	A financial instrument or other contract with all three of the following characteristics:

	(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying'), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (c) it is settled at a future date.
deterministic approach	A method which calculates the value of a policy under a defined scenario and a single set of assumptions.
discounting	The reduction to present value at a given date of future cash flows at an assumed date by the application of an appropriate discount factor reflecting the time value of money.
discretionary participation feature	A contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract.
earned premium	For general insurance business, earned premium is the proportion of written premiums (including where relevant those of previous reporting periods) attributable to the risks borne by the insurer during the reporting period.
embedded derivative	A component of a hybrid (combined) instrument that also includes a non-derivative host contract - with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
embedded value	A measure of the consolidated value of shareholder's interests in the business, calculated as free surplus plus required capital plus the value of in-force life assurance business (VIF). Different approaches are adopted in terms of methodology and valuation basis, with most entities tending to adopt either the CFO Forum's EEV or MCEV principles.
EU-adopted IFRS	IFRS Accounting Standards that have been adopted in the European Union in accordance with EU Regulation 1606/2002.
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
financial reinsurance	Where a reinsurance contract is intended, either in whole or in part, to mitigate the requirement to establish prudent provisions, and/or to provide an element of financing, the identifiable elements of the contract which do not transfer significant insurance risk are considered to be financial reinsurance.
fund for future appropriation (FFA)	The balance sheet item required by Schedule 3 to the Regulations to comprise all funds the allocation of which, either to policyholders or to shareholders, has not been determined by the end of the reporting period.

general insurance business	Insurance contracts (including reinsurance) falling within one of the classes of insurance specified in Part I of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).
gross premium method	A form of actuarial valuation of liabilities arising under long-term insurance contracts where the premiums brought into account are the full amounts receivable under the contract. The method includes explicit estimates of cash flows for: (a) premiums, adjusted for renewals and lapses; (b) expected claims and for with-profits business future regular but not occasional or terminal bonuses; (c) costs of maintaining contracts; and (d) future renewal expenses. Cash flows are discounted at the valuation interest rate. The methodology may be set out in the relevant regulatory framework. The discount rate is based on the expected return on the assets deemed to back the liabilities. This will be adjusted to reflect any further risks although, under this method, most of the key risks will be reflected in the modelling of the cash flows. For linked business, allowance may be made for the purchase of future units required by the contract terms and credit is taken for future charges permitted under those terms.
guaranteed benefits	Payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer.
insurance asset	An insurer's net contractual rights under an insurance contract.
insurance contract	A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See Appendix II for guidance on this definition.)
insurance liability	An insurer's net contractual obligations under an insurance contract.
insurance risk	Risk, other than financial risk, transferred from the holder of a contract to the issuer.
insured event	An uncertain future event that is covered by an insurance contract and creates insurance risk.
insurer	The party that has an obligation under an insurance contract to compensate a policyholder if an insured event occurs.
intangible asset	An identifiable non-monetary asset without physical substance. Such an asset is identifiable when: (a) it is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
investment contract	Contract that has the legal form of an insurance contract but does not expose the insurer to significant insurance risk, for example life insurance contracts in which the insurer bears no significant mortality risk.
investment return	Comprises all investment income, realised investment gains and losses and movements in unrealised investment gains and losses. It also includes investment expenses and charges and, if appropriate, interest payable.
liability adequacy test	An assessment of whether the carrying amount of an insurance liability needs to be increased (or the carrying amount of related deferred acquisition costs or related intangible assets decreased), based on a review of future cash flows.

linked business	Long-term insurance business where the benefits payable to policyholders are wholly or partly to be determined by reference to the value of, or the income from, property of any description or by reference to fluctuations in, or in an index of, the value of property of any description.
longer term rate of investment return	An estimate of the long-term trend investment return for the relevant category of investments having regard to past performance, current trends and future expectations.
long-term insurance business	Insurance contracts (including reinsurance) falling within one of the classes of insurance specified in Part II of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).
modified statutory solvency basis (MSSB)	The basis for determining insurance liabilities which is the statutory solvency basis adjusted for the following items: (a) to defer new business acquisition costs incurred where the benefit of such costs will be obtained in subsequent reporting periods; and (b) to treat investment, resilience and similar reserves, or reserves held in respect of general contingencies or the specific contingency that the fund will be closed to new business, where such items are held in respect of long-term insurance business, as reserves rather than provisions. These are included, as appropriate, within shareholders' capital and reserves or the fund for future appropriations (FFA).
net premium method	An actuarial valuation of liabilities arising under long-term insurance contracts where the premium brought into account at any valuation date is that which, on the valuation assumptions regarding interest, mortality and disability, will exactly provide for the benefits guaranteed. A variation of the net premium method involves zillmerisation. The detailed methodology for UK companies is included in regulations contained in the PRA Rulebook as at 31 December 2015.
non-technical account	The section of the income statement (referred to as the profit and loss account in the Act) prescribed by Part 1 of Schedule 3 to the Regulations in addition to the technical accounts for general and long-term insurance business.
options and guarantees	Features of life assurance contracts that: (a) confer potentially valuable guarantees underlying the level or nature of policyholder benefits; or (b) are options to change these benefits exercisable at the discretion of the policyholder. For the purposes of this FRS, the term is used to refer only to those options and guarantees whose potential value is affected by the behaviour of financial variables.
pipeline premiums	Premiums written but not reported to the undertaking by the reporting date.
policyholder	A party that has a right to compensation under an insurance contract if an insured event occurs.
portfolio claims	Amounts payable by one insurer to another in consideration for a contract whereby the latter agrees to assume responsibility for the unpaid claims incurred by the former prior to a date specified in the contract.
portfolio premiums	Amounts payable by one insurer to another in consideration for a contract whereby the latter agrees to assume responsibility for the claims arising on a portfolio of in-force business written by the former from a future date until the expiry of the policies.
portfolio transfer	The bulk transfer of contracts or risks to another entity.
principles and practices of financial management (PPFM)	The statement that the Financial Conduct Authority requires each with-profits life fund to make available to its policyholders containing, inter alia, a description of the fund's investment management and bonus distribution policies.

Prudential Regulation Authority (PRA)	The division of the Bank of England responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms in the UK.
Prudential sourcebook for insurers (INSPRU)	The section of the PRA Rulebook detailing the prudential rules for insurers, including capital requirements, credit, market and liquidity risk for periods ending before 1 January 2016.
reinsurance assets	A cedant's net contractual rights under a reinsurance contract.
reinsurance contract	An insurance contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant. Retrocession is the reinsurance outwards of risks previously accepted by an insurer as reinsurance inwards. The recipient is known as the retrocessionaire.
reinsurer	The party that has an obligation under a reinsurance contract to compensate a cedant if an insured event occurs.
run-off deviation	For general insurance business, the difference (before any reduction in respect of discounting) between: (a) the provisions made at the beginning of the reporting period for outstanding claims incurred in previous reporting periods; and (b) the payments made during the reporting period on account of claims incurred in previous reporting periods and the claims provision at the end of the reporting period for such outstanding claims.
separable embedded derivative	An embedded derivative where: (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss. The guidance in IAS 39 <i>Financial Instruments: Recognition and Measurement</i> and IFRS 4 <i>Insurance Contracts</i> shall be used in determining whether an embedded derivative is separable.
significant insurance risk	An insured event or risk which could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.
Solvency II Directive	Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), as amended, and as implemented in the United Kingdom and Republic of Ireland.
statutory solvency basis	The basis of determination of insurance liabilities in accordance with rule 1 of INSPRU as at 31 December 2015.
structured settlement	An arrangement by consent between the parties concerned or under a Court Order whereby damages in the form of a lump sum are replaced by a smaller lump sum and a series of periodic payments. These are also referred to as Periodic Payment Orders or PPOs.
surrender	To cease paying premiums such that the insurance contract ceases to have effect.
surrender option	The option to surrender an insurance contract in return for some form of reduced claim.

technical account	In relation to general insurance business: The section of the income statement (referred to as the profit and loss account in the Act) for recording insurance business within the classes specified in Part I of Schedule 1 to the Regulated Activities Order which must be prepared in accordance with the format prescribed in Part I of Schedule 3 to the Regulations. In relation to long-term insurance business: The section of the income statement (referred to as the profit and loss account in the Act) for recording insurance business within the classes specified in Part II of Schedule 1 to the Regulated Activities Order, which must be prepared in accordance with the format prescribed in Part I of Schedule 3 to the Regulations.
unbundle	To account for the components of a contract as if they were separate contracts.
unearned premiums provision	For general insurance business, the proportion of written premiums relating to periods of risk after the reporting date, which are deferred to subsequent reporting periods.
unexpired risks provision	The excess of the estimated value of claims and expenses likely to arise after the end of the reporting period from contracts concluded before that date, insofar as their estimated value exceeds the provision for unearned premiums (after deduction of any acquisition costs deferred), and any premiums receivable under those contracts.
value of in-force life assurance business (VIF)	The net present value of the shareholders' interest in the expected after tax cash flows from long-term insurance business, on the assumption that all assets backing the business will be distributed over time to in-force policyholders and/or shareholders. The calculation of VIF should allow for uncertainties associated with the assessment of future cash flows, as well as for the time value of money. VIF includes both the shareholders' interest which is expected to arise in the form of cash flows over the lifetime of current in-force contracts and the interest in the surplus assets which, in practice, is not expected to be distributed over this period.
with-profits business	Long-term insurance business which provides benefits through eligibility to participate in discretionary distributions based on profits arising from the insurer's business or from a particular part of the insurer's business. A with-profits contract is an example of a contract with a discretionary participation feature.
written premiums	In relation to general insurance business: Premiums, which an insurer is contractually entitled to receive from the insured in relation to contracts of insurance. These are premiums on contracts entered into during the reporting period and adjustments arising in the reporting period to premiums receivable in respect of contracts entered into in previous reporting periods. In relation to long-term insurance business: Premiums to which the insurer is contractually entitled becoming due for payment in the reporting period.
zillmerisation	A variation of the net premium method which increases the future premiums valued to take account of acquisition costs incurred.

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Overview

This chapter deals with the requirements of FRS 104 *Interim Financial Reporting*. In addition, the chapter also provides guidance on the overall recognition and measurement principles in interim financial reports. This FRS describes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. The FRS does not require an entity to prepare an interim financial report, rather, FRS 104 applies if an entity is required by laws or regulations or voluntarily chooses to prepare interim financial reports it may voluntarily choose to apply this FRS.

What you need to know

- FRS 104 provides guidance on the form and content of interim financial statements.
- FRS 104 specifies the periods, including comparative information, for which interim financial reports must be presented.
- The overall principle on measurement is based on a year-to-date approach. This includes guidance on the application of year-to-date approach on specific areas.
- FRS 104 requires significant transactions and events and other information to be disclosed in interim financial statements.

1 Introduction

FRS 104 was issued originally in March 2015. A revised version was issued in March 2018, to update the edition issued in March 2015 for the following:

- Amendments to FRS 102 Triennial review 2017 *Incremental improvements and clarifications (Triennial review 2017)* issued in December 2017.
- The replacement of Appendix III: Significant differences between FRS 104 and IAS 34 *Interim Financial Reporting* with a Basis for Conclusions.

And

- Some minor typographical and presentational corrections.

This chapter reflects the amendments to FRS 102 published in March 2024 *The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSS - Periodic Review 2024*. These are consequential minor amendments to FRS 104 effective for interim periods beginning on or after 1 January 2026 (with early adoption permitted if all the amendments to the accounting standards are early applied at the same time). If an entity applies these amendments before 1 January 2026, it must disclose that fact.

[FRS 104.56D].

FRS 104 does not require any entity to prepare an interim report, nor does it change the extent to which laws or regulations may require the preparation of such a report. FRS 104 is intended for use in the preparation of interim reports by entities that prepare financial statements in accordance with UK GAAP. In particular, it is intended for use by entities which apply FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. Most of this chapter therefore deals with the use of FRS 104 by FRS 102 preparers. However, entities which apply FRS 101 *Reduced Disclosure Framework* when preparing their annual financial statements may also use FRS 104 when preparing their interim financial reports.

FRS 104 is based on the equivalent international accounting standard IAS 34, but with some minor adjustments and the omission of certain paragraphs which deal with presentational aspects of IAS 34 or paragraphs of IAS 34 which include disclosures not required in the annual financial statements of entities reporting under FRS 102. These amendments are summarised in the Basis for Conclusions. [FRS 104.BC10].

2 Objective and scope of FRS 104

2.1 Objective

FRS 104 sets out content, recognition and measurement principles for interim financial reports. *[FRS 104.1A]*. It notes that “timely and reliable interim financial reporting can improve the ability of investors, creditors, and others to understand an entity’s capacity to generate earnings and cash flows and its financial condition and liquidity”. *[FRS 104.1]*.

2.2 Scope

FRS 104 is intended for use by entities that prepare annual financial statements in accordance with FRS 102. If an entity prepares its annual financial statements under FRS 101 and applies FRS 104, it must replace references to FRS 102 in FRS 104 with the equivalent requirements in adopted IFRS, as amended by paragraph AG1 of FRS 101. *[FRS 104.2A]*.

This chapter is written primarily for entities that prepare their annual financial statements in accordance with FRS 102. However, a discussion on the application of FRS 104 to FRS 101 reporters is included at 5 below.

FRS 104, in itself, does not require an entity to prepare interim financial reports and does not mandate, how often, or how soon after the end of an interim period an interim financial report should be issued. Where an entity is required by laws or regulations or voluntarily chooses to prepare interim financial reports it may voluntarily choose to apply FRS 104. *[FRS 104.2]*. Therefore, entities need to consider if there are any applicable laws and regulations which require them to prepare interim financial statements. For example, UK issuers not using adopted IFRS that publish half-yearly reports which include a statement that a condensed set of financial statements has been prepared in accordance with FRS 104, must apply the standard. *[FRS 104.3A]*. See 2.2.1 below.

In practice, we expect a limited number of entities (primarily investment trusts and venture capital trusts) will be required to apply FRS 104. However, for entities which prepare annual financial statements under FRS 101 or FRS 102, FRS 104 may be applied voluntarily for interim reporting purposes.

2.2.1 Issuers required to comply with the Disclosure Guidance and Transparency Rules (DTR)

Issuers of securities that are required to publish half-yearly financial reports in accordance with the Disclosure Guidance and Transparency Rules (DTR) must include a responsibility statement in the report. In accordance with paragraph 4.2.10.R of the DTR, a person making the responsibility statement will satisfy the requirement to confirm that the condensed set of financial statements gives a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer (or the undertakings included in the consolidation as a whole) by including a statement that the condensed set of financial statements has been prepared in accordance with either:

- IAS 34.
- Or
- For UK issuers not using UK-adopted international accounting standards, FRS 104 issued by the FRC. *[FRS 104.A4.3]*.

The application of FRS 104 is conditional upon the person making the responsibility statement having reasonable grounds to be satisfied that the condensed set of financial statements prepared under FRS 104 is not misleading. *[FRS 104.A4.4]*.

In accordance with the DTR, an issuer that is required to prepare consolidated accounts must prepare the condensed set of financial statements in accordance with IAS 34 and the requirements set out in FRS 104 do not apply to these issuers. *[FRS 104.A4.5]*. An issuer that is not required to prepare consolidated accounts must, as a minimum, apply the content and preparation requirements set out in paragraph 4.2.5.R of the DTR. The content and preparation requirements of FRS 104 are consistent with those set out in the DTR, although they are more prescriptive and detailed. *[FRS 104.A4.6]*.

2.2.2 Unlisted entities and entities not subject to the DTR

While not in the scope of the DTR, unlisted entities or entities with securities admitted to trading on an exchange not subject to the DTR may prepare and present interim financial statements. In those circumstances, there may be no requirement to follow a particular standard on interim financial reporting. However, we would expect that where annual financial statements are prepared under either FRS 101 or FRS 102 that the interim financial statements would be prepared under FRS 104.

3 Form and content of an interim financial report under FRS 104

FRS 104 does not prohibit or discourage an entity from:

- Publishing a complete set of financial statements (as described in Section 3 *Financial Statement Presentation* of FRS 102) in its interim financial report, rather than condensed financial statements and selected explanatory notes.
- Or
- Including in condensed interim financial statements more than the components and selected explanatory notes as set out in paragraph 8 of FRS 104.

The recognition and measurement guidance in the standard, together with the note disclosures required by the standard, apply to both complete and condensed financial statements presented for an interim period.

[FRS 104.7].

3.1 Complete set of interim financial statements

If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements must conform to the requirements of Section 3 of FRS 102. [FRS 104.9]. A complete set of financial statements must include the following components: [FRS 102.3.17]

- A statement of financial position as at the reporting date.
- A statement of comprehensive income for the reporting period to be presented either as:
 - A single statement of comprehensive income for the reporting period, displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income.
 - Or
 - A separate income statement and a separate statement of comprehensive income. In this case, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income.
- A statement of changes in equity for the reporting period.
- A statement of cash flows for the reporting period.

And

- Notes comprising material accounting policy information and other explanatory information.

The presentational requirements of Section 3 of FRS 102 are discussed in Chapter 6. In addition, the entity must make the disclosures specifically required by FRS 104 for interim financial reports (see 4 below) as well as those required by FRS 102. [FRS 104.7].

An entity that will not present a statement of cash flows in its next annual financial statements is not required to include that statement in its interim financial report. [FRS 104.9].

3.2 Condensed interim financial statements

In the interest of timeliness, cost, and avoiding repetition of previously reported information, an entity might be required or elect to give less information at interim dates as compared with its annual financial statements. [FRS 104.6]. FRS 104 defines the minimum components of an interim report, as including condensed financial statements and selected explanatory notes, as follows: [FRS 104.6, FRS 104.8]

- A condensed statement of financial position.
- A single condensed statement of comprehensive income or a separate condensed income statement and a separate condensed statement of comprehensive income.
- A condensed statement of changes in equity.
- A condensed statement of cash flows.

And

- Selected explanatory notes.

Other titles for the statements can be used, as long as they are not misleading. [FRS 104.8E].

An entity that will not present a statement of cash flows in its next annual financial statements is not required to include that statement in its interim financial report. [FRS 104.8F].

FRS 104 requires entities to confirm that the same accounting policies and methods of computation are followed in the interim financial statements as compared to their most recent annual financial statements or, if those policies or methods have changed, to describe the nature and effect of the change (see 8.1.2 below). Accordingly, an entity would only depart from the presentation applied in its most recent annual financial statements if it has determined that the format will change in its next annual financial statements. [FRS 104.8D].

The condensed income statement and condensed statement of comprehensive income referred to at (b) above must be presented using the same basis as the entity's most recent annual financial statements. Accordingly, if an entity presents a separate income statement in its annual financial statements, then it must also present a separate income statement in the interim financial report. Similarly, if a single statement of comprehensive income is presented in the annual financial statements, the same format is adopted in the interim financial report. [FRS 104.8A].

Where the only changes to equity arise from profit or loss, payment of dividends, corrections of prior period errors or changes in accounting policies, an entity may have presented a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity in its most recent annual financial statements under FRS 102. If that continues to be the case during any of the periods for which the interim financial statements are required to be presented, the entity may continue to present a single condensed statement of income and retained earnings. [FRS 104.8B].

Similarly, where an entity in its most recent annual financial statements has presented only an income statement or a statement of comprehensive income in which the bottom line is labelled profit or loss (by virtue of there being no items of other comprehensive income), that entity is permitted to use the same basis of presentation in its interim financial statements if there are no items of other comprehensive income in any of the periods for which the interim financial statements are being presented. [FRS 104.8C].

As a minimum, the condensed financial statements must include each of the headings and subtotals that were included in the entity's last annual financial statements and the selected explanatory notes as required by FRS 104 (see 4 below). [FRS 104.10].

A strict interpretation of this minimum requirement could mean that, for example, an entity is only required to present non-current assets, current assets, etc., in an interim statement of financial position. However, one of the purposes of an interim report is to help the users of the financial statements to understand the changes in financial position and performance of the entity since the end of the last annual reporting period. [FRS 104.15]. To that end, FRS 104 also requires additional line items or notes to be included if their omission makes the condensed interim financial statements misleading. [FRS 104.10]. In addition, the overriding goal of FRS 104 is to ensure that the interim report includes all information relevant to understanding the entity's financial position and the performance during the interim period. [FRS 104.25]. FRS 104 defines relevance as the quality of information that would influence the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. [FRS 104 Appendix I]. Therefore, judgement is required to determine which line items provide relevant information for decision-makers and are presented accordingly.

Inclusion of all of the line items from the annual financial statements will often be most appropriate to help users of the interim financial statements understand the changes since the previous year-end. Nonetheless, entities may aggregate line items used in the annual financial statements, if doing so does not render the information misleading or prevent users of the interim financial statements from performing meaningful trend analysis.

The following Illustration shows one possible way in which an entity might choose to combine line items presented separately in the annual financial statements when preparing a condensed set of interim financial statements for an individual set of accounts prepared under Format 1 of Schedule 1 to the Regulations. However, such presentation is at the discretion of management, based on facts and circumstances, including materiality (as discussed at 7 below), regulatory environment, and the overarching goal of FRS 104 to provide relevant information. [FRS 104.25]. Accordingly, other presentations may also be appropriate.

Illustration 3-1: Presenting the same headings and sub-totals in condensed interim financial statements

Statement of financial position	Annual individual financial statements (‘Schedule 1 statutory format’)	Condensed interim financial statements
Fixed assets		
Intangible assets	•	•
Tangible assets	•	•
Investments:		•
Investments in joint ventures	•	
Investments in associates	•	
Other investments	•	
Current assets		
Stocks	•	•
Debtors:		•
Amounts falling due within one year	•	
Amounts falling due after one year	•	
Short term deposits	•	•
Cash at bank and in hand	•	•
Creditors: amounts falling due within one year	•	•
Net current assets	•	•
Total assets less current liabilities	•	•
Creditors: amounts falling due after more than one year	•	•
Provisions for liabilities	•	•
Net assets	•	•
Capital and reserves		
Called up share capital	•	•
Share premium account	•	•
Other reserves including the fair value reserve		•
Capital redemption reserve	•	
Reserve for own shares	•	
Equity component of convertible preference shares	•	
Merger reserve	•	•
Profit and loss account	•	•
Equity attributable to owners of the parent company	•	•
Non-controlling interests	•	•
Total capital and reserves	•	•

Income statement	Annual financial statements (‘Schedule 1 statutory format’)	Condensed interim financial statements
Turnover	•	•
Cost of sales	•	•
Gross profit	•	•
Operating expenses		•
Distribution costs	•	
Administrative expenses	•	
Other operating expenses	•	
Other operating income	•	•
Operating profit	•	•
Income from investments:		•
Income from shares in group undertakings	•	
Income from participating interests	•	
Profit before interest and tax	•	
Interest payable	•	
Other finance costs	•	
Interest payable and similar expenses		•
Profit before tax	•	•
Tax on profit	•	•
Profit for the period	•	•
Statement of comprehensive income	Annual financial statements	Condensed interim financial statements
Profit for the period	•	•
Cash flow hedges	•	
Remeasurement gain/(loss) recognised on defined benefit pension schemes	•	
Movement on deferred tax relating to pension liability	•	
Total other comprehensive income	•	•
Total comprehensive income for the period	•	•

A statement of changes in equity and statement of cash flows are not presented in this example.

3.3 Requirements for complete and condensed interim financial information

The general principles for preparing annual financial statements are equally applicable to interim financial statements. These principles include fair presentation, going concern, materiality and aggregation. See Chapter 6 at 8.

Furthermore, irrespective of whether an entity provides complete or condensed financial statements for an interim period, basic and diluted earnings per share must be presented for an interim period when earnings per share (EPS) information has been presented in the entity’s most recent annual financial statements. [FRS 104.11]. Such information must be given on the face of the statement that presents components of profit or loss for an interim period. [FRS 104.11A].

Although not explicitly required by FRS 104, most entities consider it necessary to disclose the date on which the interim financial statements are authorised for issue as it may help users to understand the context of any disclosure of events after the interim reporting date. [FRS 102.32.9, FRS 102.32.3].

3.4 Management commentary

A management commentary is not explicitly required by FRS 104, however we would expect one to be included by entities in their interim financial reports along with the interim financial statements.

FRS 104 allows information required under the standard to be presented outside the interim financial statements, i.e., in other parts of interim financial report. [FRS 104.15B, FRS 104.16AJ]. Thus, some of the required disclosures may be included in a management commentary (see 4.2.1 below). The standard itself does not establish specific requirements for the content of a management commentary beyond what must be contained in (or cross-referred from) the interim financial statements.

4 Disclosures in condensed financial statements

FRS 104 contains a number of disclosure principles:

- Entities must provide information about events and transactions in the interim period that are significant to an understanding of the changes in financial position and performance since the end of the last annual reporting period. In this context it is not necessary to provide relatively insignificant updates to information reported in the last annual financial statements (see 4.1 below). *[FRS 104.15, FRS 104.15A]*.
- In addition to information explaining significant changes since the last annual reporting period, certain 'minimum' disclosures are required to be given, if not disclosed elsewhere in the interim financial report (see 4.2 below). *[FRS 104.16A]*.
- The materiality assessment for disclosure is based on the interim period alone to ensure all information provided is relevant to understanding of the entity's financial position and its performance during the interim period (further discussed at 7 below). *[FRS 104.25]*.

Overall, applying these disclosure principles requires the exercise of judgement by the entity regarding what information is material or relevant. The practice of interim reporting confirms that entities take advantage of that room for judgement, both for disclosures provided in the notes to the interim financial statements and outside.

4.1 Significant events and transactions

FRS 104 presumes that users of an entity's interim financial report also have access to its most recent annual financial report. *[FRS 104.15A]*. On that basis, an interim financial report should explain events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the previous annual reporting period and provide an update to the relevant information included in the financial statements of the previous year. *[FRS 104.15, FRS 104.15C]*. The inclusion of only selected explanatory notes is consistent with the purpose of an interim financial report, to update the latest complete set of annual financial statements. Accordingly, condensed financial statements avoid repeating previously reported information and focus on new activities, events, and circumstances. *[FRS 104.6]*.

Disclosure of the following events and transactions in interim financial reports, if they are significant, is required: *[FRS 104.15B]*

- Write-down of inventories to net realisable value and the reversal of such a write-down.
- Recognition of a loss from the impairment of financial assets, property, plant, and equipment, intangible assets, or other assets, and the reversal of such an impairment loss.
- Reversal of any provisions for the costs of restructuring.
- Acquisitions and disposals of items of property, plant and equipment.
- Commitments for the purchase of property, plant and equipment.
- Litigation settlements.
- Corrections of prior period errors.
- Changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, where those assets or liabilities are measured at fair value.
- Any loan default or breach of a loan agreement that is not remedied on or before the end of the reporting period.
- Related party transactions, unless the transaction was entered into between two or more members of a group, provided that any subsidiary which is a party to the transaction is wholly owned by such a member.

And

- Changes in contingent liabilities or contingent assets.

FRS 104 states that the above list of events and transactions is not exhaustive and the interim financial report should explain any additional events and transactions that are significant to an understanding of changes in the entity's financial position and performance. *[FRS 104.15, FRS 104.15B]*. Therefore, when information changes significantly (for example, the values of non-financial assets and liabilities that are measured at fair value), an entity should provide disclosure regarding such change, in addition to the requirements listed above, and the disclosure should be sufficiently detailed to explain the nature of the change and any changes in estimates. This would apply, for example, if:

- The range of reasonably possible changes in key assumptions has significantly changed since the end of the last annual reporting period. If this is the case an update of relevant sensitivity disclosures may be required.

Or

- The values of non-financial assets and liabilities that are measured at fair value change significantly.

The considerations in the preceding paragraph related to the disclosure of information about significant changes including the examples related to key assumptions and sensitivity is also relevant when an entity prepares its first interim financial statements adopting a new accounting pronouncement as discussed in 8.1.2.A below.

The disclosures suggested by paragraph 15B can be given either in the notes to the interim financial statements or, if disclosed elsewhere in the interim financial report, cross-referred to the disclosure in the notes to the interim financial statements. [FRS 104.15B].

4.1.1 Relevance of other standards in condensed financial statements

Whilst FRS 102 specifies disclosures required in a complete set of financial statements, if an entity's interim financial report includes only condensed financial statements as described in FRS 104, then the disclosures required by those other standards are not mandatory. However, if disclosure is considered to be necessary in the context of an interim report, FRS 102 provides guidance on the appropriate disclosures for many of these items. [FRS 104.15C]. For example, in meeting the requirements of (g) at 4.1 above to disclose the impact of corrections of prior period errors, the requirements of Section 10 *Accounting Policies, Estimates and Errors* would be relevant (see Chapter 9 at 3.6).

4.2 Other disclosures required by FRS 104

In addition to disclosing significant events and transactions as discussed at 4.1 above, FRS 104 requires an entity to include the following information either in the notes to its interim financial statements or, if disclosed elsewhere in the interim financial report, cross-referred from the notes: [FRS 104.16A]

- A statement that the same accounting policies and methods of computation are followed in the interim financial statements as in the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.
- Explanatory comments about the seasonality or cyclicity of interim operations.
- The nature and amount of items affecting assets, liabilities, equity, profit or loss, or cash flows that are unusual because of their nature, size, or incidence.
- The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years.
- Issues, repurchases, and repayments of debt and equity securities.
- Dividends paid (aggregate or per share) separately for ordinary shares and other shares.
- Certain segment disclosures as discussed at 4.3 below; but only if the entity has presented segment information in accordance with IFRS 8 *Operating Segments* in its most recent annual financial statements.
- Events after the interim period that are not reflected in the financial statements for the interim period.
- The effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. For business combinations, the entity must disclose the information required by paragraphs 19.25 and 19.25A of FRS 102 (see Chapter 22 at 4).

And

- For financial instruments, certain disclosures in respect of financial instruments measured at fair value and as required by paragraphs 11.43, 11.48A(e) and 34.22 of FRS 102; but only if the entity would be required to make the disclosure in the annual financial statements, as discussed at 4.4 below.

This information is normally reported on a financial year-to-date basis (see 8 below). [FRS 104.16A].

4.2.1 Disclosure relating to business combinations

For business combinations that occurred during the reporting period which, individually, are not material, FRS 102 allows the disclosure of revenue and profit or loss to date to be given in aggregate.

[FRS 102.19.25A]. However, materiality is assessed for the interim period, which implies that FRS 104 may require more detailed disclosures on business combinations that are material to an interim period even if they could be aggregated for disclosure purposes in the annual financial statements prepared under FRS 102.

4.2.2 Disclosures relating to disposals, discontinued operations and restructurings

If an entity has operations that are discontinued or disposed of during an interim period, these operations must be presented separately in the condensed interim statement of comprehensive income following the principles set out in Section 5 *Statement of Comprehensive Income and Income Statement*.

An entity contemplating a significant restructuring that will have an impact on its composition should follow the guidance in Section 21 *Provisions and Contingencies* for the recognition of any restructuring cost, [FRS 102.21.11C], and Section 28 *Employee Benefits* for the recognition of any termination benefits. [FRS 102.28.31]. In subsequent interim periods any significant changes, including reversals, to restructuring provisions will require disclosure. [FRS 104.15B(c)].

4.2.3 Location of the specified disclosures in an interim financial report

FRS 104 defines an “interim financial report” as “a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period”. [FRS 104 Appendix I]. Therefore, since an interim financial report contains the interim financial statements, it is clear that these are two different concepts. Accordingly, an entity is not required to disclose the information listed at 4.1 and 4.2 above in the interim financial statements themselves, as long as a cross reference is provided from the financial statements to the location of the information included in another part of the interim financial report. [FRS 104.15B, FRS 104.16A].

4.3 Segment information

If an entity has presented segment information in accordance with IFRS 8 in its most recent annual financial statements, certain segment disclosures are required in its interim financial report.

An entity applying IFRS 8 in its most recent annual financial statements must include the following information in its interim financial report about its reportable segments: [FRS 104.16A(g)]

- Revenues from external customers (if included in the measure of segment profit or loss reviewed by or otherwise regularly provided to the chief operating decision maker).
 - Intersegment revenues (if included in the measure of segment profit or loss reviewed by or otherwise regularly provided to the chief operating decision maker).
 - A measure of segment profit or loss.
 - A measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last annual financial statements for that reportable segment.
 - A description of differences in the basis of segmentation or in the basis of measurement of segment profit or loss from the last annual financial statements.
- And
- A reconciliation of the total profit or loss for reportable segments to the entity’s profit or loss before income taxes and discontinued operations. However, if an entity allocates such items as income taxes to arrive at segment profit or loss, the reconciliation can be to the entity’s profit or loss after those items. The entity should separately identify and describe all material reconciling items.

4.4 Fair value disclosures for financial instruments

If an entity would be required to make equivalent disclosures in its annual financial statements, FRS 104 requires that an entity must include the following in its interim financial report in order to help users evaluate the significance of financial instruments measured at fair value: *[FRS 104.16A(j)]*

- For all financial assets and financial liabilities measured at fair value, the entity must disclose the basis for determining fair value, e.g., quoted market price in an active market or a valuation technique. When a valuation technique is used, the entity must disclose the assumptions applied in determining fair value for each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. *[FRS 102.11.43]*. See Chapter 15 at 4.1.2.B.
- For financial instruments at fair value through profit or loss that are not held as part of a trading portfolio and are not derivatives, any difference between the fair value at initial recognition and the amount that would be determined at that date using a valuation technique, the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period, and a reconciliation of the changes in the balance of this difference. *[FRS 102.11.48A(e)]*. See Chapter 15 at 4.1.2.H.
- A financial institution must disclose for each class of financial instrument held at fair value in the statement of financial position, an analysis of the level in the fair value hierarchy (as set out in paragraph 11.27) into which the fair value measurements are categorised. *[FRS 102.34.22]*. The inclusion of the above disclosure requirements among the items required by the standard which are to be given “in addition to disclosing significant events and transactions”, *[FRS 104.16A]*, distinguishes it from the items listed at 4.1 above, which are required to update information presented in the most recent annual financial report. *[FRS 104.15]*. Therefore, disclosure of the above information is required for each interim reporting period, subject only to a materiality assessment in relation to that interim report, i.e., an entity could consider it unnecessary to disclose the above information on the grounds that it is not relevant to an understanding of its financial position and performance in that specific interim period. *[FRS 104.25]*. In making that judgement care would need to be taken to ensure any omitted information would not make the interim financial report incomplete and therefore misleading.

An entity may also consider meeting the disclosure requirement through cross-reference to the information disclosed in other parts of the interim report as discussed at 4.2.3 above.

4.5 Disclosure of compliance with FRS 104

If an interim financial report complies with the requirements of FRS 104, this fact must be disclosed. Furthermore, an entity that makes a statement of compliance with FRS 104 must comply with all of its provisions. FRS 104 does not need to be applied to immaterial items. *[FRS 104.3, FRS 104.19]*.

5 Entities reporting under FRS 101

As noted at 2 above, FRS 104 is intended for use by entities that prepare annual financial statements in accordance with FRS 102. However, it can also be used by entities that report under FRS 101, and in those circumstances, references included in FRS 104 to FRS 102 should be read as references to the equivalent requirements in adopted IFRS as amended by paragraph AG1 of FRS 101. [FRS 104.2A].

The references to FRS 102 fall into three main categories:

- Disclosure of significant events and transactions (see 5.1 below).
- Business combinations (see 5.2 below).
- And
- Financial instruments (see 5.3 below).

While there are references to FRS 102 in other paragraphs of FRS 104, we do not expect that these will give rise to any significant differences in the application of FRS 104 between FRS 101 and FRS 102 reporters. These references are in financial statement presentation, materiality, recognition and changes in accounting policy. [FRS 104.7, FRS 104.8B, FRS 104.9, FRS 104.16B, FRS 104.24, FRS 104.31, FRS 104.30, FRS 104.33, FRS 104.43].

In respect of changes in accounting policies, see 8.1.2 below.

5.1 Disclosure of significant events and transactions

As discussed at 4.1 above, FRS 104 requires entities to include, in their interim financial statements, an explanation of events and transactions that are significant to an understanding of changes in the financial position and performance of the entity since the end of the previous reporting period. FRS 104 sets out a non-exhaustive list of the types of transactions and events entities might include. [FRS 104.15, FRS 104.15B].

FRS 104 refers to individual sections of FRS 102 for guidance on disclosure requirements for many of the items on the list referred to above. [FRS 104.15C]. For entities reporting under FRS 101, this reference should be amended to the relevant standard under adopted IFRS as amended by FRS 101. For example, for guidance on the disclosure requirements in respect of the acquisitions and disposals of items of property, plant and equipment, entities should refer to IAS 16 *Property, Plant and Equipment* rather than Section 17 *Property, Plant and Equipment* of FRS 102. For further discussion on any significant differences in disclosure between the relevant section of FRS 102 and the equivalent standard under adopted IFRS, refer to the key differences section of the relevant chapter in this publication.

5.2 Business combinations

Paragraph 16A(i) of FRS 104 requires entities to include in their interim financial statements details of the effect of changes in the composition of the entity during the interim period including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings and discontinued operations. In particular, entities are required to disclose the information set out in paragraphs 25 and 25A of FRS 102 Section 19 *Business Combinations and Goodwill* (see Chapter 22 at 4.1). For FRS 101 reporters we believe the equivalent requirements under adopted IFRS are those set out in paragraph 16A(i) of IAS 34, which cross-refer to the requirements in paragraphs 59-63 and B64-67 of IFRS 3 *Business Combinations*.

5.3 Financial instruments

FRS 104 requires entities to include in their interim financial statements disclosures that help users to evaluate the significance of financial instruments measured at fair value. [FRS 104.16A(j)]. In particular, entities are required to give the disclosures set out in paragraphs 43 and 48A(e) of Section 11 *Basic Financial Instruments* and paragraph 22 of Section 34 *Specialised Activities*.

For FRS 101 reporters we believe the equivalent requirements under adopted IFRS are those set out in paragraphs 91-93(h), 94-96, 98 and 99 of IFRS 13 *Fair Value Measurement* and paragraphs 25, 26 and 28-30 of IFRS 7 *Financial Instruments: Disclosures*.

The IFRS 13 disclosures detailed above will only be required if an entity has financial instruments which (after initial recognition) are measured at fair value on a recurring or non-recurring basis.

FRS 101 allows qualifying entities that are not financial institutions (see Chapter 2 at 2.1 and Appendix I for the definitions of a qualifying entity and a financial institution, respectively) to take advantage of exemptions to disclose information required by IFRS 7 and paragraphs 91 to 99 of IFRS 13 in their annual financial statements, provided that equivalent disclosures are included in the consolidated financial statement of the group in which the entity is consolidated. If such disclosure exemptions are reasonably expected to be taken by the qualifying entity when preparing its annual financial statements, there is no requirement to disclose such information in the entity's interim financial report.

6 Periods for which interim financial statements are required to be presented

Irrespective of whether an entity presents condensed or complete interim financial statements, the components of its interim financial reports must include information for the following periods: [FRS 104.20]

- A statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year.
- A statement of profit or loss and other comprehensive income for the current interim period and, if different, cumulatively for the current financial year-to-date, with comparative statements of profit or loss and other comprehensive income for the comparable interim periods (current and, if different, year-to-date) of the immediately preceding financial year.
- A statement of changes in equity cumulatively for the current financial year-to-date period, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

And

- A statement of cash flows cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

The requirement in (d) does not apply to entities that will not present a statement of cash flows in their next annual financial statements.

An interim financial report must present for each period either a single statement of 'profit or loss and other comprehensive income', or separate statements of 'profit or loss' and 'comprehensive income', consistent with the basis of preparation applied in its most recent annual financial statements. Accordingly, if the entity presents a separate statement for items of profit or loss in its annual financial statements, it must present a separate condensed statement of profit or loss in the interim financial report. [FRS 104.8A]. If an entity's business is highly seasonal, then the standard encourages reporting additional financial information for the twelve months up to the end of the interim period, and comparative information for the prior twelve-month period, in addition to the financial statements for the periods set out above. [FRS 104.21].

An entity that presents a single condensed statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity must present a single condensed statement of income and retained earnings for the periods for which interim financial statements are required to be presented. [FRS 104.20A].

An entity that presents an income statement, or a statement of comprehensive income in which the 'bottom line' is labelled 'profit or loss' must present an income statement or a statement of comprehensive income on that basis for the periods for which interim financial statements are required to be presented.

[FRS 104.20B].

The Illustrations below show the periods that an entity is required and encouraged to disclose under FRS 104. [FRS 104 Appendix II].

Illustration 6-1: Entity publishes interim financial reports half-yearly

If an entity's financial year ends on 31 December (calendar year), it should present the following financial statements (condensed or complete) in its half-yearly interim financial report as of 30 June 20X6:

Half-yearly interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/6/20X6	30/6/20X5	31/12/20X5
Statement of financial position	●		●
Statement(s) of profit or loss and other comprehensive income			
- Current period and year-to-date (6 months) ending	●	●	
- 12 months ending	○	○	
Statement of changes in equity			
- Year-to date (6 months) ending	●	●	
- 12 months ending	○	○	
Statement of cash flows			
- Year-to-date (6 months) ending	●	●	
- 12 months ending	○	○	
● Required ○ Disclosure encouraged if the entity's business is highly seasonal			

If an entity publishes a separate interim financial report for the final interim period (i.e., second half of its financial year), it presents the following financial statements (condensed or complete) in its second half-yearly interim financial report as of 31 December 20X6:

Second half-yearly interim report	End of the current interim period	End of the comparative interim period
	31/12/20X6	31/12/20X5
Statement of financial position	•	•
Statement(s) of profit or loss and other comprehensive income		
- Current period (6 months) ending	•	•
- Year-to-date (12 months) ending	•	•
Statement of changes in equity		
- Year-to-date (12 months) ending	•	•
Statement of cash flows		
- Year-to-date (12 months) ending	•	•
• Required		

Illustration 6-2: Entity publishes interim financial reports quarterly

If an entity's financial year ends on 31 December (calendar year), it should present the following financial statements (condensed or complete) in its quarterly interim financial reports for 20X6:

First quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	31/3/20X6	31/3/20X5	31/12/20X5
Statement of financial position	•		•
Statement(s) of profit or loss and other comprehensive income			
- Current period and year-to-date (3 months) ending	•	•	
- 12 months ending	○	○	
Statement of changes in equity			
- Year-to-date (3 months) ending	•	•	
- 12 months ending	○	○	
Statement of cash flows			
- Year-to-date (3 months) ending	•	•	
- 12 months ending	○	○	
• Required ○ Disclosure encouraged if the entity's business is highly seasonal			
Second quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/6/20X6	30/6/20X5	31/12/20X5
Statement of financial position	•		•
Statement(s) of profit or loss and other comprehensive income			
- Current period (3 months) ending	•	•	
- Year-to-date (6 months) ending	•	•	
- 12 months ending	○	○	
Statement of changes in equity			
- Year-to-date (6 months) ending	•	•	
- 12 months ending	○	○	
Statement of cash flows			
- Year-to-date (6 months) ending	•	•	
- 12 months ending	○	○	
• Required ○ Disclosure encouraged if the entity's business is highly seasonal			

Third quarter interim report	End of the current interim period	End of the comparative interim period	Immediately preceding year-end
	30/9/20X6	30/9/20X5	31/12/20X5
Statement of financial position	•		•
Statement(s) of profit or loss and other comprehensive income			
- Current period (3 months) ending	•	•	
- Year-to-date (9 months) ending	•	•	
- 12 months ending	○	○	
Statement of changes in equity			
- Year-to-date (9 months) ending	•	•	
- 12 months ending	○	○	
Statement of cash flows			
- Year-to-date (9 months) ending	•	•	
- 12 months ending	○	○	
• Required ○ Disclosure encouraged if the entity's business is highly seasonal			
If an entity publishes a separate interim financial report for the final interim period (i.e., fourth quarter of its financial year), it presents the following financial statements (condensed or complete) in its fourth quarter interim financial report as of 31 December 20X6:			
Fourth quarter interim report	End of the current interim period	End of the comparative interim period	
	31/12/20X6	31/12/20X5	
Statement of financial position	•	•	
Statement(s) of profit or loss and other comprehensive income			
- Current period (3 months) ending	•	•	
- Year-to-date (12 months) ending	•	•	
Statement of changes in equity			
- Year-to-date (12 months) ending	•	•	
Statement of cash flows			
- Year-to-date (12 months) ending	•	•	
• Required			

6.1 Other comparative information

For entities presenting condensed financial statements under FRS 104, there is no explicit requirement that comparative information be presented in the explanatory notes. Nevertheless, where an explanatory note is required by the standard (such as for inventory write-downs, impairment provisions, segment revenues etc.) or otherwise determined to be needed to provide useful information about changes in the financial position and performance of the entity since the end of the last annual reporting period, [FRS 104.15], it would be appropriate to provide information for each period presented. However, in certain cases it would be unnecessary to provide comparative information where this repeats information that was reported in the notes to the most recent annual financial statements. [FRS 104.15A]. For example, it would only be necessary to provide information about business combinations in a comparative period when there is a revision of previously disclosed fair values. See Chapter 22 at 4.1.

For entities presenting complete financial statements, whilst FRS 104 sets out the periods for which components of the interim report are included, it is less clear how these rules interact with the requirement in FRS 102 to report comparative information for all amounts in the financial statements unless permitted or required otherwise by FRS 102. [FRS 102.3.14].

How we see it

In our view, a complete set of interim financial statements must include comparative disclosures for all amounts presented, unless permitted or required otherwise by FRS 102.

6.2 Change in financial year-end

The requirement in FRS 104 to present a comparative statement of profit or loss and other comprehensive income “for the comparable interim period (current and, if different, year-to-date) of the immediately preceding financial year”, [FRS 104.20], can give rise to diversity in practice in the case of an entity that changes its annual financial reporting date. For example, an entity changing its reporting date from 31 December to 31 March would change its half-yearly reporting date from 30 June to 30 September and therefore present its first half-yearly report after its new annual reporting date for the six-month period from 1 April to 30 September. A ‘comparable’ comparative interim period in this scenario could be taken to mean the six months ended 30 September in the prior year, as illustrated in Illustration 6-3 below.

[FRS 104.20].

Illustration 6-3: Entity changes financial year-end

If an entity changes its financial year-end from 31 December (calendar year) to 31 March and first reflects the change in its annual financial statements for the period ended 31 March 20X6. It determines that the requirement for comparable comparative information in FRS 104 requires it to present the following financial statements (condensed or complete) in its half-yearly interim financial report for the six months ending 30 September 20X6:

Half-yearly interim report	End of the current interim period	End of the comparable interim period	Immediately preceding year-end
	30/9/20X6	30/9/20X5	31/03/20X6
Statement of financial position	•		•
Statement(s) of profit or loss and other comprehensive income			
- Current period and year-to-date (6 months) ending	•	•	
- 12 months ending	○	○	
Statement of changes in equity			
- Year-to date (6 months) ending	•	•	
- 12 months ending	○	○	
Statement of cash flows			
- Year-to-date (6 months) ending	•	•	
- 12 months ending	○	○	
• Required ○ Disclosure encouraged if the entity’s business is highly seasonal			

The entity in the example above does not show information for the half-year ended 30 June 20X5 as the comparative period, notwithstanding the fact that this period would have been the reporting date for the last published half-yearly report.

How we see it

However, given the lack of clarity in FRS 104 as to the meaning of ‘comparable’ in the case where the current financial year runs for a period that is different to ‘the immediately preceding financial year’, other interpretations are possible.

7 Materiality

In making judgements on recognition, measurement, classification, or disclosures in interim financial reports, the overriding goal in FRS 104 is to ensure that an interim financial report includes all information relevant to understanding an entity's financial position and performance during the interim period.

[FRS 104.25]. The standard draws from Section 2 *Concepts and Pervasive Principles* of FRS 102 which defines an item as material if its omission or misstatement could influence the economic decisions of users of the financial statements but does not contain quantitative guidance on materiality. [FRS 102.2.11]. See Chapter 4 at 3.3.1.B. FRS 104 requires materiality to be assessed based on the interim period financial data.

[FRS 104.23].

Materiality is an entity-specific aspect of relevance that depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole. [FRS 104.24].

Therefore, decisions on the recognition and disclosure of unusual items, changes in accounting policies or estimates, and errors are based on materiality in relation to the interim period figures to determine whether non-disclosure is misleading. [FRS 104.25].

Neither the previous year's financial statements nor any expectations of the financial position at the current year-end are relevant in assessing materiality for interim reporting. However, the standard adds that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. [FRS 104.23].

8 Recognition and measurement

The recognition and measurement requirements in FRS 104 arise mainly from the requirement to report the entity's financial position as at the interim reporting date but also require certain estimates and measurements to take into account the expected financial position of the entity at year-end, where those measures are determined on an annual basis (as in the case of income taxes). Many preparers misinterpret this approach as representing some form of hybrid of the discrete and integral methods to interim financial reporting. This could cause confusion in application.

In requiring the year-to-date to be treated as a discrete period, FRS 104 prohibits the recognition or deferral of revenues and costs for interim reporting purposes unless such recognition or deferral is appropriate at year-end. As with a set of annual financial statements complying with FRS 102, FRS 104 requires changes in estimates and judgements reported in previous interim periods to be revised prospectively, whereas changes in accounting policies and corrections of material prior period errors are required to be recognised by prior period adjustment. However, FRS 104 allows looking beyond the interim reporting period, for example in estimating the tax rate to be applied on earnings for the period, when a year-to-date approach does not.

The recognition and measurement requirements of FRS 104 apply regardless of whether an entity presents a complete or condensed set of financial statements for an interim period, [FRS 104.7], and are discussed below.

8.1 Same accounting policies as in annual financial statements

The principles for recognising assets, liabilities, income and expenses for interim periods are the same as in the annual financial statements. [FRS 104.29]. Accordingly, an entity uses the same accounting policies in its interim financial statements as in its most recent annual financial statements, adjusted for accounting policy changes that will be reflected in the next annual financial statements. [FRS 104.28]. However, FRS 104 also states that the frequency of an entity's reporting (annual, half-yearly or quarterly) does not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes are on a year-to-date basis. [FRS 104.28A].

8.1.1 Measurement on a year-to-date basis

Measurement on a year-to-date basis acknowledges that an interim period is a part of a full year and allows adjustments to estimates of amounts reported in prior interim periods of the current year. [FRS 104.29, FRS 104.34].

The principles for recognition and the definitions of assets, liabilities, income and expenses for interim periods are the same as in the annual financial statements. [FRS 104.29, FRS 104.31]. Therefore, for assets, the same tests of future economic benefits apply at interim dates as at year-end. Costs that, by their nature, do not qualify as assets at year-end, do not qualify for recognition at interim dates either. Similarly, a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period. [FRS 104.32]. An essential characteristic of income and expenses is that the related inflows and outflows of assets and liabilities have already occurred. If those inflows or outflows have occurred, the related income and expense are recognised, otherwise they are not recognised. [FRS 104.33].

FRS 104 lists several circumstances that illustrate these principles:

- Inventory write-downs, impairments, or provisions for restructurings are recognised and measured on the same basis as at a year-end. Later changes in the original estimate are recognised in the subsequent interim period, either by recognising additional accruals or reversals of the previously recognised amount. [FRS 104.30(a)].
- Costs that do not meet the definition of an asset at the end of an interim period are not deferred in the statement of financial position, either to await information on whether it meets the definition of an asset, or to smooth earnings over interim periods within a year. [FRS 104.30(b)]. For example, costs incurred in acquiring an intangible asset before the recognition criteria in FRS 102 are met are expensed under Section 18 *Intangible Assets other than Goodwill*. Only those costs incurred after the recognition criteria are met can be recognised as an asset; there is no reinstatement as an asset in a later period of costs previously expensed because the recognition criteria were not met at that time. [FRS 102.18.17].

And

- Income tax expense is “recognised in each interim period based on the best estimate of the weighted-average annual income tax rate expected for the full financial year, using the tax rates and laws that have been enacted or substantively enacted at the end of an interim reporting period. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes”. [FRS 104.30(c)].

8.1.2 New accounting pronouncements and other changes in accounting policies

As noted at 8.1 above, an entity uses the same accounting policies in its interim financial statements as in its most recent annual financial statements, adjusted for accounting policy changes that will be reflected in the next annual financial statements. [FRS 104.28].

FRS 104 requires that a change in accounting policy, other than where the transition rules are specified by FRS 102, must be reflected by: [FRS 104.43]

- Restating the financial statements of prior interim periods of the current year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements under Section 10 of FRS 102.
- Or
- When it is impracticable to determine the cumulative effect at the beginning of the year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current year and comparable interim periods of prior years to apply the new accounting policy prospectively from the earliest date practicable.

Therefore, regardless of when in a financial year an entity decides to adopt a new accounting policy, it has to be applied from the beginning of the current year. [FRS 104.44]. For example, if an entity that reports on a quarterly basis decides in its third quarter to change an accounting policy, it must restate the information presented in earlier quarterly financial reports to reflect the new policy as if it had been applied from the start of the annual reporting period. Disclosures regarding the restatement can be presented on the face of the financial statements or disclosed in the notes to the financial statements.

8.1.2.A Accounting policy changes becoming mandatory during the current year

One objective of the year-to-date approach, described at 8.1.2 above, is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. [FRS 104.44]. To allow accounting policy changes to be reflected as of an interim date would mean applying different accounting policies to a particular class of transactions within a single year. This would make interim allocation difficult, obscure operating results, and complicate analysis and understandability of the interim period information. [FRS 104.45].

Accordingly, when preparing interim financial information, consideration is given to which amendments to FRSs are mandatory in the next (current year) annual financial statements. The entity generally adopts these amendments in all interim periods during that year.

While FRS 104 generally prohibits an entity from reflecting the adoption of a new accounting policy as of an interim date, it makes an exception for those accounting policy changes for which FRS 102 specifically requires transition during the financial year. [FRS 104.43].

The disclosure requirements with respect to amendments which are effective for the entity's next annual financial statements, but which do not contain specific disclosure requirements under FRS 104, are not clear. In some cases, it might be determined that an understanding of an amendment is material to an understanding of the entity, in which case the entity discloses this fact, as well as information relevant to assessing the possible impact of the amendment on the entity's financial statements. [FRS 102.10.13]. In other cases, an entity might conclude that a particular amendment is not material to an understanding of its interim financial report, and thus not disclose information about the issuance of the amendment, or its possible impact on the entity.

8.1.2.B Voluntary changes of accounting policy

An entity can also elect at any time during a year to apply an amendment to an FRS before it becomes mandatory or otherwise decide to change an accounting policy voluntarily. However, before voluntarily changing an accounting policy, consideration must be given to the interaction of the requirements of Sections 2 and 10 of FRS 102 which only permit an entity to change an accounting policy if the information results in information that is 'reliable and more relevant' to the users of the financial statements. [FRS 102.10.8(b)].

After concluding that a voluntary change in accounting policy is permitted and appropriate, its effect is generally reflected in the first interim report the entity presents after the date on which the entity changed its policy. The entity generally restates amounts reported in earlier interim periods as far back as is practicable. [FRS 104.44]. One exception to this principle of retrospective adjustment of earlier interim periods is when an entity changes from the cost model to the revaluation model under Section 17 or Section 18. These are not changes in accounting policy that are covered by FRS 102 in the usual manner, but instead are required to be treated as a revaluation in the period. [FRS 102.10.10A]. This means that the revaluation is accounted for prospectively using the fair value at the date of the revaluation. [FRS 102.17.15B, FRS 102.18.18B]. Therefore, the general requirements of FRS 104 do not override the specific requirements of Section 10 of FRS 102 to treat such changes prospectively.

However, to avoid using two differing accounting policies for a particular class of assets in a single financial year, consideration should be given to changing from the cost model to the revaluation model at the beginning of the financial year. Otherwise, an entity will end up depreciating based on cost for some interim periods and based on the revalued amounts for later interim periods.

8.1.3 Change in going concern assumption

Another situation in which an entity applies different accounting policies in its interim financial statements as compared to its most recent annual financial statements is when the going concern assumption is no longer appropriate.

Although FRS 104 does not specifically address the issue of going concern, the general requirements of Section 3 of FRS 102 apply to both a complete set and to condensed interim financial statements. Section 3 states that when preparing financial statements, management assesses an entity's ability to continue as a going concern, and that the financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or cease trading or has no realistic alternative but to do so. [FRS 102.3.8]. The going concern assessment is discussed in more detail in Chapter 6 at 8.3.

Under Section 3, the going concern assessment is made based on all available information about the future, which at a minimum is twelve months from the 'date when the financial statements are authorised for issue'. [FRS 102.3.8]. Therefore, with respect to interim reporting under FRS 104, the minimum period for management's assessment is also at least twelve months from the date when the interim report is authorised for issue; it is not limited, for example, to one year from the authorisation date of the most recent annual financial statements. [FRS 104.4A].

Illustration 8-1: Going concern assessment

An entity's financial year-end is 31 December (calendar year) and its annual financial statements as of 31 December 20X4 are prepared on a going concern basis. In assessing the going concern assumption as at 31 December 20X4 management considered all future available information through to 31 December 20X5. In preparing its quarterly interim financial statements (condensed or complete) as at 31 March 20X5, management must evaluate all future available information to at least 31 March 20X6.

If any material uncertainties related to events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, the entity must disclose those uncertainties. If an entity does not prepare its interim financial statements on a going concern basis, it must disclose: [FRS 104.4B]

- The fact there are material uncertainties.
- The basis on which the interim financial statements are prepared.
- And
- The reason why the entity is not regarded as a going concern.

8.1.4 Voluntary changes in presentation

In some cases, the presentation of the interim financial statements might be changed from that used in prior interim reporting periods. However, before changing the presentation used in its interim report from that of previous periods, management should consider the interaction of the requirements of FRS 104 to include in a set of condensed financial statements the same headings and sub-totals as the most recent annual financial statements, [FRS 104.10], and to apply the same accounting policies as the most recent or the next annual financial report, [FRS 104.28], and the requirements of Section 3 of FRS 102 as they will relate to those next annual financial statements. Section 3 requires an entity to retain the presentation and classification of items in the financial statements, unless it is apparent following a significant change in the nature of operations or a review of the financial statements that another presentation is more appropriate, or unless the change is required by FRS 102, or another applicable FRS. [FRS 102.3.11].

If a presentation is changed, the entity must also reclassify comparative amounts for both earlier interim periods of the current financial year and comparable periods in prior years. [FRS 104.43(a)]. In such cases, an entity must disclose the nature of the reclassifications, the amount of each item (or class of items) that is reclassified, and the reason for the reclassification. [FRS 102.3.12].

8.2 Seasonal businesses

Some entities do not earn revenues or incur expenses evenly throughout the year, for example, agricultural businesses, holiday companies, domestic fuel suppliers, or retailers who experience peak demand at Christmas. The financial year-end is often chosen to fit their annual operating cycle, which means that an individual interim period would give little indication of annual performance and financial position.

An extreme application of the integral approach would suggest that they must predict their annual results and contrive to report half of that in the half-year interim financial statements. However, this approach does not portray the reality of their business in individual interim periods, and is, therefore, not permitted under the year-to-date approach adopted in FRS 104. [FRS 104.28A].

8.2.1 Revenues received seasonally, cyclically or occasionally

FRS 104 prohibits the recognition or deferral of revenues that are received seasonally, cyclically or occasionally at an interim date, if recognition or deferral would not be appropriate at year-end. [FRS 104.37]. Examples of such revenues include dividend revenue, royalties, government grants, and seasonal revenues of retailers; such revenues are recognised when they occur. [FRS 104.38].

FRS 104 also requires an entity to explain the seasonality or cyclicity of its business and the effect on interim reporting. [FRS 104.16A(b)]. If businesses are highly seasonal, FRS 104 encourages reporting of additional information for the twelve months up to the end of the interim period and comparatives for the prior twelve-month period (see 6 above). [FRS 104.21].

8.2.2 Costs incurred unevenly during the year

FRS 104 prohibits the recognition or deferral of costs for interim reporting purposes if recognition or deferral of that type of cost is inappropriate at year-end, [FRS 104.39], which is based on the principle that assets and liabilities are recognised and measured using the same criteria as at the year-end. [FRS 104.29, FRS 104.31]. This principle prevents smoothing of costs in seasonal businesses. Furthermore, the recognition of assets or liabilities at the interim date would not be appropriate if they would not qualify for recognition at the end of an annual reporting period.

For direct costs, this approach has limited consequences, as the timing of recognising these costs and the related revenues is usually similar. However, for indirect costs, the consequences may be greater, depending on which section of FRS 102 an entity follows.

For example, manufacturing entities that use fixed production overhead absorption rates recognise an asset in respect of attributable overheads based on the normal capacity of the production facilities in accordance with Section 13 *Inventories*. Any variances and unallocated overheads are expensed. [FRS 102.13.9].

9 Examples of the recognition and measurement principles

Appendix II of FRS 104 provides several examples that illustrate the recognition and measurement principles in interim financial reports. [FRS 104.40].

9.1 Property, plant and equipment and intangible assets

9.1.1 Depreciation and amortisation

Depreciation and amortisation for an interim period is based only on assets owned during that interim period and does not consider asset acquisitions or disposals planned for later in the year. [FRS 104.A2.26].

An entity applying a straight-line method of depreciation (amortisation) does not allocate the depreciation (amortisation) charge between interim periods based on the level of activity. However, under Sections 17 and 18, an entity may use a 'unit of production' method of depreciation, which results in a charge based on the expected use or output (see Chapter 20 at 3.6.5.C and Chapter 21 at 3.3.3.B). An entity can only apply this method if it most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The chosen method must be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits. Therefore, an entity cannot apply a straight-line method of depreciation (amortisation) in its annual financial statements, while allocating the depreciation (amortisation) charge to interim periods using a 'unit of production' based approach.

9.1.2 Impairment of assets

Section 27 *Impairment of Assets* of FRS 102 requires an entity to recognise an impairment loss if the recoverable amount of an asset declines below its carrying amount. [FRS 104.A2.37]. An entity must apply the same impairment testing, recognition, and reversal criteria at an interim date as it would at year-end. [FRS 104.A2.38].

However, FRS 104 states that an entity is not required to perform a detailed impairment calculation at the end of each interim period. Rather, an entity must perform a review for indications of significant impairment since the most recent year-end to determine whether such a calculation is needed. [FRS 104.A2.38]. Nevertheless, an entity is not exempt from performing impairment tests at the end of its interim periods. For example, an entity that recognised an impairment charge in the immediately preceding year, may find that it needs to update its impairment calculations at the end of subsequent interim periods because impairment indicators remain.

9.1.3 Recognition of intangible assets

An entity must apply the same definitions and recognition criteria for intangible assets, as set out in Section 18 of FRS 102, in an interim period as in an annual period. Therefore, costs incurred before the recognition criteria are met must be recognised as an expense. [FRS 104.A2.10]. Expenditures on intangibles that are initially expensed cannot be reinstated and recognised as part of the cost of an intangible asset subsequently (e.g., in a later interim period). [FRS 102.18.17]. Furthermore, 'deferring' costs as assets in an interim period in the hope that the recognition criteria will be met later in the year is not permitted. Only costs incurred after the specific point in time at which the criteria are met must be recognised as part of the cost of an intangible asset. [FRS 104.A2.10].

9.1.4 Capitalisation of borrowing costs

As discussed in Chapter 27 an entity may adopt a policy of capitalising borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Where an entity adopts a policy of capitalisation of borrowing costs, it must be applied consistently to a class of qualifying assets. Where an entity does not adopt a policy of capitalising borrowing costs, all borrowing costs must be recognised as an expense in profit or loss in the period in which they are incurred. [FRS 102.25.2]. When the asset is funded out of general borrowings, by applying a capitalisation rate equal to the weighted average of the finance costs attributable to actual borrowings outstanding during the period. [FRS 102.25.2C]. For interim financial reporting, measurement must be on a year-to-date basis, [FRS 104.28A], regardless of how often the entity issues interim reports during a year. For example, an entity that issues quarterly interim reports would have to revise its estimated capitalisation rate in successive quarters during the same year for changes in actual year-to-date borrowings and finance costs. The cumulative effect of changes in the estimated capitalisation rate must be recognised in the current quarter (as a change in estimate) and not retrospectively. [FRS 104.35]. In such situations entities must consider the requirement in paragraph 16A(d) of FRS 104 (see 8.1.1 above) to disclose the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year.

9.2 Employee benefits

9.2.1 Employer payroll taxes and insurance contributions

If employer payroll taxes or contributions to government-sponsored insurance funds are assessed on an annual basis, the employer's related expense must be recognised in interim periods using an estimated average annual effective rate, even if it does not reflect the timing of payments. A common example is an employer payroll tax or insurance contribution subject to a certain maximum level of earnings per employee. Higher income employees would reach the maximum income before year-end, and the employer would make no further payments for the remainder of the year. [FRS 104.A21.3].

9.2.2 Year-end bonuses

The nature of year-end bonuses varies widely. Some bonus schemes only require continued employment whereas others require certain performance criteria to be attained on a monthly, quarterly, or annual basis. Payment of bonuses may be purely discretionary, contractual or based on years of historical precedent.

[FRS 104.A2.7]. A bonus is recognised for interim reporting if, and only if: [FRS 104.A2.8]

- The entity has a present legal or constructive obligation to make such payments as a result of past events.
- And
- A reliable estimate of the obligation can be made.

A present obligation exists only when an entity has no realistic alternative but to make the payments.

[FRS 102.21.6]. Section 28 of FRS 102 gives guidance on accounting for profit sharing and bonus plans (see Chapter 30 at 3.2).

In recognising a bonus at an interim reporting date, an entity must consider the facts and circumstances under which the bonus is payable and determine an accounting policy that recognises an expense reflecting the obligation on the basis of the services received to date. Several possible accounting policies are shown in Illustration 9-1 below.

Illustration 9-1: Measuring interim bonus expense

An entity pays an annual performance bonus if earnings exceed £10 million, under which 5% of any earnings in excess over £10 million will be paid up to a maximum of £500,000. Earnings for the six months ended 30 June 20X6 are £7 million, and the entity expects earnings for the full year ended 31 December 20X6 to be £16 million.

The following table shows various accounting policies and the expense recognised thereunder in the interim financial statements for the six months ended 30 June 20X6.

	Expense (£)
Method 1 - constructive obligation exists when earnings target is met	Nil
Method 2 - assume earnings for remainder of year will be same	200,000
Method 3 - proportionate recognition based on full-year estimate	131,250
Method 4 - one-half recognition based on full-year estimate	150,000

Method 1 is generally not appropriate, as this method attributes the entire bonus to the latter portion of the year, whereas employees provided services during the first six months to towards earning the bonus.

Likewise, Method 2 is generally not appropriate, as the expense of £200,000 $[(£14 \text{ million} - £10 \text{ million}) \times 5\%]$ assumes that the employees will continue to provide services in the latter half of the year to achieve the bonus target, but does not attribute any services to that period.

In contrast to Methods 1 and 2, Method 3 illustrates an accounting policy whereby an estimate is made of the full-year expense and attributed to the period based on the proportion of that bonus for which employees have provided service at 30 June 20X6. The amount recognised is calculated as $(£7 \text{ million} \div £16 \text{ million}) \times [5\% \times (£16 \text{ million} - £10 \text{ million})]$.

Similar to Method 3, Method 4 also takes the approach of recognising an expense based on the full year estimate, but allocates that full-year estimate equally to each period (which is similar to the approach used for share-based payment transactions). The amount recognised is calculated as $[50\% \times 5\% \times (£16 \text{ million} - £10 \text{ million})]$.

In addition to Methods 3 and 4, which might be appropriate, depending on the facts and circumstances, an entity might determine another basis on which to recognise bonus that considers both the constructive obligation that exists as of 30 June 20X6, and the services performed to date, which is also appropriate.

9.2.3 Pensions

Section 28 requires an entity to determine the present value of defined benefit obligations and the fair value of plan assets at the end of the reporting period. While Section 28 does not require an entity to involve a professionally qualified actuary in the measurement of the obligations, nor to undertake a comprehensive annual actuarial valuation, we expect that in practice most entities will do so.

For interim reporting purposes, the defined benefit obligation can often be reliably measured by extrapolation of the latest actuarial valuation adjusted for changes in employee demographics such as number of employees and salary levels. *[FRS 104.A2.42]*.

If there are significant changes to pension arrangements during the interim period (such as changes resulting from a material business combination and disposals, or from a major redundancy programme) then entities may wish to consider whether they should obtain a new actuarial valuation of scheme liabilities. Similarly, if there are significant market fluctuations, such as those arising from changes in corporate bond markets, the validity of the assumptions in the last actuarial estimate, such as the discount rate applied to scheme liabilities, must be reviewed and revised as appropriate.

Fair Market values of plan assets as at the interim reporting date should be available without recourse to an actuary and in normal circumstances, companies will not necessarily go through the full process of measuring pension liabilities at interim reporting dates but rather will look to establish a process to assess the impact of any changes in underlying parameters (e.g., through extrapolation). As with all estimates, the appropriateness in the circumstances should be considered.

9.2.4 Vacations, holidays and other short-term paid absences

Section 28 distinguishes between accumulating and non-accumulating paid absences. *[FRS 102.28.67]*.

Accumulating paid absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Section 28 requires an entity to measure the expected cost of an obligation for accumulating paid absences at the amount the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period (see Chapter 30 at 3.2).

FRS 104 requires the same principle to be applied at the end of interim reporting periods. Conversely, an entity must not recognise an expense or liability for non-accumulating paid absences at the end of an interim reporting period, just as it would not recognise any at the end of an annual reporting period.

[FRS 104.A2.12].

9.3 Inventories and cost of sales

9.3.1 Inventories

The recognition and measurement principles of Section 13 are applied in the same way for interim financial reporting as for annual reporting purposes. At the end of any financial reporting period an entity would determine inventory quantities, costs and net realisable values. However, FRS 104 does comment that to save cost and time, entities often use estimates to measure inventories at interim dates to a greater extent than at annual reporting dates. *[FRS 104.A2.27]*.

Net realisable values are determined using selling prices and costs to complete and dispose at the end of the interim period. A write-down is reversed in a subsequent interim period only if it would be appropriate to do so at year-end. See Chapter 16 at 3.3.2. *[FRS 104.A2.28]*.

9.3.2 Contractual or anticipated purchase price changes

Both the payer and the recipient of volume rebates, or discounts and other contractual changes in the prices of raw materials, labour, or other purchased goods and services should anticipate these items in interim periods if it is probable that these have been earned or will take effect. However, discretionary rebates and discounts are not anticipated because the resulting asset or liability would not meet the recognition criteria in FRS 102. *[FRS 104.A2.25]*.

9.3.3 Interim period manufacturing cost variances

Price, efficiency, spending and volume variances of a manufacturing entity must be recognised in profit or loss at interim reporting dates to the same extent that those variances are recognised at year-end. It is not appropriate to defer variances expected to be absorbed by year-end, which could result in reporting inventory at the interim date at more or less than its actual cost. *[FRS 104.A2.30]*. See 8.2.2 above for a discussion on this topic as it applies to costs incurred by service providers.

9.4 Taxation

Taxation is one of the most difficult areas of interim financial reporting, primarily because FRS 104 does not clearly distinguish between current income tax and deferred tax, referring only to 'income tax expense'. This causes tension between the approach for determining the expense and the asset or liability in the statement of financial position. In addition, the standard's provisions combine terminology, suggesting an integral approach with guidance requiring a year-to-date basis to be applied. The integral method is used in determining the effective income tax rate for the whole year, but that rate is applied to year-to-date profit in the interim financial statements. In addition, under a year-to-date basis, the estimated rate is based on tax rates and laws that are enacted or substantively enacted by the end of the interim period. Changes in legislation expected to occur before the end of the current year are not recognised in preparing the interim financial report. The assets and liabilities in the statement of financial position, at least for deferred taxes, are derived solely from a year-to-date approach, but sometimes the requirements of the standard are unclear, as discussed below.

9.4.1 Measuring interim income tax expense

FRS 104 states that income tax expense must be accrued using the tax rate applicable to expected total annual earnings, by applying the estimated weighted-average annual effective income tax rate to pre-tax income for the interim period. [FRS 104.A2.14]. However, this is not the same as estimating the total tax expense for the year and allocating a proportion of that to the interim period (even though it might sometimes appear that way), as demonstrated in the discussion below.

Because taxes are assessed on an annual basis, using the integral approach to determine the annual effective income tax rate and applying it to year-to-date actual earnings is consistent with the basic concept in FRS 104, that the same recognition and measurement principles apply in interim financial reports as in annual financial statements. [FRS 104.A2.15].

In estimating the weighted-average annual income tax rate, an entity must reflect a blend of any progressive tax rate structure expected to be applicable to the full year's earnings, including changes in income tax rates scheduled to take effect later in the year that are enacted or substantively enacted as at the end of the interim period. [FRS 104.A2.15]. This situation is shown in Illustration 9-2 below which is based on the example in paragraph 17 of Appendix II to FRS 104. [FRS 104.A2.17].

Illustration 9-2: Measuring interim income tax expense

An entity reporting quarterly expects to earn £10,000 pre-tax each quarter and operates in a jurisdiction with a tax rate of 20% on the first £20,000 of annual earnings and 30% on all additional earnings. Actual earnings match expectations. The following table shows the income tax expense reported each quarter:

(All values in £)	Pre-tax earnings	Effective tax rate	Tax expense
First quarter	10,000	25%	2,500
Second quarter	10,000	25%	2,500
Third quarter	10,000	25%	2,500
Fourth quarter	10,000	25%	2,500
Annual	40,000		10,000

£10,000 of tax is expected to be payable for the full year on £40,000 of pre-tax income (£20,000 @ 20% + £20,000 @ 30%), implying an average annual effective income tax rate of 25% (£10,000/£40,000).

In the above example, it might look as if the interim income tax expense is calculated by dividing the total expected tax expense for the year (£10,000) by the number of interim reporting periods (4). However, this is only the case in this example because profits are earned evenly over each quarter. The expense is actually calculated by determining the effective annual income tax rate and multiplying that rate to year-to-date earnings, as shown in Illustration 9-3 below which is based on the example in paragraph 18 of Appendix II to FRS 104. [FRS 104.A2.18].

Illustration 9-3: Measuring interim income tax expense - quarterly losses

An entity reports quarterly, earns £15,000 pre-tax profit in the first quarter but expects to incur losses of £5,000 in each of the three remaining quarters (thus having zero income for the year), and operates in a jurisdiction in which its estimated average annual income tax rate is 20%. The following table shows the income tax expense reported each quarter:

(All values in £)	Pre-tax earnings	Effective tax rate	Tax expense
First quarter	15,000	20%	3,000
Second quarter	(5,000)	20%	(1,000)
Third quarter	(5,000)	20%	(1,000)
Fourth quarter	(5,000)	20%	(1,000)
Annual	0		0

The above example shows how an expense is recognised in periods reporting a profit and a credit is recognised when a loss is incurred. This result is very different from allocating a proportion of the expected total income tax expense for the year, which in this case is zero.

If an entity operates in a number of tax jurisdictions, or where different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), the standard requires that to the extent practicable, an entity: [FRS 104.A21.16]

- Estimates the average annual effective income tax rate for each taxing jurisdiction separately and applies it individually to the interim period pre-tax income of each jurisdiction.

And

- Applies different income tax rates to each individual category of interim period pre-tax income.

This means that the entity must perform the analysis shown in Illustration 9-3 above for each tax jurisdiction and arrive at an interim tax charge by applying the tax rate for each jurisdiction to actual earnings from each jurisdiction in the interim period. However, the standard recognises that, whilst desirable, such a degree of precision may not be achievable in all cases and allows using a weighted-average rate across jurisdictions or across categories of income, if such rate approximates the effect of using rates that are more specific. [FRS 104.A2.16].

Illustration 9-4: Measuring interim tax expense - many jurisdictions

An entity operates in 3 countries, each with its own tax rates and laws. In order to determine the interim tax expense, the entity determines the effective annual income tax rate for each jurisdiction and applies those rates to the actual earnings in each jurisdiction, as follows:

(All values in £)	Country A	Country B	Country C	Total
Expected annual tax rate	25%	40%	20%	
Expected annual earnings	300,000	250,000	200,000	750,000
Expected annual tax expense	75,000	100,000	40,000	215,000
Actual half-year earnings	140,000	80,000	150,000	370,000
Interim tax expense	35,000	32,000	30,000	97,000

By performing a separate analysis for each jurisdiction, the entity determines an interim tax expense of £97,000, giving an effective average tax rate of 26.2% ($£97,000 \div £370,000$). Had the entity used a weighted-average rate across jurisdictions, using the expected annual earnings, it would have determined an effective tax rate of 28.7% ($£215,000 \div £750,000$), resulting in a tax expense for the interim period of £106,190 ($£370,000 @ 28.7\%$). Whether the difference of over £9,000 lies within the range for a reasonable approximation is a matter of judgement.

9.4.2 Changes in the effective tax rate during the year

9.4.2.A Enacted changes for the current year that apply after the interim reporting date

As noted above, the estimated income tax rate applied in the interim financial report must reflect changes that are enacted or substantively enacted as at the end of the interim reporting period, but scheduled to take effect later in the year. [FRS 104.A2.15]. Tax rates can be regarded as substantively enacted when the remaining stages of the enactment process historically have not affected the outcome and are unlikely to do so. In particular, a UK tax rate is regarded as having been substantively enacted if it is included in:

[FRS 104 Appendix I]

- A Bill that has been passed by the House of Commons and is awaiting only passage through the House of Lords and Royal Assent.
- Or
- A resolution having statutory effect that has been passed under the Provisional Collection of Taxes Act 1968.

A Republic of Ireland tax rate can be regarded as having been substantively enacted if it is included in a Bill that has been passed by the Dáil.

For example, assume that the 30% tax rate (on earnings above £20,000) in Illustration 9-2 was substantively enacted as at the second quarter reporting date and applicable before year-end. In that case, the estimated income tax rate for interim reporting would be the same as the estimated average annual effective income tax rate computed in that example (i.e., 25%) after considering the higher rate, even though the entity's earnings are not above the required threshold at the half-year.

If legislation is enacted only after the end of the interim reporting period but before the date of authorisation for issue of the interim financial report, its effect is disclosed as a non-adjusting event.

[FRS 102.32.11(h)]. This is consistent with the requirement under Section 32 *Events after the End of the Reporting Period* of FRS 102 estimates of tax rates and related assets or liabilities are not revised in these circumstances. [FRS 102.32.6].

9.4.2.B Changes to previously reported estimated income tax rates for the current year

FRS 104 requires an entity to re-estimate at the end of each interim reporting period the estimated average annual income tax rate on a year-to-date basis. [FRS 104.A2.15]. Accordingly, the amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period if that estimate changes. [FRS 104.30(c)]. FRS 104 requires disclosure in interim financial statements of material changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years. [FRS 104.16A(d)].

Accordingly, just as the integral approach does not necessarily result in a constant tax charge in each interim reporting period, it also does not result in a constant effective tax rate when circumstances change.

Illustration 9-5: Changes in the effective tax rate during the year

Taking the fact pattern in Illustration 9-2 above, an entity reporting quarterly expects to earn £10,000 pre-tax each quarter; from the start of the third quarter the higher rate of tax on earnings over £20,000 increases from 30% to 40%. Actual earnings continue to match expectations. The following table shows the income tax expense reported in each quarter:

(All values in £)	Period pre-tax earnings	Pre-tax earnings: year to date	Effective tax rate	Tax expense: year to date	Period tax expense
First quarter †	10,000	10,000	25%	2,500	2,500
Second quarter †	10,000	20,000	25%	5,000	2,500
Third quarter	10,000	30,000	30%	9,000	4,000
Fourth quarter	10,000	40,000	30%	12,000	3,000
Annual	40,000				12,000

† As previously reported from Illustration 9-2 using an effective tax rate of 25%.

The increase in the tax rate means that £12,000 of tax is expected to be payable for the full year on £40,000 of pre-tax income (£20,000 @ 20% + £20,000 @ 40%), implying an average annual effective income tax rate of 30% (£12,000/£40,000). With cumulative pre-tax earnings of £30,000 as at the end of the third quarter, the estimated tax liability is £9,000, requiring a tax expense of £4,000 (£9,000 - £2,500 - £2,500) to be recognised during that quarter. In the final quarter, earnings of £10,000 result in a tax charge of £3,000, using the revised effective rate of 30%.

9.4.2.C Enacted changes applying only to subsequent years

In many cases, tax legislation is enacted that takes effect not only after the interim reporting date but also after year-end. Such circumstances are not addressed explicitly in the standard. As FRS 104 does not clearly distinguish between current income tax and deferred tax, combined with the different approaches taken in determining the expense recognised in profit or loss compared to the statement of financial position, these issues can lead to confusion in this situation.

On the one hand, the standard states that the estimated income tax rate for the interim period includes enacted or substantively enacted changes scheduled to take effect later in the year. [FRS 104.A2.15]. This implies that the effect of changes that do not take effect in the current year is ignored in determining the appropriate rate for current tax. On the other hand, FRS 104 also requires that the principles for recognising assets, liabilities, income and expenses for interim periods are the same as in the annual financial statements. [FRS 104.29]. In annual financial statements, deferred tax is measured at the tax rates expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) enacted or substantively enacted by the end of the reporting period, as required by FRS 102. [FRS 102.29.12]. Therefore, an entity must recognise the effect of a change applying to future periods if this change is enacted by the end of the interim reporting period.

These two requirements seem to be mutually incompatible. FRS 104 makes sense only in the context of calculating the effective 'current' tax rate on income earned in the period. Once a deferred tax asset or liability is recognised, it must be measured under Section 29 *Income Tax*. Therefore, an entity must recognise an enacted change applying to future years in measuring deferred tax assets and liabilities as at the end of the interim reporting period. One way to treat the cumulative effect to date of this remeasurement is to recognise it in full, by a credit to profit or loss or to other comprehensive income, depending on the nature of the temporary difference being remeasured, in the period during which the tax legislation is enacted, in a similar way to the treatment shown in Illustration 9-5 above, and as shown in Illustration 9-6 below.

Illustration 9-6: Enacted changes to tax rates applying after the current year

An entity reporting half-yearly operates in a jurisdiction subject to a tax rate of 30%. Legislation is enacted during the first half of the current year, which reduces the tax rate to 28% on income earned from the beginning of the entity's next financial year. Based on a gross temporary difference of £1,000, the entity reported a deferred tax liability in its most recent annual financial statements of £300 (£1,000 @ 30%). Of this temporary difference, £200 is expected to reverse in the second half of the current year and £800 in the next financial year. Assuming that no new temporary differences arise in the current period, what is the deferred tax balance at the interim reporting date?

Whilst the entity uses an effective tax rate of 30% to determine the tax expense relating to income earned in the period, it should use a rate of 28% to measure those temporary differences expected to reverse in the next financial year. Accordingly, the deferred tax liability at the half-year reporting date is £284 (£200 @ 30% + £800 @ 28%).

Alternatively, if the effective *current* tax rate is not distinguished from the measurement of deferred tax, it could be argued that FRS 104 allows the reduction in the deferred tax liability of £16 (£300 - £284) to be included in the estimate of the effective income tax rate for the year. Approach 2 in Illustration 9-9 below applies this argument.

How we see it

In our view, because FRS 104 does not distinguish between current and deferred taxes, either approach would be acceptable provided that it is applied consistently.

9.4.3 Difference in financial year and tax year

If an entity's financial year and the income tax year differ, the income tax expense for the interim periods of that financial year must be measured using separate weighted-average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years. [FRS 104.A2.19]. In other words, an entity must compute a weighted-average estimated effective tax rate for each income tax year, rather than for its financial year.

Illustration 9-7: Difference in financial year and tax year

An entity's financial year ends 30 June and it reports quarterly. Its taxable year ends 31 December. For the financial year that begins 1 July 20X5 and ends 30 June 20X6, the entity earns 10,000 pre-tax each quarter. The estimated average annual income tax rate is 30% in the income tax year to 31 December 20X5 and 40% in the year to 31 December 20X6.

Quarter ending (All values in £)	Pre-tax earnings	Effective tax rate	Tax expense
30 September 20X5	10,000	30%	3,000
31 December 20X5	10,000	30%	3,000
31 March 20X6	10,000	40%	4,000
30 June 20X6	10,000	40%	4,000
Annual	40,000		14,000

9.4.4 Tax loss and tax credit carrybacks and carryforwards

FRS 104 repeats the requirement in Section 29 of FRS 102 that for carryforwards of unused tax losses, a deferred tax asset must only be recognised to the extent that it is probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits. [FRS 104.A2.23]. In assessing whether future taxable profit is available, the criteria in Section 29 are applied at the interim date. If these criteria are met as at the end of the interim period, the effect of the tax loss carryforwards is included in the estimated average annual effective income tax rate.

Illustration 9-8: Tax loss carryforwards expected to be recovered in the current year

An entity that reports quarterly has unutilised operating losses of £10,000 for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The entity earns £10,000 in the first quarter of the current year and expects to earn £10,000 in each of the three remaining quarters. Excluding the effect of utilising losses carried forward, the estimated average annual income tax rate is 40%. Including the carryforward, the estimated average annual income tax rate is 30%. Accordingly, tax expense is determined by applying the 30% rate to earnings each quarter as follows:

(All values in £)	Pre-tax earnings	Effective tax rate	Tax expense
First quarter	10,000	30%	3,000
Second quarter	10,000	30%	3,000
Third quarter	10,000	30%	3,000
Fourth quarter	10,000	30%	3,000
Annual	40,000		12,000

This result is consistent with the general approach for measuring income tax expense in the interim report, in that any entitlement for relief from current tax due to carried forward losses is determined on an annual basis. Accordingly, its effect is included in the estimate of the average annual income tax rate and not, for example, by allocating all of the unutilised losses against the earnings of the first quarter to give an income tax expense of zero in the first quarter and £4,000 thereafter.

In contrast, the year-to-date approach of FRS 104 means that the benefits of a tax loss carryback are recognised in the interim period in which the related tax loss occurs, [FRS 104.A2.22], and are not included in the assessment of the estimated average annual tax rate, as shown in Illustration 9-3 above. This approach is consistent with Section 29 of FRS 102 which requires the benefit of a tax loss that can be carried back to recover current tax already incurred in a previous period to be recognised as an asset. [FRS 102.29.4]. Therefore, a corresponding reduction of tax expense or increase of tax income is also recognised.

[FRS 104.A2.22].

Where previously unrecognised tax losses are expected to be utilised in full in the current year, it seems intuitive to recognise the recovery of those carried forward losses in the estimate of the average annual tax rate, as shown in Illustration 9-7 above. However, where the level of previously unrecognised tax losses exceeds expected taxable profits for the current year, a deferred tax asset will be recognised for the carried forward losses that are now expected to be utilised, albeit in future years.

The examples in FRS 104 do not show how such a deferred tax asset is created in the interim financial report.

How we see it

In our view, both approaches above are acceptable, where tax loss carryforwards exceed expected profits in the current year as shown in Illustration 9-9 below.

Illustration 9-9: Tax loss carry forwards in excess of current year expected profits

An entity that reports half-yearly has unutilised operating losses of £75,000 for income tax purposes at the start of the current financial year for which no deferred tax asset has been recognised. At the end of its first interim period, the entity reports a profit before tax of £25,000 and expects to earn a profit of £20,000 before tax in the second half of the year. The entity reassesses the likelihood of generating sufficient profits to utilise its carried forward tax losses and determines that the FRS 102 recognition criteria for a deferred tax asset are satisfied for the full amount of £75,000. Excluding the effect of utilising losses carried forward, the estimated average annual income tax rate is the same as the enacted or substantially enacted rate of 40%.

As at the end of the current financial year the entity expects to have unutilised losses of £30,000 (£75,000 carried forward less current year pre-tax profits of £45,000). Using the enacted rate of 40%, a deferred tax asset of £12,000 is recognised at year-end. How is this deferred tax asset recognised in the interim reporting periods?

Approach 1

Under the first approach, the effective tax rate for the effect of the change in the assessment of recoverability of the unused tax losses carried forward to future periods that existed at the beginning of the current financial year is not adjusted. The estimate of the average annual effective tax rate includes only those carried forward losses expected to be utilised in the current financial year and a separate deferred tax asset is recognised for those carried forward losses now expected to be utilised in future annual reporting periods.

In the fact pattern above, using £45,000 of the carried forward tax losses gives an average effective annual tax rate of nil, as follows:

Estimation of the annual effective tax rate - Approach 1

(All values in £)

Expected annual tax expense before utilising losses carried forward (45,000 @ 40%)	18,000
Tax benefit of utilising carried forward tax losses (45,000 @ 40%)	(18,000)
Expected annual tax expense before the effect of losses carried forward to future annual periods	0
Expected annual effective tax rate	0%
Effect of tax losses carried forward to future periods (75,000 - 45,000 @ 40%)	(12,000)
Tax income to be recognised in the interim period	(12,000)

The remaining tax losses give rise to a deferred tax asset of £12,000, which is recognised in full at the half-year, to give reported profits after tax as follows:

(All values in £)	First half-year	Second half-year	Annual
Profit before income tax	25,000	20,000	45,000
Income tax (expense)/credit			
- at expected annual effective rate	0	0	0
- recognition of deferred tax asset	12,000	0	12,000
Net profit after tax	37,000	20,000	57,000

Approach 2

Under the second approach, the effective tax rate for the effect of the change in the assessment of recoverability of the unused tax losses carried forward to future periods that existed at the beginning of the current financial year is adjusted. The estimate of the average annual effective tax rate reflects the expected recovery of all the previously unutilised tax losses from the beginning of the period in which the assessment of recoverability changed. In the fact pattern above, recognition of the unutilised tax losses gives an average effective annual tax rate of -26.67%, as follows:

Estimation of the annual effective tax rate - Approach 2

(All values in £)

Expected annual tax expense before utilising losses carried forward (45,000 @ 40%)	18,000
Tax benefit of recognising unutilised tax losses (75,000 @ 40%)	(30,000)
Expected annual tax credit after recognising unutilised tax losses	(12,000)
Expected annual effective tax rate (-12,000 ÷ 45,000)	-26.67%

This approach results in reported profits after tax as follows:

(All values in £)	First half-year	Second half-year	Annual
Profit before income tax	25,000	20,000	45,000
Income tax (expense)/credit			
- at expected annual effective rate	6,667	5,333	12,000
Net profit after tax	31,667	25,333	57,000

Approach 1 is consistent with the requirements of Section 29 as it results in recognising the full expected deferred tax asset as soon as it becomes “probable that they will be recovered against the reversal of deferred tax liabilities or other future taxable profits”. [FRS 102.29.7].

How we see it

However, given that FRS 104 does not specifically address this situation, and is unclear about whether the effective tax rate reflects changes in the assessment of the recoverability of carried forward tax losses, we also believe that Approach 2 is acceptable.

9.4.5 Tax credits

FRS 104 also discusses in more detail the treatment of tax credits which may, for example, be based on amounts of capital expenditures, exports, or research and development expenditures. Such benefits are usually granted and calculated on an annual basis under tax laws and regulations and therefore are reflected in the estimated annual effective income tax rate used in the interim report. However, if tax benefits relate to a one-time event, they are excluded from the estimate of the annual rate and deducted separately from income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate. Occasionally, some tax credits are more akin to a government grant, which are recognised in the interim period in which they arise. [FRS 104.A2.21]. Similar considerations arise in determining the extent to which the existence of non-taxable income or non-deductible expenditure must be incorporated into the estimate of the weighted-average annual income tax rate expected for the full financial year. This requires the exercise of judgement.

9.4.6 Pillar Two Income Taxes

Governments around the world are introducing local legislation to implement the Base Erosion and Profit Shifting (BEPS) Pillar Two Model Rules published by the Organisation for Economic Co-operation and Development (OECD). The Pillar Two model rules apply to multinational enterprises (MNEs) with revenue in excess of EUR 750 million per their consolidated financial statements. These rules introduce new taxing mechanisms under which MNEs would pay a minimum level of tax. In July 2023, the FRC issued *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* and *FRS 101 Reduced Disclosure Framework - International tax reform - Pillar Two model rules*. These are similar to; *Amendments to IAS 12 International Tax Reform - Pillar Two Model Rules* issued by the IASB. Pillar Two income taxes and the related amendments to FRS 102 are discussed in Chapter 31 at 3.7.

The amendments have introduced the following disclosure requirements that are applicable to interim financial statements:

- (a) To disclose that the entity has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes. [FRS 102.29.12A].
- (b) To disclose separately its current tax expense/(income) relating to Pillar Two income tax. [FRS 102.29.26].
- (c) In periods in which Pillar Two legislation is enacted or substantively enacted but not yet in effect, to disclose known or reasonably estimable information that helps users of financial statements understand the entity's exposure to Pillar Two income taxes arising from that legislation. [FRS 102.29.28].
And
- (d) To meet the disclosure requirement in (c) above, an entity must disclose 'qualitative and quantitative information about its exposure to Pillar Two income taxes at the end of the reporting period'. [FRS 102.29.29].

FRS 104 was not consequentially amended to reflect the new requirements introduced in section 29 of FRS 102. Accordingly, the general principles and requirements in FRS 104, in respect of condensed interim financial statements (see 3.2 above), must be applied and disclosure given where relevant.

9.5 Foreign currency translation

9.5.1 Foreign currency translation gains and losses

An entity measures foreign currency translation gains and losses for interim financial reporting using the same principles that Section 30 *Foreign Currency Translation* of FRS 102 requires at year-end (see Chapter 32). [FRS 104.A2.31]. An entity must use the actual average and closing foreign exchange rates for the interim period (i.e., it may not anticipate changes in foreign exchange rates for the remainder of the current year in translating at an interim date). [FRS 104.A2.32]. When Section 30 requires translation adjustments to be recognised as income or expense in the period in which they arise, the same approach must be used in the interim report. An entity must not defer some foreign currency translation adjustments at an interim date, even if it expects the adjustment to reverse before year-end. [FRS 104.A2.33].

9.5.2 Interim financial reporting in hyperinflationary economies

Interim financial reports in hyperinflationary economies are prepared using the same principles as at year-end. [FRS 104.A2.34]. Section 31 *Hyperinflation* of FRS 102 requires that the financial statements of an entity that reports in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at the end of the reporting period, and the gain or loss on the net monetary position be included in profit or loss. In addition, comparative financial data reported for prior periods must be restated to the current measuring unit (see Chapter 33). [FRS 104.A2.35]. As shown in Illustration 6-1 and Illustration 6-2 above, FRS 104 requires an interim report to contain many components, which are all restated to the current measuring unit at every interim reporting date.

The measuring unit used is that as of the end of the interim period, with the resulting gain or loss on the net monetary position included in that period's net income. An entity cannot annualise the recognition of gains or losses or estimate an annual inflation rate in preparing an interim financial report in a hyperinflationary economy. [FRS 104.A2.36].

While it is highly unlikely for a UK company to have the functional currency of a hyperinflationary economy, a UK based group may prepare consolidated financial statements under FRS 102 with a subsidiary that operates in, and has a functional currency of, a country subject to hyperinflation.

9.6 Provisions, contingencies and accruals for other costs

9.6.1 Provisions

FRS 104 requires an entity to apply the same criteria for recognising and measuring a provision at an interim date as it would at year-end. [FRS 104.A2.6]. Hence, an entity must recognise a provision when it has no realistic alternative but to transfer economic benefits because of an event that has created a legal or constructive obligation. [FRS 104.A2.5]. FRS 104 emphasises that the existence or non-existence of an obligation to transfer benefits is a question of fact and does not depend on the length of the reporting period. [FRS 104.A2.6].

The obligation is adjusted upward or downward at each interim reporting date, if the entity's best estimate of the amount of the obligation changes. The standard states that any corresponding loss or gain should normally be recognised in profit or loss. [FRS 104.A2.5]. However, an entity applying IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* under the hierarchy in Section 10 (see Chapter 9 at 2.1) might instead need to adjust the carrying amount of the corresponding asset rather than recognise a gain or loss.

9.6.2 Other planned but irregularly occurring costs

Many entities budget for costs that they expect to incur irregularly during the year, such as advertising campaigns, employee training and charitable contributions. Even though these costs are planned and expected to recur annually, they tend to be discretionary in nature. Therefore, it is generally not appropriate to recognise an obligation at the end of an interim financial reporting period for such costs that are not yet incurred, as they do not meet the definition of a liability. [FRS 104.A2.13].

As discussed at 8.2.2 above, FRS 104 prohibits the recognition or deferral of costs incurred unevenly throughout the year at the interim date if recognition or deferral would be inappropriate at year-end. [FRS 104.39]. Accordingly, such costs must be recognised as they are incurred.

9.6.3 Major planned periodic maintenance or overhaul

The cost of periodic maintenance, a planned major overhaul, or other seasonal expenditures expected to occur after the interim reporting date cannot be recognised for interim reporting purposes unless an event before the end of the interim period causes the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditures in the future is not sufficient to recognise an obligation as at the interim reporting date. [FRS 104.A2.4]. Similarly, an entity may not defer and amortise such costs if they are incurred early in the year, but do not satisfy the criteria for recognition as an asset as at the interim reporting date.

9.6.4 Variable lease payments

Variable lease payments based on sales can create legal or constructive obligations that are recognised as liabilities. If a lease includes variable payments based on achieving a certain level of annual sales (or annual use of the asset), an obligation can arise in an interim period before the required level of annual sales (or usage) is achieved. If the entity expects to achieve the required level of annual sales (or usage), it must recognise a liability as it has no realistic alternative but to make the future lease payment. [FRS 104.A2.9]. See Chapter 23 at 5.5.1 for further discussion on variable lease payments.

9.6.5 Levies charged by public authorities

When governments or other public authorities impose levies on entities in relation to their activities, as opposed to income taxes, it is not always clear when the liability to pay a levy arises and a provision should be recognised. As there is no specific guidance on accounting for such provisions under FRS 102, entities may, under the hierarchy set out in Section 10, refer to the guidance in IFRIC 21 *Levies* in formulating an appropriate accounting policy for these obligations. See Chapter 24 at 3.11.5 for further discussion on levies charges.

9.7 Earnings per share

As noted at 3.3 above, FRS 104 requires that where an entity has presented EPS information in accordance with IAS 33 *Earnings per Share* (as adopted in the relevant jurisdiction) in its most recent annual financial statements, then it will present basic and diluted EPS in its interim financial statements. [FRS 104.11]. EPS in an interim period is computed in the same way as for annual periods. However, IAS 33 does not allow diluted EPS of a prior period to be restated for subsequent changes in the assumptions used in those EPS calculations. [IAS 33.65]. This approach might be perceived as inconsistent to the year-to-date approach which should be followed for computing EPS for an interim period. For example, if an entity, reporting quarterly, computes diluted EPS in its first quarter financial statements, it cannot restate the reported diluted EPS subsequently for any changes in the assumptions used. However, following a year-to-date approach, the entity must consider the revised assumptions to compute the diluted EPS for the six months in its second quarter financial statements, which, in this case would not be the sum of its diluted EPS for first quarter and the second quarter.

10 Use of estimates

FRS 104 requires that the measurement procedures followed in an interim financial report must be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. Whilst estimation is necessary in both interim and annual financial statements, the standard recognises that preparing interim financial reports generally requires greater use of estimation methods than at year-end. [FRS 104.41]. Consequently, the measurement of assets and liabilities at an interim date may involve less use of outside experts in determining amounts for items such as provisions, contingencies, pensions or non-current assets revalued at fair values. Reliable measurement of such amounts may simply involve updating the previously reported year-end position. The procedures may be less rigorous than those at year-end. The Illustration below is based on Appendix II to FRS 104. [FRS 104.A2.39, FRS 104.A2.40, FRS 104.A2.41, FRS 104.A2.42, FRS 104.A2.43, FRS 104.A2.44, FRS 104.A2.45, FRS 104.A2.46, FRS 104.A2.47].

Illustration 10-1: Use of estimates

Inventories	Full stock-taking and valuation procedures may not be required for inventories at interim dates, although it may be done at year-end. It may be sufficient to make estimates at interim dates based on sales margins.
Classifications of current and non-current assets and liabilities	Entities may do a more thorough investigation for classifying assets and liabilities as due within one year or after more than one year (or an equivalent classification between current and non-current assets and liabilities) at annual reporting dates than at interim dates.
Provisions	Determining the appropriate provision (such as a provision for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating of the prior annual provision rather than the engaging of outside experts to do a new calculation.
Pensions	Section 28 of FRS 102 requires an entity to determine the present value of defined benefit obligations and the fair value of plan assets at the end of each reporting period. Section 28 does not require an entity to involve a professionally qualified actuary in measurement of the obligations, nor does it require an annual comprehensive actuarial valuation. As discussed at 9.2.3 above, market values of plan assets as at the interim reporting date should be available without recourse to an actuary, and reliable measurement of defined benefit obligations for interim reporting purposes can often be extrapolated from the latest actuarial valuation adjusted for changes in employee demographics such as number of employees and salary levels.
Income taxes	Entities may calculate income tax expense and deferred income tax liability at annual dates by applying the tax rate for each individual jurisdiction to measures of income for each jurisdiction. Paragraph A2.16 of Appendix II (see 9.4.1 above) acknowledges that while that degree of precision is desirable at interim reporting dates as well, it may not be achievable in all cases, and a weighted-average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.
Contingencies	The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained for contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.
Revaluations and fair value accounting	Section 17 of FRS 102 allows an entity to choose as its accounting policy the revaluation model whereby items of property, plant and equipment are revalued to fair value. Similarly, Section 16 of FRS 102 <i>Investment Property</i> requires an entity to measure the fair value of investment property. For those measurements, an entity that relies on professionally qualified valuers at annual reporting dates is not required to rely on them at interim reporting dates.

Specialised industries	Because of complexity, costliness, and time, interim period measurements in specialised industries might be less precise than at year-end. An example is calculation of insurance reserves by insurance companies.

Although an entity is not required to use professionally qualified valuers at interim reporting dates, and may only update the previous year-end position, the entity is required to recognise impairments in the appropriate interim period (see 9.1.2 above).

11 First-time presentation of interim reports complying with FRS 104

FRS 104 defines “interim period” as a financial reporting period shorter than a full financial year, [FRS 104 Appendix I], and requires the format of condensed financial statements for an interim period to include each of the headings and subtotals that were included in the entity’s most recent annual financial statements. [FRS 104.10].

However, FRS 104 provides no guidance for an entity that chooses to issue condensed interim financial statements before it has prepared a set of FRS 102 compliant annual financial statements. This situation will arise in the entity’s first year of existence. Whilst FRS 104 does not prohibit the entity from preparing a condensed set of interim financial statements, it does not specify how an entity would interpret the minimum disclosure requirements of FRS 104 when there are no annual financial statements to refer to.

The entity should consider making additional disclosures to recognise that a user of this first set of interim financial statements does not have the access otherwise assumed to the most recent annual financial report of the entity. Accordingly, the explanation of significant events and transactions and changes in financial position in the period must be more detailed than the update normally expected in FRS 104. [FRS 104.15]. In the absence of any specific regulatory requirements to which the entity is subject, the following are examples of additional considerations that would apply:

- Since it is not possible to make a statement that the same accounting policies and methods of computation have been applied, [FRS 104.16A(a)], the entity must disclose all those accounting policies and methods of computation in the same level of detail as it would in a set of annual financial statements. When the entity issues interim reports on a quarterly basis, the first quarter interim report should provide the abovementioned details; subsequent quarterly reports could refer to the details included in the first quarter report.
 - Similarly, the disclosure of the nature and amount of changes in estimates of amounts reported in prior periods will have to go into more detail than just the changes normally required to be disclosed. [FRS 104.16A(d)].
 - More extensive disclosure than simply the changes since the last report date will be required for contingent liabilities and contingent assets. [FRS 104.15B(m)].
- And
- In the absence of a complete set of annual financial statements complying with FRS 102, the entity should include each of the headings and subtotals in the condensed financial statements that it would expect to include in its first financial statements prepared under FRS 102.

Entities that have transitioned from another financial reporting framework to FRS 102 and have not yet published FRS 102 annual financial statements are required to make additional disclosures when presenting interim reports in accordance with FRS 104: [FRS 104.16B]

- A description of the nature of each change in accounting policy.
- A reconciliation of its equity determined in accordance with its previous financial reporting framework to its equity determined in accordance with the new financial reporting framework for the following dates:
 - The date of transition to the new financial reporting framework.

And

 - At the end of the comparable year to date period of the immediately preceding financial year.

And
- A reconciliation of profit or loss determined in accordance with its previous financial reporting framework for the comparable interim period (current and if different year-to-date) of the immediately preceding financial year.

If an entity becomes aware of errors made under its previous financial reporting framework, the reconciliations above must, to the extent practicable, distinguish the correction of those errors from changes in accounting policies. For an entity converting to FRS 102 in their next annual financial statements, the requirements of Section 35 *Transition to this FRS* - must be applied. Those requirements, which include the reconciliations above, are discussed in Chapter 37.

12 Periodic Review 2024

FRS 104 was amended as a result of the periodic review in 2024. The amendments to this standard are applicable for interim periods beginning on or after 1 January 2026. Early application is permitted provided that all amendments are applied at the same time, and that fact is disclosed. [FRS 104.56D].

13 Summary of GAAP differences

FRS 104 reporting requirements are mainly based on IAS 34 as it's not an accounting standard²⁵⁵. Both standards require that an entity must disclose any events or transactions which are significant to an understanding of the changes in an entity's financial position or performance (see 4.1 above). However, certain requirements from FRS 104, such as paragraphs 15B(j), 15B(k) and 16A(k) were removed as similar disclosures are not required by FRS 102 in the annual financial statements.

²⁵⁵ Footnote 1 to FRS 104.

Appendix A - Defined terms

Appendix I to FRS 104 contains a number of terms. Below are those that are specific to Interim financial reporting.

Extracts from FRS 104	
Appendix I Glossary	
interim financial report	A financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.
interim period	A financial reporting period shorter than a full financial year.

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UK GAAP 2026 Overview

UK GAAP provides a comprehensive guide to interpreting and implementing UK accounting standards, particularly:

- FRS 100: Application of Financial Reporting Requirements
- FRS 101: Reduced Disclosure Framework - Disclosure exemptions from EU-adopted IFRS for qualifying entities
- FRS 102: The Financial Reporting Standard applicable in the UK and Republic of Ireland
- FRS 103: Insurance Contracts
- FRS 104: Interim Financial Reporting

This book is an essential tool for anyone applying, auditing, interpreting, regulating, studying or teaching those accounting standards. Written by the financial reporting professionals from the Financial Reporting Group of EY, this book provides a clear explanation of the UK GAAP accounting requirements which apply in 2026 and will prove invaluable in implementing these requirements. It also addresses the requirements of the UK Companies Act and relevant statutory instruments, as well as practical worked examples.

Also available is the EY publication International GAAP® that provides a comprehensive guide to interpreting International Financial Reporting Standards (IFRS). This covers the many interpretations, practices and solutions which have been developed based on our work with clients, and discussions with regulators, standard-setters and other professionals. We believe that International GAAP® plays an important role in ensuring consistent application of IFRS accounting standards and helping address emerging issues.